

THE PUZZLING DISCONNECT BETWEEN TREASURY AND BUND YIELDS

Yields on US Treasuries and German Bunds tend to be highly correlated but since the end of August, Bund yields have been essentially stable whereas treasury yields have increased. This spread widening is explained by a rising real rate differential, to a large degree due to a decline in German real yields. This could reflect a more gloomy view of bond investors about the growth outlook in Germany and, by extension, the Eurozone. Another, more likely, interpretation is that the real rate risk premium has declined in Germany due to the asset purchases of the ECB. In such case, investors will become increasingly nervous about the prospect that in a post-pandemic world the ECB will eventually have to stop the net purchases under its PEPP.

Yields on US Treasuries and German Bunds tend to be highly correlated. This is related to a high degree of business cycle synchronization between the US and the Eurozone and to international capital flows. Although the 20-week rolling correlation declined somewhat in the course of 2020, it remained within the range observed since 2009 (Chart 1).

The recent decline in correlation is also clearly visible in chart 2. Whereas historically, US and German yields have tended to move up and down together – although with differences in terms of amplitude – this relationship has changed in 2020. In the first half of last year, the Treasury-Bund spread evolved in a narrow range but since the end of August, Bund yields have been essentially stable whereas treasury yields have increased, leading to a rising interest rate differential.

Nominal bond yields can be decomposed in a real yield – the yield on inflation-linked bond- and an inflation expectations component – the difference between the nominal and the real yield. This allows for an analysis of what is behind the development of the US-German yield differential. Chart 3 plots, since 31 August 2020, the cumulative change in the nominal as well as the inflation-linked bond yield spread. It also plots the difference of the cumulative change of market-based inflation expectations.

Interestingly, this increase is about the same for nominal and real yields, which implies that market-based inflation expectations have moved in line between the US and Germany. As a consequence, the spread widening is explained by a rising real rate differential. Chart 4 shows that, in the US, real rates initially moved up in the run-up to the elections on 3 November and declined thereafter.

The latter might reflect a market view that, in the absence of a Senate majority, the Biden administration would struggle to bring significant extra fiscal stimulus. However, following the victory early this year of both Democratic Party candidates at the run-off elections in Georgia, the Democrats will be controlling the Senate. This paves the way for a more expansionary fiscal policy, which may explain the increase in real rates. German real bond yields on the other hand have been on a declining trend throughout the period under review and this development explains the bulk of the spread widening. When

GERMAN 10-YEAR BUND YIELD VS US 10-YEAR TREASURY YIELD

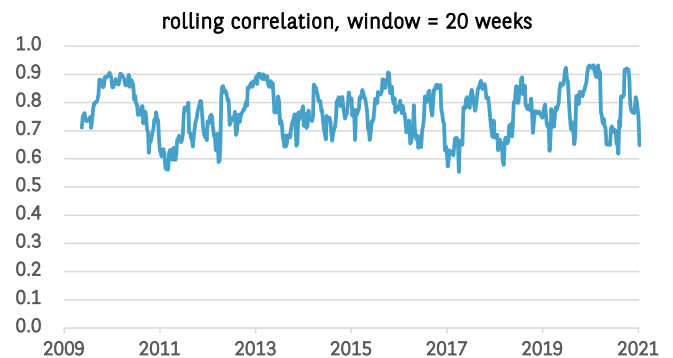


CHART 1

SOURCE: REFINITIV, BNP PARIBAS

GOVERNMENT BOND YIELDS, 10-YEAR

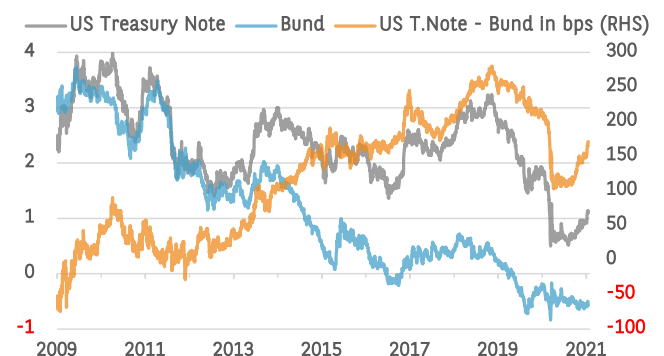


CHART 2

SOURCE: REFINITIV, BNP PARIBAS

The decline in recent months of inflation-adjusted German bond yields may reflect the effectiveness of ECB QE. In such case, investors will eventually become increasingly nervous about the prospect that in a post-pandemic world, the net purchases under the PEPP may have to stop.



