FINANCIAL TIMES

May 22, 2012 4:20 pm

Germany expected to borrow at no cost

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By Robin Wigglesworth and Mary Watkins in London

Germany is to sell a zero coupon bond for the first time in an auction of two-year government debt on Wednesday, as investors concerned about a potential Greek exit from the eurozone flock to safer assets.

Berlin will sell up to €5bn of two-year debt carrying a 0 per cent coupon, a record low, according to the Bundesbank, the German central bank, compared with a coupon of 0.25 per cent at the previous sale of two-year notes on April 18.

Fears over Greece's future in Europe's currency bloc – triggered by elections that produced strong gains for parties that oppose the terms of the eurozone's bailout package – have caused a global "flight to quality", benefiting the government bonds of Germany, the UK, the US and Japan.

Germany has been one of the biggest beneficiaries. The country's two-year yield is at six basis points, below that of Japan's comparable bonds, while the 10-year yield is 1.48 per cent.

Berlin will sell an additional €1.5bn of inflation-linked Bunds maturing in 2023 at what is likely to be a negative yield, in effect meaning that investors are willing to pay for the privilege of lending to Germany in return for protecting against European inflation.

Aside from Germany's three-month government bills, its bonds are trading at a positive nominal yield. However, Mark Schofield, global head of rates strategy at Citigroup, said Europe's economic deterioration and rising fears over a eurozone break-up could push longer-dated Bunds into negative yield territory, and the 10-year yield to as low as 1.25 per cent.

"Bunds have had a heck of a rally and a lot of bad news is currently factored in. But I don't think we'll see a big rise in Bund yields, as there's still a lot of uncertainty, and the eurozone fundamentals are still deteriorating," he said.

Divyang Shah, global strategist at IFR Markets, said that with the haven universe shrinking it was difficult to dissuade investors from holding on to assets such as German notes when the rationale for buying "was not to make money but to preserve capital".

Wider concerns over the risk of contagion to other countries in the eurozone should Greece exit the euro continue to affect other parts of credit markets.

Bank funding markets remain largely shut. On Friday the iTraxx Financial index, which tracks the credit default swaps on senior debt belonging to 25 of Europe's biggest banks, closed at 306. That marked its highest point since December 19, two days before lenders took advantage of the first three-year offer of loans under the European Central Bank's longer-term refinancing operations.

While the index has since fallen back below 300bp this week as markets have rallied, some analysts remained concerned over how quickly the effects of the €1tn funding injection into the region's banks appear to have worn off.

Mr Shah said this week's rally reflected short-term hopes that there would be some positive policies emerging from the European Union summit. The problem, he said, was that policy makers were "losing their degree of freedom" to implement effective action to curtail a crisis.

"The ECB could do another LTRO but what would that do now? It's more effective when there is a tail risk. But what if there is deposit flight from Europe's banks? Policy makers are losing their traction and their ability to set animal spirits on fire. Now we're left with the option of a eurobond or a deposit guarantee scheme."

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