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Reports & Events,…
…Mr. King, US Equities & the Fed, the Bund, Chirac, Bin Laden, Energy

The Bund

The degree to which the Bund has been able to defy gravity by de-linking from the T-note that has been leading the way down since the mid-2003 deflation scare has been very impressive. In fact, while the T-note has repeatedly held 108-00/107-16 support since first dropping back down to it in May 2004, it has indeed been in a down trend since the 121-00 June 2003 high. Compare that to Bund's current level relative to its 120.00 June 2003 high, and it is obvious that market must still be characterized as a bull trend, even after its sharp drop late last week. The Gilt is somewhat betwixt and between, only getting back up to near its overall 116.58 June 2003 high last week.

With the Bund still well above that high it would be easy enough to presume that it is still a bull market, and last week's break was nothing more than the next response to recent ECB sabre rattling, and somewhat worse than expected inflation numbers. However there may be more to it than that. While it is actually typical for the Bund to outperform the T-note at the tops, and even make a modest new high after the T-note begins to trend down, the scope of the Bund's out-performance in this cycle is unprecedented. And that may have something to do with both the scope of the cycle, and certain one time factors.

Previous the Bund would sustain its better tone at the top of intermediate economic upturns because the European economy tended to lag the US coming out of the bottom. As such, the return to a more inflation prone environment was also less apparent in Europe until the US recovery was clearly on track, and likely to stimulate Europe as well. This was usually accompanied by the Bund holding up and potentially making a new high across the three to six months after the trading high in the T-note.

In this case it has been over two-and-a-half years, and that is likely due in part to the correction from the 2000 equity market and economic highs being a major cycle correction, as opposed to the intermediate term ones that shaped previous T-note/Bund comparisons. This was all exacerbated by formation of the Euro currency, and establishment of the European Central Bank. In their almost exclusive focus on inflation mitigation (which quite a few observers including this writer have isolated as a key mistake in the bank's mandate), they were unable to stimulate key European economies that were navigating the shoals of significant reform. As such, they were a drag on economies exhibiting more than normal cyclically weak tendencies, with all of the fiscal conundrums that created as well.

(For those interested in more background on the major cycle, we will be happy to send a copy of our extensive March 2005 Special Market Highlight “1970’s Redux: Son of Stagflation.” While not all of its market projections were fulfilled in the near term, it remains of interest. The deferred conclusions are likely still moreso correct than not.)

All of which means the extended bull market in the Bund is substantially based upon assumptions of continued economic weakness, and relatively benign inflation. While we are not necessarily convinced the German grand coalition government will prove successful in solving the various fiscal an economic dilemma’s which face the nation, they have stimulated a stronger near term recovery than many thought possible. This might be due in part to the reinvigoration of Keynes “animal spirits” after such a long stagnancy. Or it could relate to the one year deferral (until the first of 2007) of the rather sharp increase in VAT, which is likely to prove self-defeating.

What ever the case, this was not the economy or psychology for which the Bund is currently priced. As such, sitting up at these extended highs, it is likely the most vulnerable of the long dated fixed income markets. Even in consideration of the Euro-zone economy starting at a lower base, the “country” spreads are instructive. When the long ends were at the top of their rally into mid-June 2003, the lead contract T-note future was trading at a modest premium to the lead contract Bund (that’s right, a premium.) Subsequent assumptions, and ultimately the reality of the divergence between the US economy and major European economies has seen the Bund climb to a 12.75 point premium to the T-note, both in the fall of 2005 and again early this year.

Now this previous upside leader is back to some very critical support in the 121.00 area, with trend indicators weaker than either the T-note or the Gilt. It is therefore going to be very interesting to see whether it recovers back above its 121.40-.50 and 121.80-.85 resistances in the near term, or puts on a bigger failure below the 121.00 area that could signal a much more extensive break to follow. While a certain amount of any failure of that sort could be just so much retracement in its rather significant premium to the T-note (and the similar gain against the Gilt that has already reversed since last October.) However, if the previous upside leader gets into a sharp bear trend, on past form that could also spell significant trouble for the other long ends as well.