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THE GERMAN BOND MARKET: SAFE, SO SAFE

In the movie *Primal Fear* Ed Norton plays Aaron, an altar boy accused of brutally murdering a priest who turns to Richard Gere to clear his name. Yet, as it turns out, Aaron is really playing a masterful mind game as we, the audience, are eventually clued in that the “good ol’ country boy falsely accused” bit is all an act and Gere’s egotistical lawyer actually unwittingly gets a killer off the hook.

It’s one of those classic tales of deception where the market/audience are led to believe one thing only to find out that they’ve been completely wrong and by the time they find this out it’s all too late.

The story is fitting for what we’re seeing presently taking place in Europe.

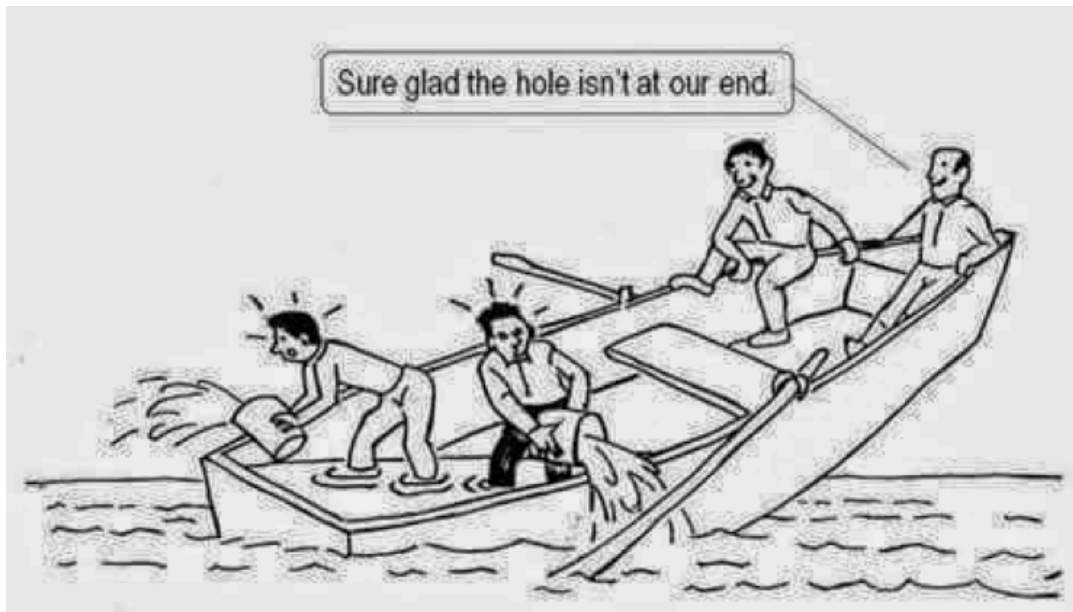
Over the last few months, and especially in the last couple of weeks, there has been a tidal wave of cash pouring into the German bond market.

I’ve written about this a little but it’s important to understand that this is likely a fleeting trade (capital shifting into German bonds, that is) and certainly one which doesn’t present much payoff for the frightened capital that is finding its home in the relative warmth and comfort of German debt markets. I mean, how do these investors expect to make money? By rates going more negative?

Here’s what’s likely to happen as I see it.

Capital will continue to shift from European periphery countries such as Spain, Portugal, Italy, and even France, maybe even especially France. In fact, any country which is seen to

be a potential “exiter” from the EU will initially be seen as higher risk than those within the “safety” of the clusterfuck that is the EU.



German Bund holders at the bow, currently smug

Ultimately this trade will be seen for what it is: silly. Sure, German bonds will likely be better than say Italian ones but when the member states leave, then the burden will actually be left with those still holding the bag. Chief among them will be Germany who have benefitted most from the single currency arrangement. And if anyone actually thinks that the member states will pay back their debts when they're out of the euro, then they're sadly out of touch with reality. If member states such as the infamous PIGS couldn't gather the political willpower to do so when they were in the EU, pray tell what the incentive will be like with new fire-brand leaders in the cockpit and after they've left?

German bunds, therefore, are a short.

Will they go straight down from here? Unlikely.

In fact, we'll be putting this position on expecting full well that it immediately begins to move against us and may continue to do so for some time. How much time? We don't know.

