EA Rates Strategy
BREAK A (SWAP) SPREAD

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The tightening momentum of Bund swap spreads has gained traction lately, with swap spreads reaching unprecedented historical levels. In this note, we investigate the potential forces behind the move and provide our medium-term outlook.

In our view, the following forces are largely responsible for the move:

1) *Increased availability of high-quality collateral.*
2) *Increased government bond supply, especially at the long end of the curve.*
3) *Change in the ownership structure of EGBs.*
4) *Expectations of fiscal easing in Germany.*
5) *A change in investors' perception of Germany's safe-haven status.*

While we expect Bunds to remain historically cheap vs. swaps, we do not expect Bunds to cheapen further and move towards UST or UK swap spread levels for two reasons:

1) *We expect Eurosystem's holdings of Bunds to reach 17% by end-2025, higher than 14% of USTs held by the Fed and 5% of Gilts held by the BoE.*
2) *Barring sizeable fiscal packages, fiscal metrics in EA remain much better than in the rest of the developed world.*

Against this backdrop, the 10Y Bund swap spread new trading range could be 5-15bp. Risks are skewed towards a more pronounced richening in case of protracted political instability in France and Germany or in the case of an aggressive tariff policy towards Europe.

BREAKING DOWN THE RECENT CHEAPENING OF SWAP SPREADS

I) What happened and why it is different than in the past?

Since mid-2024, tightening momentum of Bund swap spreads[1] (that first started in Q4 2022) has gained traction, taking the 10Y Bund to trade from swap -35bp at the end of June to slightly positive vs. swaps in the first half of November, at a record cheap level since the EUR inceptions.

Over the last few days, the movement has partially retraced, with 10Y Bund yields coming back to trade at a small premium vs. swaps, but the current levels still remain extremely cheap historically.

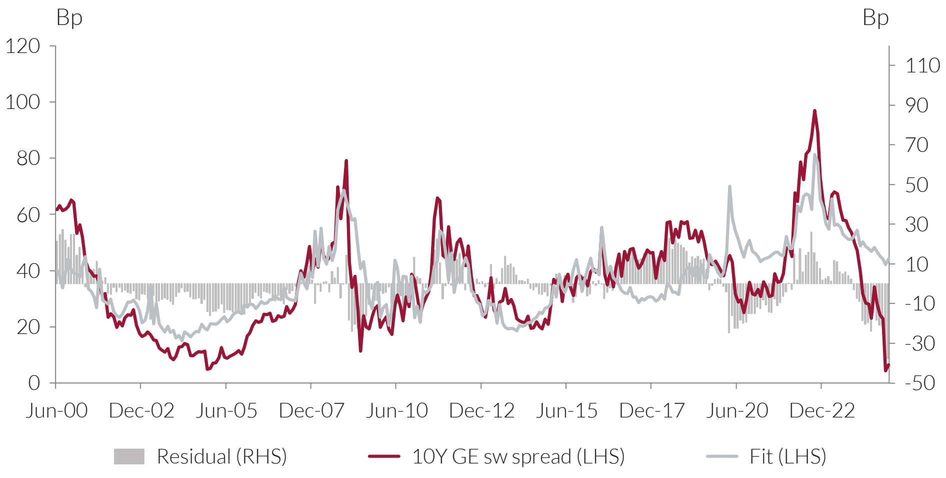
In our view, two factors point to different spread dynamics compared to the past:

1) **Current level of Bund swap spread dislocation at the long end compared to fundamentals is extreme.**

Figure 1 shows that our fair value model[2] has closely tracked the first leg of Bund swap spreads tightening from the end of 2022 to mid-2024 (which was mostly due to a sharp decline in systemic risk in the Euro area), but it has not been able to explain the cheapening of the 10Y Bund swap spreads since mid-2024, with residuals reaching unprecedented high levels compared to the past.

FIGURE 1.

Current level of the 10Y Bund swap spread extremely cheap and not explained by fundamentals



Source: Bloomberg, ANIMA Research

1 - In this article, the swap spread is calculated as swap rate minus government bond yield. A tightening of the swap spread indicates a cheapening of government paper vs. swap.

