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SSA spreads pushed wider as underlying sovereign levels get reassessed

Sovereign-related and supranational issuers are not just caught up in the reassessment of sovereign risk. If longer rates start drifting higher, credit curves should remain steeper with the sector also facing elevated funding levels. The EU bond market evolves further but faces challenges as key states are under pressure and supply risks loom

We await the detailed plans for the next six months from the EU

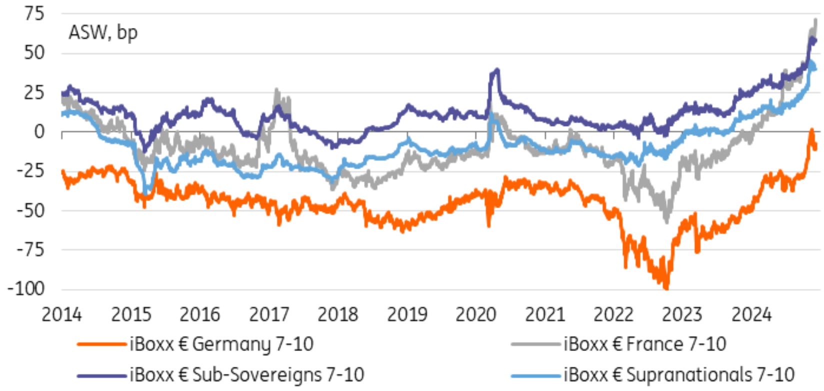
SSAs face ongoing pressure from the underlying reassessment of sovereign risk

For supranational, sub-sovereign and agency (SSA) bonds, 2024 was, for a large part, a year of gradually widening spreads over swaps. This was mainly the effect of the European Central Bank continuing to normalise its policy implementation amid an overall elevated supply flow. This pushed the entire credit spectrum wider starting from the government bonds space, and Bunds specifically. Some issuers have lagged in the last widening move more than others. Especially for less liquid names, screen prices may not reflect prices where bonds would actually change hands – in many cases, price discovery typically runs through the primary market.

The start of the next year will be key when primary markets reopen and issuers usually frontload a good part of their funding for the year. This can put pressure on spreads. The larger issuers coming early in the year will particularly set the tone for other issuers – all eyes will be on KFW, EIB and of course the EU.

For the time being, the recovery of Bunds may provide some relief as relative valuations now look less stretched – i.e. versus the sovereign, but also less liquid relative to liquid names (think for instance German Laender versus KFW). But to the degree that French political turmoil is the underlying reason this could be a double-edged sword with only core and more liquid names to really benefit. On the positive side, even the latest escalation has had muted spillover into other jurisdictions, save Belgium to some extent.

SSA spreads were pressured wider by Bunds



Source: Markit, ING

The start of the year will set the tone

One question will be whether there is a reason to frontload funding or whether there is room to postpone some of it amid current political uncertainty in France and Germany.

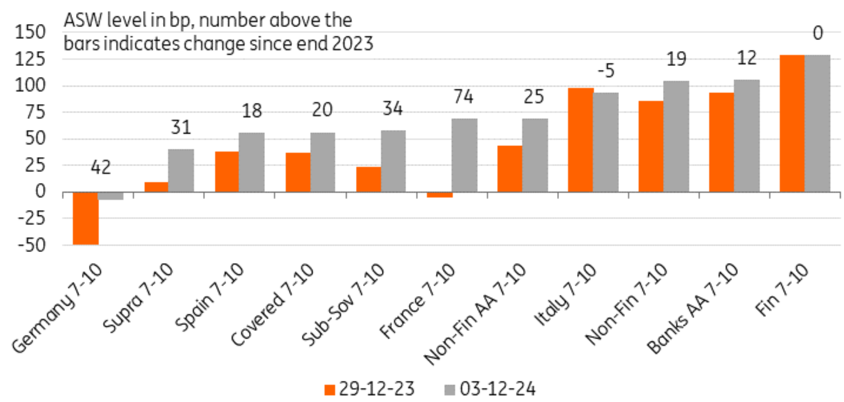
Funding of SSAs via EUR in 2024 had seen a pronounced frontloading with an issuance volume of €80bn in total in January setting a new record. Reasons were many, with the ECB slowing reinvestments, the EU elections in summer and the US presidential race looming later; there was plenty to get ahead of. But it was also due to the overall high funding volume. In the end, January accounted for just below 20% of funding for the entire year, a similar share as in 2023.