What we do know is that the probability of a sharp reversal when the inevitable becomes apparent (take another look at that boat above) is higher with each passing day. Trying to time this is incredibly tough. It's not the way to play it. Many of the trades presented to you in Insider are designed to be of a longer duration period - up to 5 years. We want to buy the asymmetry when nobody else is considering it and be able to hold our positions through the

meat of the trade. This takes some intestinal fortitude but then, if it was easy well everyone would be doing it, right?

Onward then... Let's deal directly with how best to position ourselves for those big payoff trades we're hunting for. In this case short German bunds.

My view is that 5 years from now yields on the German bund (German government 10-year bond) will be materially higher, not lower.

I say this due to what I've already mentioned above but also due to my outlook for inflation globally and the crowding that has occurred into "safe haven" investments. Not to mention that we're witnessing the beginning of the end of both the euro and the EU project itself.

Ever since the GFC central banks (the ECB in particular) have engaged in programs of ultra easy monetary policy the likes of which the world hasn't seen in modern history. To date there has been little let up in these policies. It seems that central bankers are completely oblivious to the possibility of long-term consequences to their actions. So be it.

Not only are central bankers oblivious, but so, too, is the crowd in general. For the last 7 years there has been this seemingly insatiable appetite for "safe haven" assets (treasuries and fixed income products in general). So much so that yields on the majority of government bonds (70%) went negative by mid-last year. I think the apex of this insanity was the Swiss 50-year bond yield going negative in July last year. It'd have made more sense to buy Swiss cheese. In 50 years time it'd still be in existence, it'd be aged, and worth something.

