HOW TO HEDGE EUROPEAN FIXED INCOME AMIDST THE ECB'S QE TAPERING

Wisdomtree EU
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Showcasing the capital-efficient use of leveraged short ETPs tracking 10Y German Bunds

This article is relevant to European high-grade bond investors looking to hedge their exposure in the current rising interest rate environment.

Leveraged short ETPs that track Bunds can serve as capital-efficient hedging tools for investors seeking to protect their European high-grade bond portfolios in rising interest rate scenarios. The usefulness of such ETPs is particularly relevant in the current environment, with the European Central Bank (ECB) recently announcing that it will begin tapering its quantitative easing (QE) programme. Credit markets are slowly adjusting back to policy normalisation.

This blog showcases how leveraged short ETPs tracking 10Y German Bunds perform as hedging instruments for high-grade European government and corporate bonds.

If you would like to find out more about the mechanics of leveraged short ETPs and the factors to consider when these products are used as hedging instruments for fixed-income portfolios, read our blog How to hedge safe haven duration risk with ultra-long short strategies.

Hedging corporate bonds with leveraged short ETPs

Will leveraged short ETPs tracking government bond benchmarks work as capital-efficient hedging instruments for corporate bond portfolios? It depends on market conditions.

Hedge overlays using high-grade government bond benchmarks such as 10Y German Bunds are likely to perform poorly in abnormal market conditions. This was illustrated during the Global Financial Crisis and more recently, in the face of ultra-loose monetary policy. Frequently, central banks' exceptional open-ended support for government bonds in response to financial uncertainty trumped the fundamental arguments of 'runaway inflation' and 'higher yields' for shorting German government bonds. German government bond yields have essentially trended in one direction only: down.

De-correlating prices between corporate and government bonds further complicate hedge structures with shorts that use government bonds as the underlying. Consider the ECB's sterilised interventions in select bond markets in 2010 (Security Markets Programme) and

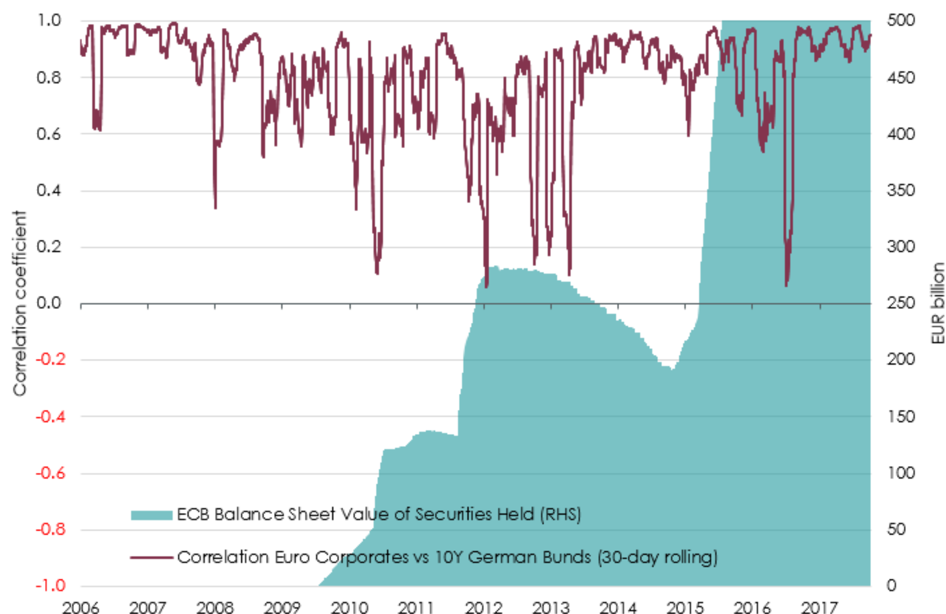
2012 (Outright Monetary Transactions) which, in conjunction with zero interest rates and cheap term loans, primarily supported covered (mainly mortgage backed) bank bonds and, indirectly, sovereign bonds on a large scale. The exclusion of high-grade, non-financial corporate issuers from bond-buying programmes forced corporate spreads to widen sharply, as the lack of liquidity undermined price discovery and instigated a decoupling in even the high-grade segments of the bond market (see Chart 1).

Epitomising the distortions caused by ultra-loose monetary policy was the degree to which investors took on more term risk to chase government yields to the floor and into negative territory, following the ECB's announcement of its QE launch in 2015. This initially widened corporate spreads, until QE was expanded to include corporate bonds in 2016 and the widening of spreads reversed. With the whole bond market on artificial support and interest rates falling, hedging Eurozone interest rate risk was—within high grade—effectively unnecessary for long-only investors.

When corporates decouple from government bonds to a large extent and move in the opposite direction, setting up hedges using government bond benchmarks as the short's underlying will be ineffective. Investors must therefore carefully assess market conditions before deciding if and when a short government bond benchmark exposure will behave in line with both the underlying fundamentals and the portfolio.

Chart 1: Price distortions in credit markets during exceptional stimulus

Correlation between corporate and government bonds vs ECB interventon in bond markets



Source: WisdomTree, Bloomberg.

Most effective in a rising rate environment

The purpose of hedging with leveraged short ETPs that track government bond benchmarks is to neutralise duration risk. Credit risk, explicitly, is not captured. However, assuming government and corporate bonds are generally moving in the same direction (with different magnitudes), in normal market conditions, varying credit spreads will generally not reduce the effectiveness of hedging a corporate bond portfolio with leveraged short ETPs tracking government bonds.

- While a hedge will not be perfect when using inverse government bond exposures as hedge overlays for corporate bonds, an offset position created with the leveraged short ETP and held for approximately a month may cancel out the majority of the interest rate risk within the corporate bond portfolio. This is due to the tendency of government and corporate bonds to move in lockstep during tightening monetary conditions.
- To maintain the hedged position and control volatility, rebalancing the hedged exposure may be necessary in a rising rate backdrop, when, amidst increased risk-taking behaviour, corporate spreads narrow and short positions could be added (i.e. buying leveraged short ETPs). Rebalancing may also be necessary amidst increased risk-averse behaviour when corporate spreads widen and short positions could be cut (i.e. selling leveraged short ETPs). Such adjustments to the hedged position may need to be more frequent when price volatility increases and correlations between government and corporate bonds weaken.
- When fear took hold at the height of the Global Financial Crisis, safe-haven assets were highly sought after. Needless to say, the frequent occurrence of inverse movements between 10Y German Bunds and Euro corporate bonds meant a short position in 10Y Bunds would have failed as a hedge overlay. Rather than reduce the risk, in many instances this type of hedge would have subjected the investor to increased volatility and higher downside risk. Frequent rebalancing of the hedged exposure could have reduced the volatility and downside risk, but at the price of accruing relatively large transaction costs, which would have defeated the beta-hedging strategy's purpose of capital efficiency.

Inflection point on the horizon

Finally, managing the hedged position is key in an environment where monetary policy is still exceptionally loose and high-grade debt valuations remain close to historic highs relative to other asset classes and the fundamentals underpinning them. As we approach an extraordinary stimulus inflection point in the Eurozone, following the ECB's announcement in October 2017 that it intends to taper QE, Europe's high-grade bonds may experience increased price volatility. Last year's negative to near-zero yield period for Germany triggered a sharp sell-off.

Consequently, investors that have allocated to high-grade bonds and the term risk associated with obtaining a positive yield, risk being disproportionately exposed to policy normalisation. These investors should consider the very low coupon yields at which many long-dated issues currently trade on secondary markets and the convexity assumed.

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