The wiggle room now appears limited as overall funding volumes should stay high in 2025. In terms of timing, French politics will remain an ongoing concern and could see another round of legislative elections in the summer. French-related spreads are likely to remain elevated, but it appears that other jurisdictions remain shielded for now.

If potential French elections do not trigger wider spread turmoil and another outperformance leg of Bunds, we think there is a chance that their gradual underperformance trend versus swaps continues amid persistent supply headwinds. This would likely feed through to SSAs again. At the same time, the ECB could signal by mid-year that it is close to being done with easing, while we see long-end rates continuing to drift higher. We think credit curves will likely remain steeper in such an environment.

However, there is still room for SSAs to perform relative to sovereigns, even if that does not translate to tighter spreads versus swaps. More importantly, any underperformance versus swaps might also be moderated by valuations of the SSA sector now being more attractive relative to other asset classes, from covered to (non-)financial corporates.

SSAs are wider, but also relatively more attractive



Source: Markit, ING calculations

High net supply remains a headwind

High grade € SSA issuance from the regions we track – Western Europe, North America, Japan, Australia and New Zealand plus global supranationals – has reached more than €412bn in 2024, well surpassing the €360bn of 2023 and setting a new record. Western Europe typically accounts to more than 90% of the €-denominated issuance, more than a third of which again is solely down to one single issuer – the European Union. For 2025 we expect only a slightly higher gross issuance level closer to €420bn with minor shifts below the surface.

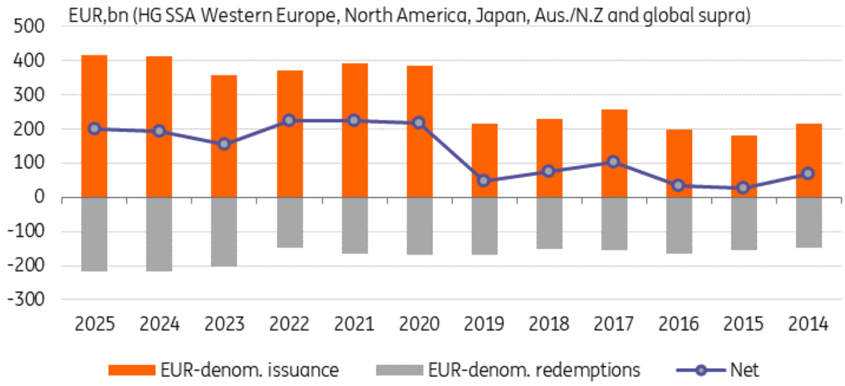
While we await the detailed plans for the next six months from the EU, it has already flagged that gross issuance could increase to €150-160bn in 2025. This comes amid rising refinancing needs with larger bond maturities due next year – €28bn compared to €3bn in 2024. This also means that net issuance could actually decline from €135bn to €122-132bn.

ESM and EFSF will issue €28.5bn in 2025, up from €26bn in 2024, which includes the one USD dollar bond per year from the ESM. For the EIB, we again pencil in around €30bn in €-denominated funding out of roughly €60bn in total. Taking the E-Names and EU together we already arrive at 45% of the total €-issuance we forecast for 2025.

Another 25% of overall issuance will come from the German agencies and Lander. We assume an issuance volume of again close to €105bn, with KFW likely to account for €45bn alone – its €-denominated funding share. Filling in the rest, we look to French and Dutch agencies – slightly lower to similar in magnitude compared to last year, of €18bn and €15bn, respectively – and as the next largest block to supranationals other than the E-names as well as Canadian agencies and provinces – for both we look for slightly lower volumes as especially the latter tend to fund more opportunistically in EURs.

