

German Bunds still face pressure relative to risk-free rates

Bunds have underperformed versus risk-free rates at an accelerated pace amid structural headwinds from supply and the ECB's quantitative tightening. Further underperformance from the long end looks likely, but there are arguments for some stabilisation as Bunds still occupy a special place in the eurozone bond market



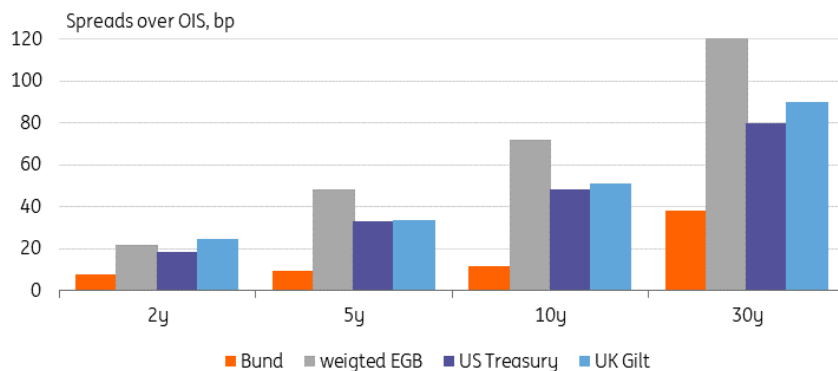
If any country has the capacity for more investment spending, it is Germany

The Bund spread remains under pressure, but we also see arguments for stabilisation

There had been a general sense that the central banks' quantitative tightening paired with ongoing high funding needs would require a reassessment of sovereign spreads – both relative to each other and versus “risk-free” rate expectations. This is a theme not exclusive to European government bonds but also observed in US Treasuries and Gilts.

However, what was a gradual underperformance of eurozone government bonds versus swaps led by Bunds suddenly accelerated early in October and turned into a vicious repricing that had repercussions across the wider EUR fixed-income market.

Treasuries and Gilts are much wider versus risk-free rates than Bunds



Source: Refinitiv, ING calculations

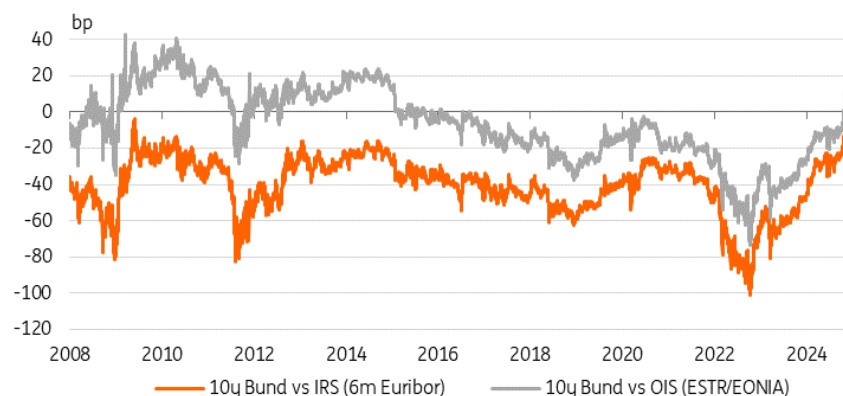
Bunds still hold a special position in the eurozone context...

The poor performance of Bunds has raised concerns since they usually serve as a benchmark for the wider sovereign and sovereign-related bond market. Many have raised the spectre of valuations similar to those in the US or UK, where 10y government bonds trade around 50bp above OIS. We do not see such levels as a target for 10y Bunds anytime soon.

What sets Bunds apart is that they are just a small slice of the wider eurozone bond market, less than 20% of a €9.6tr market. But importantly they are still the highest rated slice with liquidity underpinned by a futures market. If we take the weighted average spread of 10Y eurozone government bonds versus OIS, we are already at cheaper levels compared to the US and UK.

