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EUR government bond spreads: More convergence, waning dynamic

European government bonds will likely see more convergence amid Germany's fiscal expansion and consolidation efforts bearing fruit elsewhere. The macro backdrop remains benign for carry positions, but without the ECB easing more, the dynamics are likely to wane while political uncertainties continue to linger

German government bonds still hold a solid AAA rating – an increasingly scarce commodity nowadays

European government bond spreads: More convergence, but waning dynamics

The conditions going into the end of 2025 have been very benign for carry positions. Rates markets were seeing very low volatility with the European Central Bank on hold since the June meeting and setting the bar for further moves very high.

The countering theme is that government bonds have been facing widening pressure on the back of elevated funding needs, while central bank balance sheets have been on the retreat. In very simplified terms, the private sector has been deleveraging on the back of governments over the past years, leading to convergence in spreads in general.

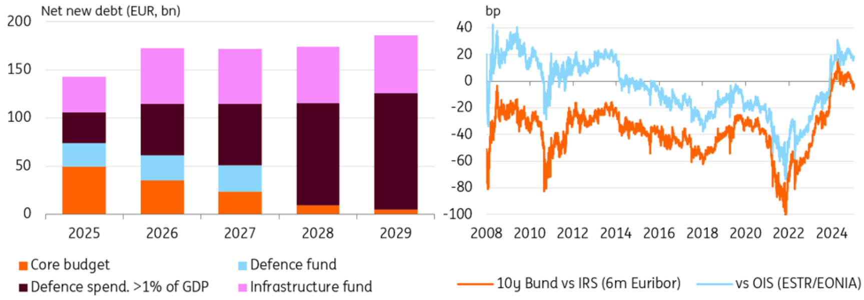
Within the eurozone, individual countries have come from very different starting points and are still at different stages of this process. The underlying dynamic is provided by the developments of the German Bund spread, (still) the safe-haven benchmark in our view, and the rest of the eurozone in relation to it.

German Bunds: Supply pressure versus safe haven status

Bunds are transitioning from a setting of scarcity to one of abundance. European governments are being faced with new geopolitical challenges, and Germany itself has had a fiscal change of heart, having to tackle a backlog of infrastructure investments on top of that.

From trading to as rich as 100bp *below* ESTR overnight indexed swaps (OIS) in 2022, 10y Bunds are now at around 18bp *above* OIS – and they peaked at 30bp above as the new fiscal plans were announced late March 2025. Historically, levels like that were last observed in the wake of the global financial crisis, when German debt levels rose above 80% of GDP temporarily.

Rising funding needs have already pushed Bunds to their cheapest levels since 2014



Source: German finance ministry, Refinitiv, ING

But we are likely heading back to these levels of debt as €850bn in added spending is rolled out through 2029. And the added issuance alongside the ECB balance sheet unwind will keep structural cheapening pressure on Bunds.

Steepening of government credit curves is a global phenomenon

The steepening of government credit curves is a global phenomenon. In the US and the UK, 10yr yields are 40bp to 50bp above their respective OIS rates. But we do not foresee German Bunds cheapening quite as dramatically and look more for a range below 30bp. Germany is coming from a very different starting point with a gross debt level of 62% of GDP in 2024, while the UK already stood at 100% and the US at 124% of GDP.

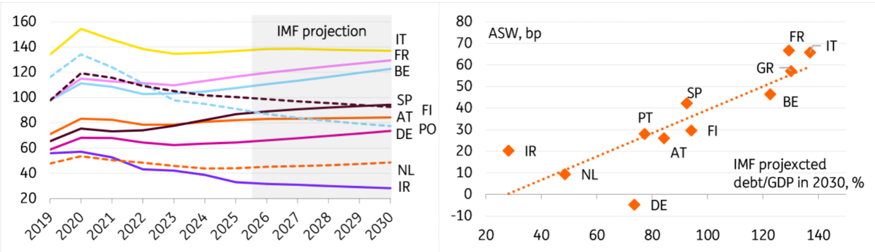
What's more is that German government bonds still hold a solid AAA rating – an increasingly scarce commodity nowadays. Of the remaining global AAA bond universe of just below US$10tr (Barclays AAA index), more than 55% is denominated in EUR, while 20% alone are made up of German Bunds. They remain the most liquid AAA debt available. In a world of high (geo)political uncertainty, this should be reflected in the price.

European government bond spreads versus Germany: Still picky

The reordering in the European sovereign bonds space – where the periphery outperforms while the traditional core to semi-core markets cheapen – may find headwinds in 2026.

Italian and Spanish bonds have hit multi-decade lows in spreads over Bunds. This has materialised following an outperformance in economic growth and substantially improved fiscal trajectories, as well as relative political stability. All this was also reflected in multiple sovereign rating upgrades. To be fair, a lot of the periphery outperformance came about due to the fiscal transfers via the NGEU, one factor that will run out after 2026. And further rating upgrades could be more difficult to attain as Italy is still facing high overall debt levels.

Markets are preempting the sovereign debt trajectories as EGBs are reordered



Source: IMF, Refinitiv, ING

On the other end of the spectrum sit France and, to some extent, Belgium. Still, wide French spreads in turn appear more down to a (political) risk premium than just the shift in fundamentals, with anticipated rating downgrades largely having taken place and outlooks stabilising. While this can provide spreads with some temporary respite, that is not to say that politics can't still come back to haunt France going into the presidential elections of early 2027.

Overall, we still think that more spread convergence can emerge between the higher and lower rating categories, given the backdrop of stable ECB rates and gradual economic recovery. Without actual further ECB easing, the dynamic will likely be more gradual than we have seen over the past year. We suspect that, at least for Italian spreads, it could become more difficult to price materially richer than France when there is still a considerable rating gap and also a difference in (current) debt levels. We are therefore more selective by still favouring Spain or Portugal, and as more defensive positions, Dutch bonds as opposed to Bunds.

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