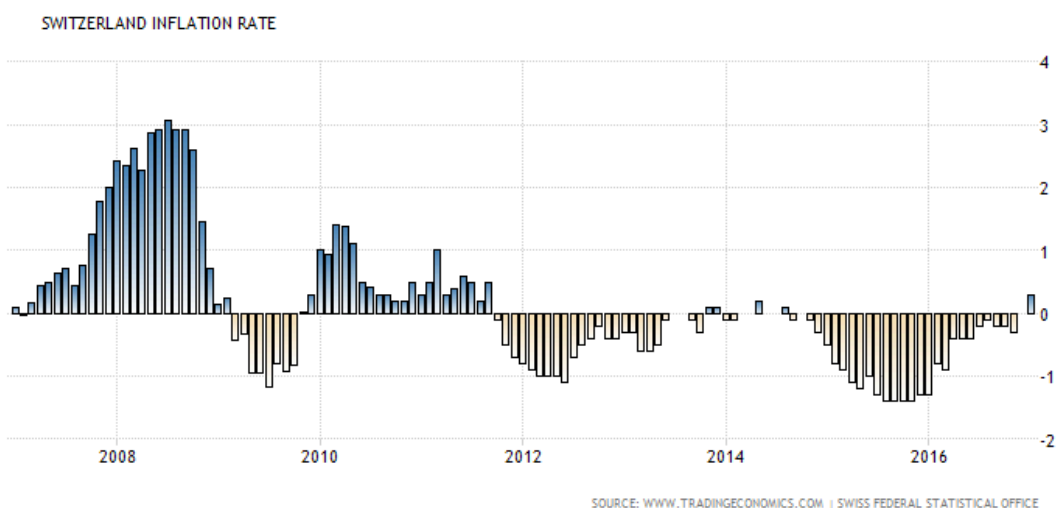
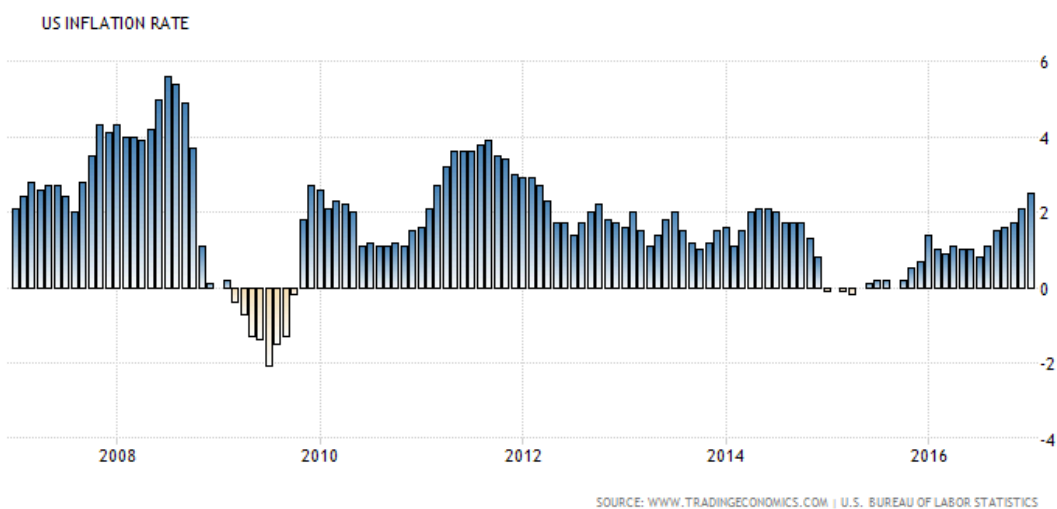
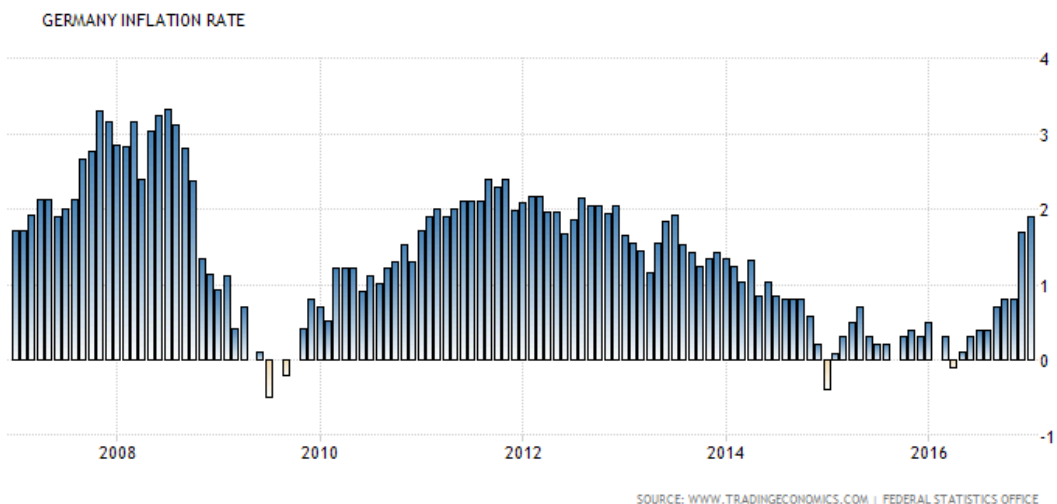
Anyway, what does this behaviour hint at? An insanely overcrowded market and it is over crowded markets where the largest downside occurs. Right now we have a market that is extremely uncertain about the future, and one where there is absolutely no fear over inflation.

While I don't know what the future has in store for us I am well aware that **when everyone thinks alike the opposite is most likely to happen because there is no one left to think alike.**

One question that's worth asking ourselves is the following: Will the consequence to easy monetary policy (ultra low rates) be of equal or greater magnitude to the action itself? Well, even if the consequence was "half" of the action it would still make the inflation of the 1970s look like a walk in the park.

What is happening on the inflation front here and now? Below are the inflation stats for the US, Germany, UK, and Switzerland. Seems to me that on all accounts inflation is trending higher and has been doing so since the beginning of last year - funnily about 4 months after I suggested the bond market had finally turned. We'll have to sit it out to see if I'm proven right on that or not.

It is bizarre that very few are talking about this trend in inflation. It is actually a stealth bull market in inflation.





OK, so you have seen the inflation charts above and it seems like they are trending higher. Now check out the table below. Forecasts for inflation are essentially unchanged from current levels right out to 2020.

Seems to me like the crowd doesn't believe in the "trends" in the charts above. This is more evidence they are completely oblivious to the threat of inflation. Lovely!

And sitting at the intersection of these two is asymmetry.