The overall EUR net funding volume could come in at €200bn, up from €195bn in 2024, but still below the peak levels of 2020 through 2022. However, this does not account for the ECB no longer reinvesting any maturing bonds from its portfolio holdings.

SSA supply will remain at elevated levels



Source: BondRadar, issuer websites, ING

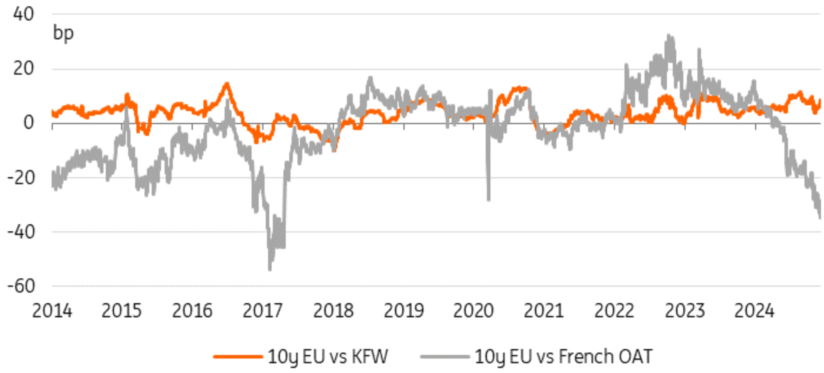
EU bonds' role within SSAs: challenges and opportunities

The EU remains a focus: for one it dominates the SSA space with its high issuance levels. Paired with its high rating AAA/Aaa/AA+, it also serves as a benchmark to a degree.

The further evolution of that benchmark role was dented this year when MSCI and ICE decided against incorporating the EU into sovereign debt indices. It is not the end of the story, as other index providers iboxx and S&P/Barclays still have to report back on their consultations where feedback rounds just closed in November. It would be surprising if the feedback resulted in materially different conclusions from the earlier two exercises. Still, this topic could be revisited, especially if there were more indications that the NGEU would not remain a one-off. Funding a common defence strategy amid a changing geopolitical landscape for instance could have significant supply implications for the future, although recent headlines suggest that options via a separate financing vehicle are being explored.

Further development was made on other fronts, though. ICE has just launched a Long EU bond futures contract, although it is cash-settled and based on an 8-13Y bond index rather than a basket of deliverable bonds as markets are accustomed to in the eurozone government bonds space. That might hinder it from gaining wider traction. But Eurex – the name behind the government bond contracts – has indicated that the EU is meeting the conditions for a launch of its own contract, especially since the EU has established a repo facility and also joined the Eurex repo platform for clearing and trading.

EU bonds have so far managed to stay aloof of French political



Source: Markit, ING calculations

Those are the more technical underpinnings, but the EU will be closely watched for the impact that France may have on its credit perceptions. Fitch bases its AAA rating for the EU mainly on the capacity of AAA-rated member states to provide financial support if needed. Moody's, meanwhile, highlights that the rating is more sensitive "to changes in the ratings of the three countries rated Aaa to Aa2 that make large contributions to the EU budget, i.e. Germany, France, and the Netherlands," though notes a degree of resilience if downgrades are limited in extent and focussed on one member state. S&P seems to follow a GDP-weighted average rating approach more mechanically than currently results in its AA+ assessment.

The market has at its peak placed French swap spreads on levels implying a rating up to three notches lower from its current AA- rating. With two negative outlooks, a one-notch downgrade looks possible over the next year. This alone would unlikely already impact the average calculations underpinning the EU, even as France has an almost 17% weight in the EU. But the market might well see this as the beginning of a cycle if French politics do not show signs of turning the corner on budget issues. An offsetting factor could remain the positive sentiment with regards to Italy and Spain in particular – together with a weight of just over 20%.

EU bonds do look rich versus the French sovereign as the widening of the latter has had a modest spillover effect, but they tended to correlate more with German SSAs in the long run. On this measure, the EU currently is at the wider end of a spread dynamic that has typically stuck to a relatively narrow band.

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