21. April 2017

https://blog.en.erste-am.com/2017/04/21/curves-part-2-land-of-unlimited-possibilities/

Curves (part 2) – land of unlimited possibilities

Johann Griener

USA, the land of unlimited possibilities, the Grand Canyon, and the Big Mac. Here, everything is bigger, better, and higher. But is this also true for interest rates?

We want to discuss this question on the basis of the yield curve of US Treasuries, and will point out a few interesting aspects as we go along.

The yield curve of US Treasuries

The yield curve, or more precisely, yield structure curve, shows the yield with reference to the remaining time to maturity. Usually, the longer the money is tied up, the higher the yield (longer remaining time to maturity = higher risk = higher yield). Let's have a look at the current yield curve of US Treasuries (i.e. US government bonds).

The chart illustrates the US yield curve as of 6 April 2017 for a remaining time to maturity of two to ten years:

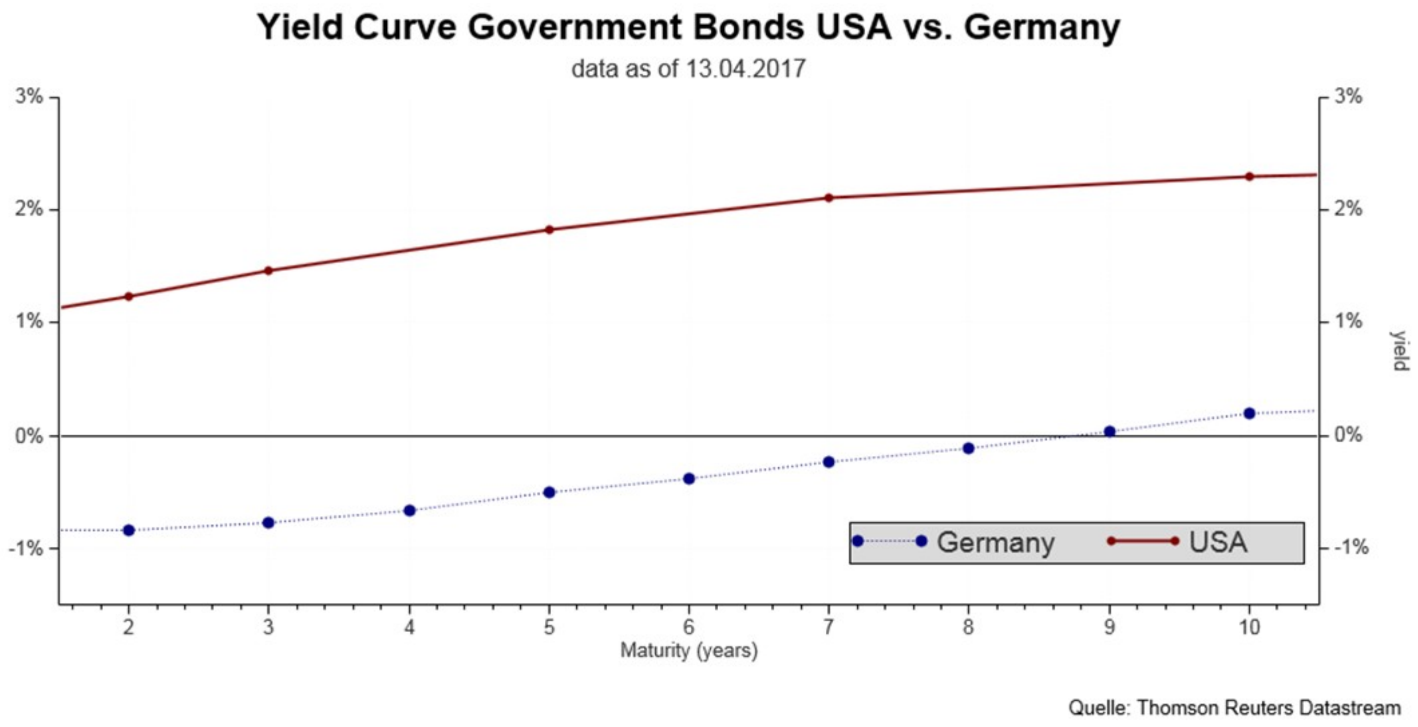

Chart: Yield structure curve US Treasuries (i.e. US government bonds) in red vs. German government bonds in blue, 2Y to 10Y remaining time to maturity
Source: Datastream, as of 6 April 2017

