

10 Seconds Into The Future. Peripheral vs German Yields. ECB.

The spread between Spanish and German bonds has widened from 0.93 to 1.22 in 6 weeks. While the spread between Italian, Spanish, Portuguese and even French bonds and German bunds has widened in the last 6 weeks, Spain's reaction is the most substantial. A referendum on October 1 for Catalan secession is raising political risk in Spain.

Eurozone bonds have been diverging for over a month, in part due to expectations that the ECB will have to stop its bond purchases. While Eurozone economic growth is perking up it is driven mostly by Germany, the country least requiring monetary accommodation. The ECB's intentions to taper QE are driven not just by divergent economic growth but by technical constraints based on its capital key which forces it to buy more German bonds than peripheral ones. It will have to deviate from the capital key or find a replacement for the current QE, which will have to stop. The most intuitively probable replacement is its unconditional LTRO which will encourage local banks to resume buying of government bonds which they can finance at zero. This will force convergence as 5 year French and German bonds are the only ones trading below zero yield.