Inflation Rate | Forecast | 2016-2020

	Last		Q1/17	Q2/17	Q3/17	Q4/17	2020	
United States	2.50	Jan/17	2.5	2.5	2.6	2.5	2.5	percent
Euro Area	1.80	Jan/17	▲	2	1.8	1.7	1.6	2.1 percent
China	2.50	Jan/17	▲	2.6	2.7	2.8	3	4.5 percent
Japan	0.30	Dec/16	▼	0.2	0.3	0.5	0.6	2 percent
Germany	1.90	Jan/17	▲	2	2.2	2.1	2.3	2.4 percent
United Kingdom	1.80	Jan/17	▲	2	2.2	2.5	2.7	2.2 percent
France	1.30	Jan/17	▲	1.6	1.8	2	1.9	2.3 percent

You are now aware of the "rumble" getting underway with respect to the French election, Le Pen gaining in popularity, and her threat to take France out of the euro system. When I tell people Le Pen's likely to win they scoff. I almost don't get it. This is what they said about Brexit and then about Trump. Will a Geert Wilders win in the Netherlands in a couple weeks time change their mind?

I really don't know what that catalyst will be. Clearly the bond market is already moving. We've seen this in the spread between French and German bond yields but still the market

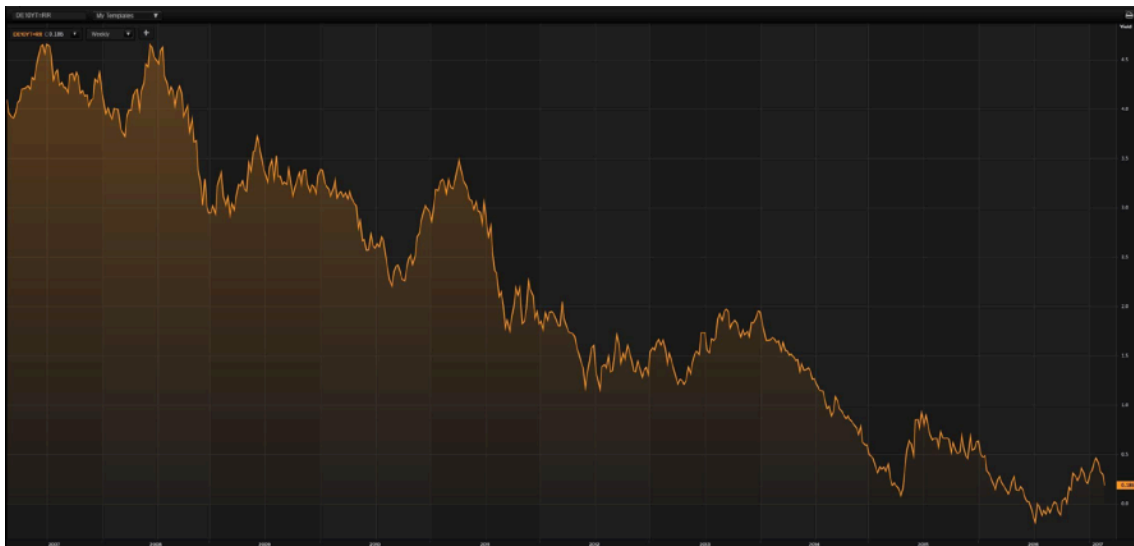
is waaay behind the curve here. It is also a knee jerk reaction where first level thinking is being used. Second level thinking brings us to a set of quite different conclusions.

With the new elections bringing collective “strong men” to the cockpit we’re going to just be pouring more inflationary fuel on the fire. More “investors” will probably pile into the “safety” of bunds due to all the uncertainty. **How a market can be seen as a “safe haven” when everybody owns it is beyond me. but that is the way they see it.**

This position will likely move against us (being short bunds and the proxies I’ll discuss in this alert). Expect it, acknowledge it, get comfortable with it, and do it anyway.

No country is an island if inflation continues to rise globally and so, too, will bond yields. And German bunds won’t escape.

From a “technical” perspective, bund yields did not go down in a straight line so don't expect them to go up in a straight line either.



German 10-year yield

How Best to Play This?

I don't think there is a one best way to apply a bearish view. It really depends on your capabilities, your trading platform's capabilities, and your risk tolerance. This letter should be used to augment your own trading skills, your own portfolio structure and indeed your own thinking.

Let me discuss a number of ways together with their pros and cons.

Shorting Bund Futures

Probably the most obvious way. The Bund future is currently trading at 166. If you are short one contract then essentially you are short €166,000 worth of bunds. So if the future was to drop 1 point to 165 then you would make €1,000. You will need about €3,000 in margin per contract, although this depends on the broker.