As a first step, we shall analyse the objective facts of the US yield curve:

- For a remaining time to maturity of 2Y the yield is currently at 1.3%, while at a remaining time to maturity of 10Y it is at 2.3%. This means that the yield is positive across all maturities.
- The yields of longer maturities are higher than those of shorter maturities. This means that the yield curve is steep (i.e. normal).

The comparison of US yields and German yields (government bonds) reveals the following facts:

- In the USA, yields are higher across all maturities than for German government bonds. This yield differential is referred to as “spread”.
- Interestingly, the US yield curve is almost exactly 2% (i.e. 200bps) above the German curve.

But why are the interest rates in the USA above those of Germany? There are a few different explanations. The most widely used ones are:

- From an economic perspective, one could argue that the economic growth (and inflation) are higher in the USA, as a result of which higher interest rates are plausible and justified
- In terms of the central bank policy, one can argue that the US central bank (Fed) has embarked on a cycle of rising interest rates. The Fed funds rate is currently at 0.75%-1.00%, whereas the key-lending rate in the Eurozone (ECB) is 0.00%.
- Or could it be that the market participants will only prefer US Treasuries to German government bonds if the surplus yield is sufficient?

What is the risk associated with US Treasuries in comparison with German government bonds?

We are talking about different currency areas here. Investors who buy US Treasuries expose themselves in foreign currency (USD). And the US dollar fluctuates at a significantly higher rate than the euro (=> currency risk!).

The following chart illustrates the development of the US dollar relative to the euro since the launch of the euro.