interpreting this, one should keep in mind that the real bond yield corresponds to the sum of expected real interest rates and a real rate risk premium (*Exhibit 1*)¹. One interpretation is that the view of bond investors about the growth outlook in Germany and, by extension, the Eurozone, has become gloomier compared to the US. Another interpretation is that the real rate risk premium has declined in Germany compared to the US. This could be due to the prospect of a significant additional increase in borrowing requirements of the US treasury – to finance a new stimulus package – but it could also reflect that the ECB through its asset purchases (QE, PEPP) has been very successful in controlling the level of bond yields by influencing the risk premium. If the latter interpretation would be the more appropriate one, investors will become increasingly nervous about the prospect that in a post-pandemic world the ECB will eventually have to stop the net purchases under its PEPP.

William De Vijlder

GOVERNMENT BOND YIELDS, 10-YEAR: CUMULATIVE CHANGE IN US - GERMANY SPREAD SINCE 31 AUGUST 2020 (%)

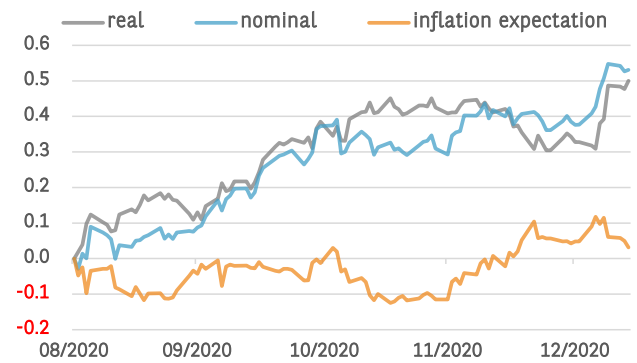


CHART 3

SOURCE: REFINITIV, BNP PARIBAS

REAL YIELDS IN US AND GERMANY: CUMULATIVE CHANGE SINCE 31 AUGUST 2020 (%)

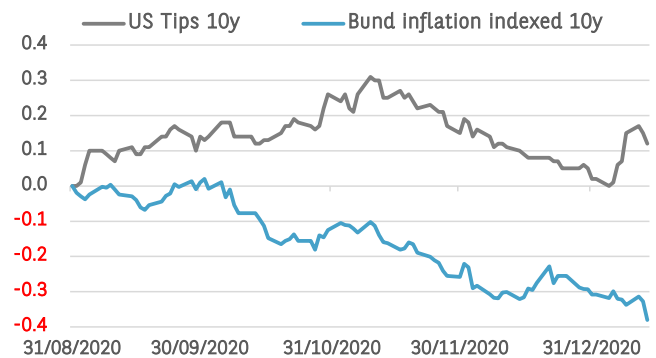


CHART 4

SOURCE: REFINITIV, BNP PARIBAS

NOMINAL BOND YIELD DECOMPOSITION

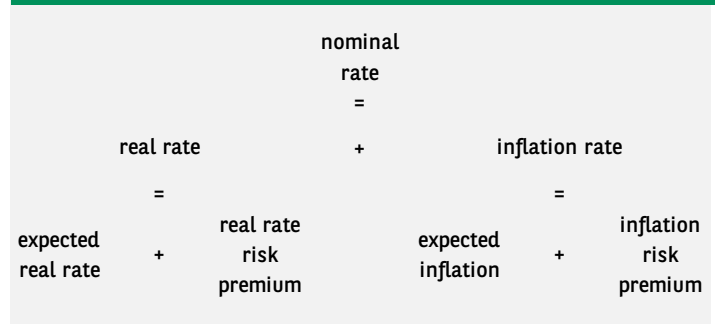


EXHIBIT 1

SOURCE: BANK OF ENGLAND

1. Source: "The yield curve and QE", speech by Gertjan Vlieghe, Bank of England, 25 September 2018.