Note: this instrument is only for experienced traders who are well versed to trading with leverage.

Pro: Leverage, get it right and you can make huge returns.

Con: If you have ever traded with leverage you will know what the cons are! You may have to constantly roll the futures contract as they expire every month, the longest you can go out is three months. These futures are physically settled so if you let them expire you will end up being long or short a big exposure to German 10-year bonds and have to come up with the funding. Not the jolliest of experiences if you never intended to take delivery!

Note, although the broker will only ask you to hold about 3,000 in margin against the position (effectively 50:1 gearing) you are free to hold whatever above that level you deem necessary. For example, if you held 16,000 against one future contract this would give you about 10:1 gearing. As a result, you can (and should) manage your risk according to your own skill, experience and risk tolerance within your overall portfolio.

Personally, **I think trading bund futures is a mug's game.** The futures price jumps around like an epileptic bushman which is a trend traders worst nightmare. And trading with leverage is ultimately a soul destroying pastime!

Options on Bund Futures

The big issue I have with bund future options is they only go out 3 months to expiry which renders them somewhat useless if you want to apply a long-term view. Three months really isn't long enough for how I want to be positioned.

What About the German 2 and 5-year bund futures? Whatever applies to the 10-year future applies to the 2 and 5-year futures.

Euribor Futures

The Euribor futures are based on what the crowd (market) expects the 3-month rate for Euros to be at a point in the future. I won't go into the specifics of the contracts of Euribor futures otherwise this Trade Alert will become a novel.

This isn't directly trading German government bonds but if the bund was to move materially lower (yields higher), then you would see Euribor futures trade materially lower.

If you are into trend trading, then have a look at long dated Euribor futures (5-years or more expiry). The volatility in these contracts is only remotely that of bund futures.

Options on Euribor Futures

What makes options on Euribor futures so attractive is that they go out 2yrs to expiry. Added to this is the fact they are trading at such cheap levels.

Checkout the December 2018 futures chart below, you can buy the 100.125 strike put (more or less ATM) for just 18 bps. So to get a 100% return all you would need is for the future to close at 99.815 (a mere 36 bps move)!



These options are also very affordable to the average investor. A one point move equals 2,500€, so at 18 bps it's 450€ per option contract. And it is a bought option so your maximum liability is what you pay for the contract (the premium). You don't have to worry about leverage, margin calls or any of those headaches and as new contracts come on you can roll your positions buying yourself more time.

By the way, note the December 2018 Euribor future is trading at 100.175. This means the crowd expects the 3-month rate for euros to be -0.175% come December 2018.

These options trade both on the ICE (London) and EUREX (Frankfurt) exchanges so you would need an account that gives you access to trade in Europe to execute Euribor futures option trades (I'll deal with this at the end of this alert).

Inverse Bund ETFs

There are ETFs that go up as bund futures go down. However, before I launch into a discussion on these ETFs (trading in Europe) let me rave on about these double and triple daily movement ETFs. To get straight to the point: **stay away from these fucking horrible creatures**. They only, and I mean only, make sense if you're short term trading otherwise they're going to 100% lose you money.

The reason why is volatility. Volatility works against the holder of these ETFs in a big way.

Let me quickly illustrate my point because sometimes knowing what not to do is more or just as important as knowing what to do.

I will use the US 30-year and Direxion Daily 20+ Yr Trsy Bear 3X ETF (TMV).

Let's say that both securities were trading at 100. On day one the US 30-year goes up by 10%, then down by 10% on day two. So the US 30-year price would go from 100 to 110 then down to 99 (so virtually unchanged). TMV, on the other hand (which moved 3x the daily percentage change of the US 30-year), falls from 100 down to 70 (a 30% fall), then up to 91 (a 30% rise from 70).

Sure, I just took things to the extreme to prove a point but that is exactly what happens.

If you want to trade the double or triple ETFs then **you are making two implicit "calls"**: firstly, the direction of the underlying market and secondly, the behavior of that direction.

It is hard enough to get the direction right let alone the behavior (volatility) of that direction. The only way these work is when the market moves almost immediately in the direction you are positioned for and continues to do so in a linear fashion. You're far better off with bond futures or options on bond futures for leverage.