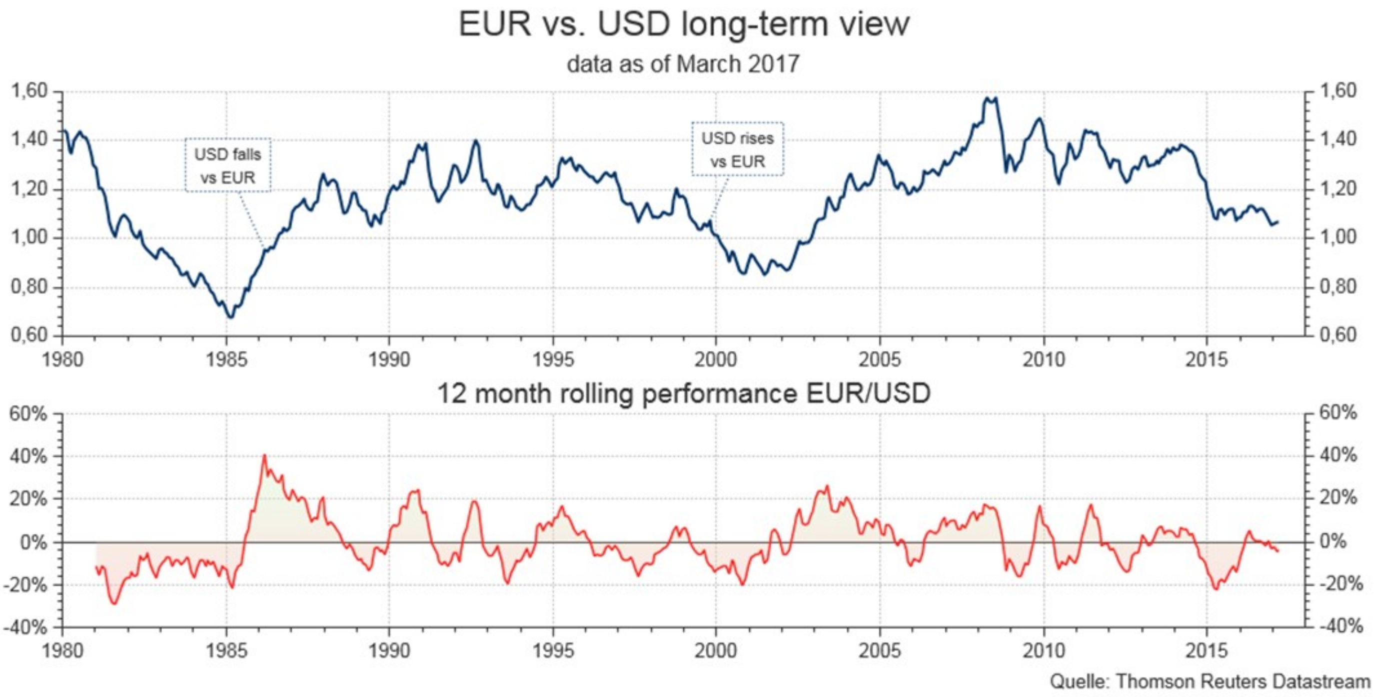

Chart: Development EUR/USD long-term. Prior to the launch of the euro in ECU.
Source: Datastream, as of 6 April 2017

The high degree of fluctuation of the US dollar vis-à-vis the euro is obvious. The top chart depicts the development in absolute terms. A rising curve indicates an appreciating euro, i.e. a falling US dollar. The bottom chart illustrates the development in percent in rolling 12M periods. Rises or falls of 20% within a year have not been scarce in the past, from a euro investor's point of view.

The fluctuations of the EUR/USD exchange rate outweigh bond price fluctuations by far for the euro investor.

Is it possible to hedge the foreign currency?

For larger volumes (mostly for institutional investors such as for example capitalInvestment companies) and with know-how in this field, the USD can be hedged against the EUR. The costs of this strategy tend to be roughly equal to the yield differential.

This means that for euro investors who do not want to expose themselves to currency risk, US Treasuries are no deal relative to German government bonds after all.

What this means to our investors

The question of whether in the USA the interest rates are higher than in the Eurozone can be answered in a qualified fashion: "Yes, but…" In addition to the interest rate level, the currency component has to be taken into account. You need to realise that in the financial world, there is no such thing as a free lunch – higher chances have to be bought with higher risk (e.g. currency risk)!

Conclusion:

The US yield curve offers a positive yield across all maturities. At first glance, investing in US Treasuries as opposed to German government bonds seems like the clearly preferable move. Investors should bear in mind that individual economies develop differently, which results in different interest rate levels. The development of the currency is also crucial to the investment decision.

However, financial markets are global networks – and if there were "deals" available (without commensurate risks), these investments would be bought immediately and their prices would rise – and the deal would be gone!

For more information on the product range of Erste Asset Management, please visit our homepage atwww.erste-am.at

Note: Forecasts are no reliable indicator of future developments.

Legal disclaimer

Johann Griener

Johann Griener has worked at Erste Asset Management in Sales Retail since 1 January 2001. In this function he supported for example the Sparkasse banks in Austria, with a current focus on Upper Austria. His scope of duties includes the servicing, training, training and education of Sparkasse employees who work in the securities field. This means creating and holding presentations in the local branches and in Erste Asset Management for the purpose of promoting sales of ERSTE-SPARINVEST, Ringturm, and Erste Immobilien KAG funds. He also supports the Sparkasse banks (Austria-wide) in their own investments (nostro business). In addition, Griener is developing numerous publications for internal and external use. The “1x1 of Investment Funds” that he wrote is found in all of the branch offices of Erste Bank and the Sparkasse banks as basic reading and an introduction for customers on how investment funds work.

Griener began his career in 1988 as an employee at the bank counter in a local Sparkasse bank. There he learned the banking business, from a savings book to loans to investment operations. After a few years at the Sparkasse, he decided to continue his studies at the Vienna University of Economics and Business, with a focus on “banks” and “securities”. After completing his master’s degree, he remained loyal to the Sparkasse sector and has been working at Erste Asset Management since.

His motto: “Only a day with laughter is a good day”