Fan out the spectrum across the ratings and liquidity of the eurozone market and there is good reason for Bunds to trade at a premium. Bund valuations have stabilised and even recovered somewhat in recent weeks, mainly on the back of geopolitical risks in Eastern Europe flaring up again and also political tensions rising in France. But it is also worth pointing out that the 10Y Bund spread versus OIS peaked at levels last seen around 2014 just before the European Central Bank started buying government bonds.

10y Bunds are back at pre-QE levels versus the risk-free rate



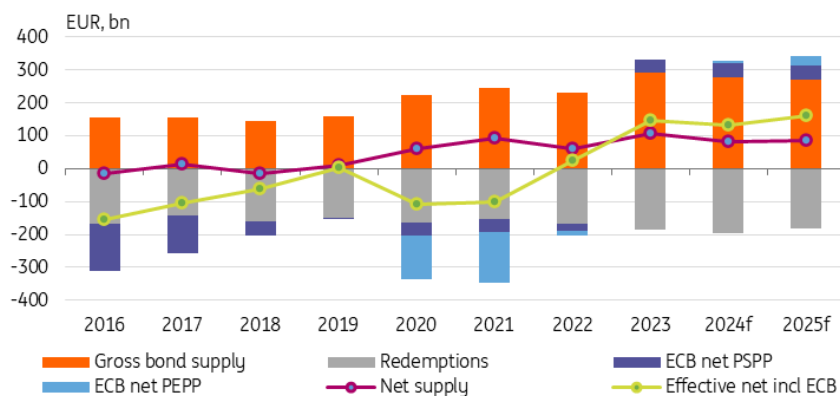
Source: Refinitiv

Pre-QE levels may serve as a first anchor point but the structural headwinds to sovereign valuations persist – foremost in the form of the large volumes that private investors will have to absorb going forward as issuance plans remain elevated and the ECB no longer reinvests redemptions from its bond portfolios.

Another cyclical factor also looks less likely to turn favourable anytime soon – the ECB will remain in a rate-cutting mode, which means that net flows on the swap leg of the spread should remain biased towards receiving. Additionally, at the long end of the curve, the prospect of receiving flows from Dutch pension funds looms large – on the back of indexations and going forward in preparation for transitioning to a new pension system.

The uncertainty around the German political backdrop could pose another headwind to Bund valuations versus swaps early in the year. Snap elections are scheduled for February after the current governing coalition broke apart over the budget and the handling of Germany’s constitutional debt brake. We doubt there will be big impacts on near-term spending solely from this. Reforming the debt brake will take time, but if the increased spending is ultimately directed towards investment, it could positively impact the long-term outlook of the German economy. If any country has the capacity for more investment spending, it is Germany.

Effective Bund supply remains elevated as the ECB runs down its bond portfolio



Source: ECB, Deutsche Finanzagentur, ING calculations

... and amid persistent headwinds the front end provides an anchor, too

The very front-end provides the most important anchor though, where the 2y Schatz has been more range bound since November at 7-12bp above OIS. In money markets, the pricing of German collateral in repo markets seems to have stabilised at levels around 5bp above the overnight ESTR rate, having already come off a peak at around 10bp in late September through early October. Some of the accelerated underperformance versus swaps further out the curve was indeed triggered by the repo market’s term-premium adjusting to these spot levels as the pricing over the year-end failed to repeat the rich valuations of past years.

For spreads further out the curve such as the 10Y Bund, we think this argues for some stabilisation at levels around 10-20bp above OIS (5 to -5bp around IRS) with risk-on/off episodes mainly driving the deviations towards flat and below swaps again. Bunds should always have a place as a

portfolio diversifier to hedge against unforeseen events and recent events have shown that the reflexes still work in the right direction.

Going forward, we see three main sources of such risks – geopolitical risks, eurozone political and sovereign risks and macro outlook risks – although the episode around Silicon Valley Bank of early 2023 also shows how other events can quickly lead to a larger outperformance of Bunds.

Author

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.