Eurozone bond spreads: a reordering in progress

Quantitative tightening and a still elevated supply are headwinds for the overall eurozone sovereign bond space. But that does not mean individual countries can't outperform further while others remain under more pressure. All eyes are on French deficit concerns, while the periphery continues on a positive footing

This time around all eyes are of course on France

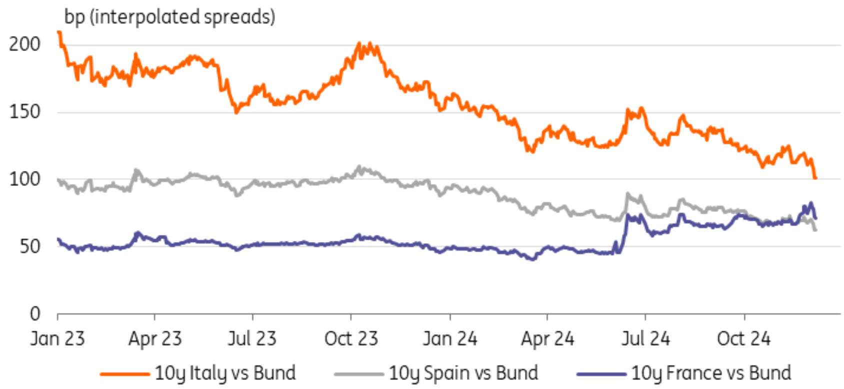
Spread risks look more contained and idiosyncratic

The market seems to sense that eurozone risks are by now largely contained and we are looking more at idiosyncratic country stories. The reaction of Bund swap spreads to episodes of eurozone political turmoil had become smaller in scope and more short-lived. Notably, periphery bond spreads have remained on a tightening trend despite French political unrest. In fact, markets are challenging the hierarchy of spreads from the past years as the conventional high-risk countries, e.g. Italy, Spain and Portugal are doing relatively well compared to say France and Belgium.

The market has internalised the European Central Bank's reaction function to signs of market dysfunction and the ECB's suite of instruments has also evolved including the Transmission Protection Mechanism (TPI). Add to this that the EU has moved closer together with each of the past crises, culminating in the common debt issuance through the NGEU.

The counterargument is that one cannot expect any further progress as long as political uncertainty hampers leadership in both France and Germany. With debt levels overall still elevated, deficits high and the macro outlook fragile, even the ECB warned recently that 'fiscal slippage' could reignite market concerns over sovereign debt sustainability. The political situation could leave the ECB picking up the pieces again.

Towards a new hierarchy within eurozone bonds



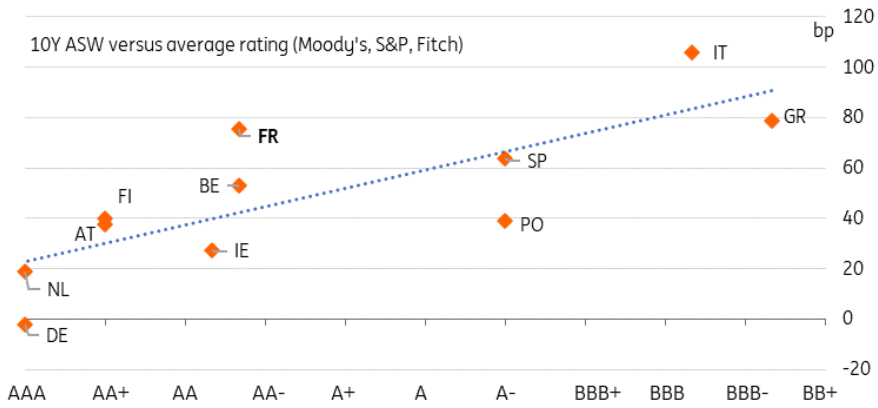
Source: Refinitiv, ING

Eyes will remain on France, but a lot of pessimism is already priced...

This time around all eyes are of course on France. The 10y yield spread of French government bonds over their German peers widened to 88bp in December before retreating to previously already elevated ranges. Further widening looks possible as politics enter a new phase of heightened uncertainty and new parliamentary elections now loom large in summer 2025. But markets had been wary about the prospects of quickly solving French fiscal problems to begin with, as pricing already reflects an expectation of rating downgrades. With the latest widening, French 10y spreads over swaps were more in line with an 'A-' rating rather than its current 'AA-' – three notches lower.

Government fragility was always part of the picture, even if not expected to come to a head quite so soon. The focus is now on the implications for a longer-run debt trajectory and where France finds its place relative to its peers. French spreads are already well above Spain's and are now close to par with those of Greece.

French bond spreads already reflect a lot of rating pessimism



Source: Rating agencies, Refinitiv, ING calculations

... and wider spillover has been muted, which should allow further selective tightening elsewhere

Importantly, the rekindled concerns surrounding France have not prevented, for instance, Italian government bond spreads versus Bunds trading close to the tightest level since 2021. What we are still seeing with regard to the wider eurozone periphery is an increased market optimism on the back of relative political stability and macro resilience leading to hopes for further rating upgrades. With spreads also supported by the general ECB rate-cutting environment for now, this more than counterbalances the impact of the ECB's gradual quantitative tightening.

This setup may hold in the early part of 2025. But it could become more and more challenging as ECB reinvestments now come to a complete stop. Our central scenario also sees the ECB reaching the trough in policy rates at just below neutral levels by mid-year and longer rates beginning to trend higher, thus steepening the curve from the back end. But the outlook comes with a great degree of uncertainty, not least because of the unpredictability of US politics. Volatility is never a friend of spread products.

For eurozone spreads, that may mean a modest potential for more selective tightening in the early part of the year – if political tensions do not escalate further. But further spread performance in the latter part of the year looks more challenging. A downside risk scenario that would see the ECB cut rates more substantially and also contemplate deploying its balance sheet gains would likely have the most profound impact on spreads, starting with Bunds.

Author

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

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