So back to the inverse bund ETFs (not the leveraged kind!). There are a few listed in Paris and Frankfurt (not that this helps much if your broker only trades US listed securities). Lyxor (Société Générale) and ComStage (Commerzbank) have listed these securities. Let me discuss the Comstage ETF.

Below is the ComStage Inverse Bund ETF. The code that Interactive Brokers use is "5X62". So this ETF moves inverse to the price of the bund.



I think buying this ETF provides a great way to apply a bearish view on the bund. The only thing is that it isn't a huge payoff trade. If the bund was to get back to 2013 levels it would equate to a 30% move. Although, if you were to buy it on margin with 3x gearing, it would be close on a 100% return.

Indirect Ways of Applying a Bearish View on the Bund

This is where things become somewhat subjective. The question to ask yourself is: what markets will do very well if we see a material rise in the yield of the German bund over the next 5 years?

I guess we could get close to answering that question by observing what sectors/markets did badly/laboured/underperformed over the last 5 years as the crowd piled into bunds?

The obvious answer is European banks. They have really struggled particularly from late 2015 when super Mario (Draghi) decided on his delusional idea of taking interest rates negative! But as European bond yields started to rocket higher from October last year so to did the stock prices of European banking stocks. But which banks to pick or do we just buy the index?

If you did want to buy the European banking Index there are a couple of ETFs - "MSE" which trade in Europe (tracking the Stoxx European bank index). For those who are constrained to the US market due to their platform provider's product offering there is "EUFN" (European financials)

But let me get a little more micro.

I have been watching the “plight” of Swiss banks, UBS and Credit Suisse, at earnings release time. **They are constantly on about how it is difficult to make a buck due to clients not wanting to do anything with their cash.** In other words, clients are crowded into the safety of low fee yielding securities (namely bonds).

So it stands to reason when clients of UBS and Credit Suisse start selling their bond exposure and buying equities or equity linked products their earnings should rocket, even more so given all their recent efforts to cut unnecessary costs.

How to trade Credit Suisse or UBS? Ultra long dated options on these stocks are available in Europe (assuming you have a platform that can execute these trades like Interactive Brokers).

Take a look at the chart of Credit Suisse (CSGN) below. You can buy the 16 strike December 2021 expiry for about 2.50. So if CSGN was to get back to where it was trading in 2013-2015 (i.e. 25), then it would equate to a 260% return at expiry (obviously if it got there quicker then the return would be higher). As I have said on many occasions before, these options are way underpriced. In fact, as I write this the price sits at 2.39.



For those who don't have access to trade securities in Europe there are ADRs for Credit Suisse (CS) and UBS (UBS) trading on the NYSE. There are options on these but these only go out to January 2019.

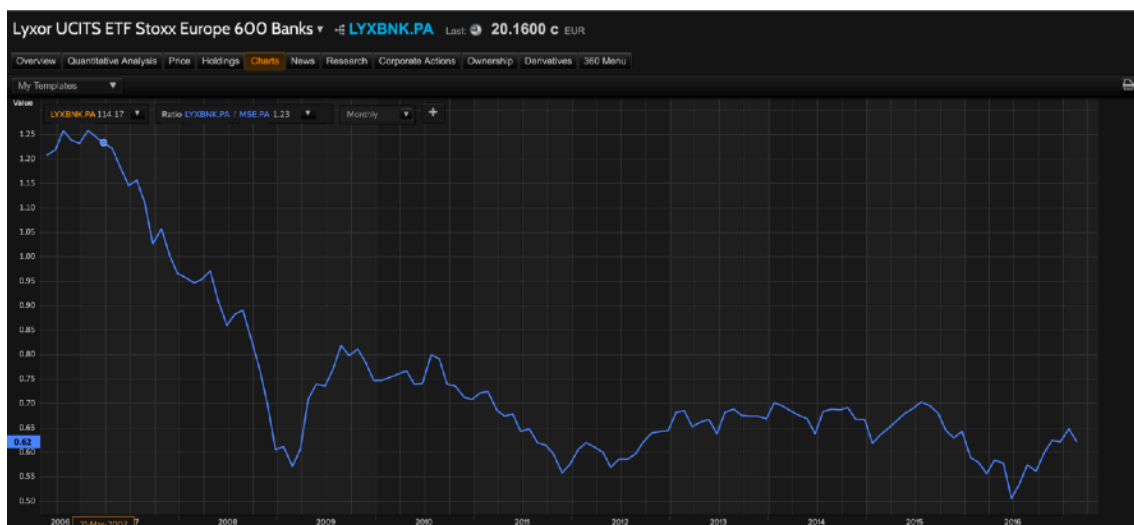
What about a “Market Neutral” long/short trade?

