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Dangerous divergence: the strange behaviour of Stoxx 600 and Bunds

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AN (ALMOST) PERFECT CORRELATION



Share prices rise and bond prices fall (producing a rise in their returns). That's the inverse correlation taught by the finance market manuals, a correlation that still holds – just about. Because in periods - not frequent - like this first part of 2019 one of the two directions might be reversed: and that's certainly a curious signal. In some respects it's favourable for investors, in others it's worrying. Since the start of the year the pan-European Stoxx 600 index has gained over 9%. But the prices of German Bunds, the most important government bonds, are also rising, as shown by returns for the 10-year Bund, which have fallen again: from 0.25% to 0.10%.

This is an anomalous trend, for which there are two explanations. First, the reduction in tensions linked to the US-China trade war. And second, the slowdown in the global economy. Two divergent factors that the market - having emerged from a 2018 that on nearly all fronts is best forgotten - has interpreted favourably. However, this is also a situation that is unlikely to last long, structurally speaking. "The fall in bonds has always been associated with a decline in implicit inflation or a reduction in real rates", explains Angelo Meda, Head of Equity at Banor SIM. He points out that for three months now the market has been focusing on inflation, which in Germany is down from 1.40% to 0.95%.

However, a falling consumer price index belies the fact that the bond market is expecting a significant economic slowdown. In part this can

already be seen in the figures (in Italy, but elsewhere too). But it is not yet being priced in by the stock market, which instead is continuing to regain ground.

This last factor is the main risk. "The stock markets aren't looking at the economic slowdown", warns Meda, "or at any rate they view it as temporary. If, however, it lasts longer than a quarter, there's room for a fall".

The 2015 precedent (with QE)

To find a precedent for a movement like this we don't really have to turn the clock back too far. In early 2015 the European stock markets had risen by as much as 25% in four months, while the rate for 10-year Bunds had fallen by 0.5%, almost to zero. However, that was the period that saw the launch of the purchase programme linked to the Draghi plan, which the European Central Bank has decided to end - now of all times. As Meda adds, "this makes the current distortive effect even more significant". And it weighs even more heavily on the scales of risk. Bonds or shares: one of the two has gone in the wrong direction, and sooner or later will have to get back on track.

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