Rates Spark: Risk-off reflexes at work

The prospect of an escalation in Ukraine has led to a higher demand for Bunds, bringing the Bund swap spread close to zero. However, the underlying factors that caused the Bund swap spread to turn negative are still present, as shown by similar trends in the USD/EUR cross-currency basis

Bunds in demand as Ukraine faces uncertain times

Over the past month, markets have rapidly adjusted to the realities of post-QE and QT. This is most evident in Bund swap spreads, but similar trends were also seen in the USD/EUR cross-currency basis, which has shared the same pattern as risk-premia into the looming year-end was reassessed. The shared trends suggest that concerns about German credit amid political instability were less influential, though they likely contributed to the overall movement.

Tuesday's market reaction to headlines pointing to an escalation in the Ukraine conflict showed that the risk-off reflexes are still working. Bunds were the main recipient of safe-haven flows, outperforming other European government bonds with the 10y initially outperforming versus swaps by almost 4bp. The 10Y yield still sits slightly above swaps and time will tell how lasting the move will be or whether it is seen as an opportunity to jump back on the Bund underperformance trade. So far, the spread performance has been more resilient than the immediate reaction to headlines. However, recent history has shown that Bunds have had a weaker and shorter-lived response to risk-off events, such as the French election turmoil.

We still think that the levels broadly around 5bp above swaps could mark an equilibrium around which 10y Bund spreads evolve with risk-off episodes and supply as well as political turmoil continuing to add volatility. Recall that the equivalent spread of around 20bp above OIS was last observed in 2014 ahead of the European Central Bank's QE.

Today’s events and market view

UK October CPI data this morning came in hotter than expected with services inflation at 5% year-on-year and core CPI at 3.3% versus an estimated 3.1%. However, leaving out categories the Bank has told us it cares less about, our economist calculates that this "core-services" measure fell from 4.8% to 4.5%.

The data calendar remains lighter after the release of the UK CPI in the morning, although the ECB will release its indicator for negotiated wages in the third quarter today. A rise here, mainly given developments in Germany, is likely to garner some headlines amid markets that have become a tad more cautious about pricing aggressive easing from the ECB. We still think Friday’s PMIs will be key. Also look out for more commentary from ECB members, including de Guindos and Stournaras, while the ECB will also release its Financial Stability Review.

In primary markets, Germany will tap two bonds in the 30Y part of the curve for €1bn each. Later the US Treasury will sell a new 20Y bond for US$16bn.

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