This is something that few have given any detailed thought to so let's go there.

It is a rather simple strategy where you would go long the European financial/banking sector and short the major market index (Stoxx50) against it.

In Europe it would be long the ETF “BNK” and short the ETF “MSE” euro for euro. For example, 10,000€ long BNK and short 10,000€ of MSE. You don’t care which way the market goes so long as BNK goes up by more than MSE or down by less than MSE.

Below is the relative performance of BNK and MSE. If the chart was “rising” then banks would be outperforming the general market. So in effect, if you were long BNK and short MSE, then you would be “long” the graph below.



The same trade in the US could be achieved by going long the ETF “EUFN” and shorting “FEU” against it.

The General Stock Market in Europe

If we did see inflation continue to push higher in Europe and yields on German bunds follow, then I am inclined to think that European equities would do very well.

There is a huge amount of capital tied up in the “safety” of German bond markets (otherwise yields wouldn’t be near zero) and where would this capital go if inflation starts to accelerate? I don’t think equities are very widely held. I certainly don’t see any evidence of the average retail investor buying equities in Europe.

Take a look at the chart of the European stock market on the next page (Eurostoxx 50). It really struggles (was butt ugly) ever since Draghi went down the path of negative interest rates in the later half of 2015.



How to play it? As discussed above, there are various ETFs that track the European stock market, MSE in Paris and FEU on the NYSE. These can be bought outright as stock (just like you would buy the S&P via the ETF SPY). Or if you're more adventurous you can buy 2025 options on the Eurostoxx 50 (it's actually really surprising how few people are aware these exist but they do). Granted liquidity isn't so great if you go out this far but there is plenty of liquidity 5-years out. Once again, you would need a platform like IB that has European capabilities.

Lastly, let me say this. You know full well my view that Europe is in for some difficult times ahead. I believe that we're moving into an environment where investors will shun fixed income in favour of "stuff".

"Stuff" will be found in equities, amongst other things. Sure, you and I can go buy ourselves some shiny yellow stuff but the big capital will need a home.

That home will be found in the "safety" of the US but also in equities in Europe. Bear in mind this can all happen, if I'm correct, while the euro gets beaten like a red headed step child. This is one reason that you'll find my call to be long UUP.

Net-net I want to be long USD but that doesn't mean I can't be long select European equities. How you position size these trades really depends on your conviction with each position. It's naturally going to be different for everyone.

There are probably other ways to play rising rates in Germany that I haven't thought about but basically it comes down to all (most) of those securities/markets that struggled in the shadow of the crowd's appetite for safe haven assets will do well. I guess you could generically say that **anything that will do well under an inflationary environment will do well as yields on German bunds rise.**

I know you are all interested to hear what my preference is.

Well, I will give you two answers. For my “safe” pension fund I will go with the ComStage Inverse Bund ETF, while the aggressive side to me is inclined to go for 5-year call options on Credit Suisse (in Zurich). These will be the two trades tracked in this service but please feel free to use this service to design your own portfolio.

What if you don't have a platform that allows you to trade all these great ideas coming out of Europe?

Then get yourself an Interactive Brokers (IB) platform. It will open up a whole new world of opportunity to you as there aren't many markets in the world that aren't covered by IB. I wouldn't put you in touch with this platform unless I thought it was the best available for retail traders and I get absolutely no kickbacks from IB (or anyone) if you do open an IB account. The only kick I get is to see you all do well and participate in these big payoff trades.

Please note that (for disclosure purposes) the Asymmetric Fund is long Credit Suisse and BBVA call options and has been for some months now. Additionally, we are short Euribor futures via put options. We have not taken any other positions mentioned in this alert but may do so over the coming months.

Sincerely,

Chris MacIntosh

Founder & Editor In Chief, Capitalist Exploits Independent Investment Research
Founder & Managing Partner, Asymmetric Opportunities Fund

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