

Rates: On Bunds swap spreads...

The cheapening of German Bunds versus swaps has resumed and a cross read from the global cheapening phenomenon points to even wider levels at the long end, although the comparison has its shortcomings. By now the 10y Bund spread versus OIS is back to pre-QE levels, but persistent structural headwinds and political turmoil still warrant caution



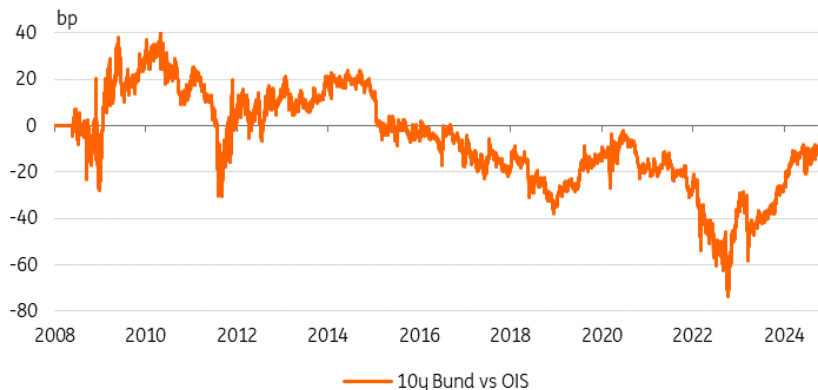
Bund cheapening resumes amid German political turmoil and persistent structural headwinds

After a brief break around the US elections the cheapening in Bunds has resumed, and if not is even accelerating. One trigger, as we mentioned yesterday, is the political turmoil in Germany where the governing coalition has fallen apart over amid negotiations for next year's budget. The backdrop for Bunds spreads has already been one of persistent structural headwinds, coming from mainly the supply side including the run-down of the European Central Bank's balance sheet (Schnabel's speech from yesterday is also recommended, illustrating the repo market drivers behind the Bund's tightening).

By now the accelerated pace of tightening since early October has cheapened 10Y Bunds from around 23bp below swaps to now 3bp above, and ramifications have been felt through assets. For

example, SSAs have also been pushed wider versus swaps to varying degrees.

Bund spread versus OIS is now back to pre ECB QE levels



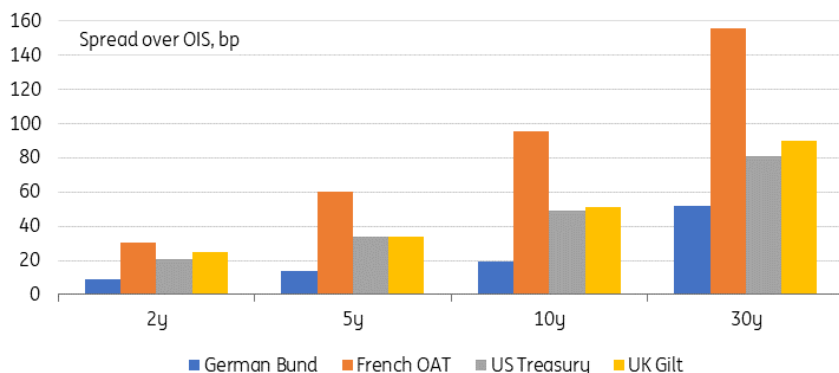
Source: Refinitiv, ING

How far can Bunds cheapen further?

The question is, how far this cheapening can extend. At least at the short end we seem to have found some anchor in repo market valuations already. Further out the picture remains less clear. If we take a longer history of 10Y Bunds versus OIS the current level of 16bp above corresponds to levels in the 15-20bp range seen just before the ECB started quantitative easing at the start of 2015. There are some caveats around this metric since we are using an adjusted EONIA to compare with current ESTR based OIS levels, nevertheless by now the impact of the ECB on Bunds seems to be fully unwound.

We have witnessed cheaper levels, but those were also associated with the wider deficits just after the global financial crisis. Those are now a fair concern as well with the spat around handling the constitutional debt brake leading to the fall of the government. Fears are that Germany might well have to spend its way out of looming trade and or geopolitical crises in the wake of the US election outcome.

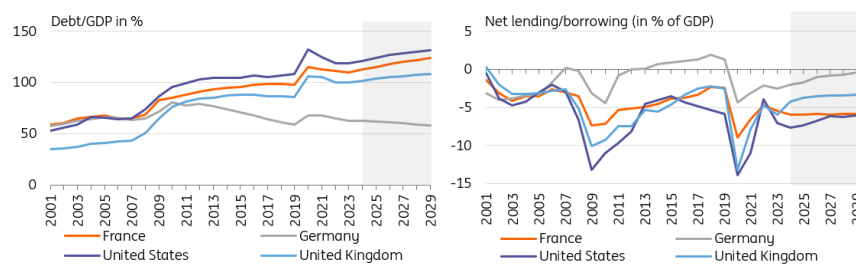
The cheapening of government bonds versus swaps is a global phenomenon



Source: Refinitiv, ING

Market observers also like to point to the global underperformance of government bonds versus OIS, from the US to the UK. That comparison would leave ample of scope for further cheapening particular in long end Bund spreads. We would still highlight that the US and the UK are playing more in a league alongside France when it comes to government debt and deficit metrics. If we also consider the notion that there should be a premium between French and German government bonds, since the latter are also AAA rated, then Bunds may not have to cheapen that much further – think of the European government bond spread spectrum fanning out around an average spread that is already comparable to its US or UK peers.

But Germany is still in a different league on its debt metrics



Source: IMF, ING

While the above observations argue for some stabilisation in Bund spreads versus swaps, the structural headwinds, domestic (political) and global sentiment make us wary of standing against the trend for now.

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