2 - Our model regresses the 10Y Bund swap spread on 2Y Bund yields, the slope of the Bund curve, excess liquidity in the Eurosystem and the systemic stress in the Eurosystem. The model is regressed on monthly data starting from 1999 until the present

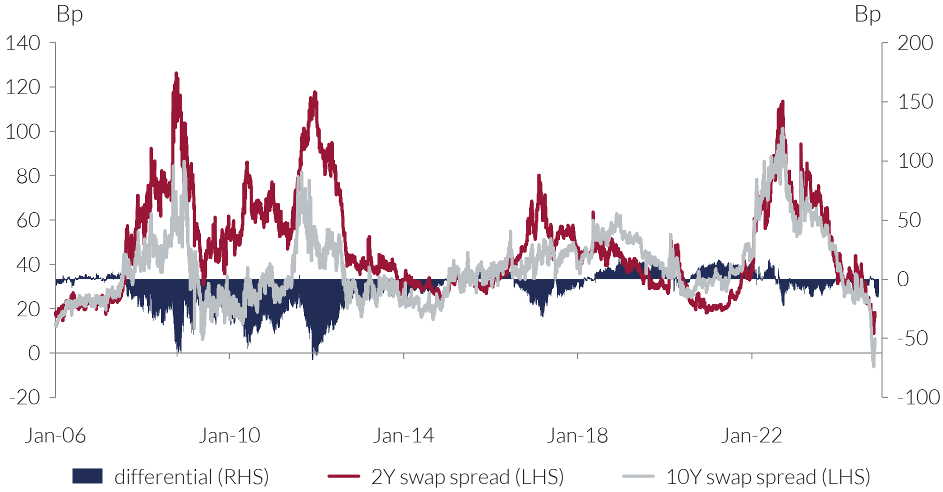
2) **The swap spread curve is inverted, but differently from the past, in a context of Bunds cheapening vs. swaps**

The recent cheapening of Bunds vs. swaps has been more pronounced at the long end of the curve, leading to an inversion of the swap spreads curve.

While the swap spread curve has been inverted before in the past (for instance between 2007 and 2013, in 2016 and 2017, (**Figure 2**), during all the past episodes, Bunds were richening vs. swaps and more so at the short maturities, leading to an inversion of the swap spreads curve. During all these periods, the reason for the inversion of the swap spread curve was an increase in systematic stress (Great Financial Crisis, Eurozone debt crisis, 2017 French elections, bond sell-off in 2022), especially at the short-end of the curve (**Figure 3**). Scarcity of safe government paper also played a role, especially after ECB's PEPP. On the other hand, the recent inversion of the swap spreads curve happened in a context of a cheapening of Bunds vs. swaps that has been more pronounced at the long end of the curve.

FIGURE 2.

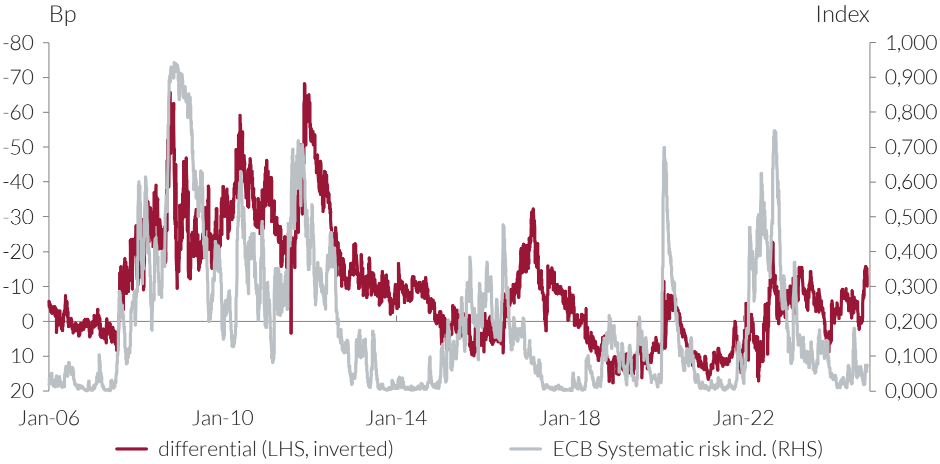
This is not the first time that the swap spreads curve is inverted...



Source: Bloomberg, ANIMA Research

FIGURE 3.

...but it is the first time that its inversion is not happening in a context of rising systematic risk



Source: Bloomberg, Anima Research

II) Our take

In our view, the recent cheapening of swap spreads reflects the following factors:

1) **Increased availability of high-quality collateral.**

The increase in high-quality collateral in the Eurosystem came from two sources: 1) the repayments of the Targeted Long-Term Operations (TLTROs) introduced by the ECB post-Covid, which started in June 2022; 2) the phasing out of the reinvestments of both the Asset Purchase Program (APP), which started in March 2023 and of the Pandemic Emergency Purchasing Programme (PEPP), which started in July 2024.

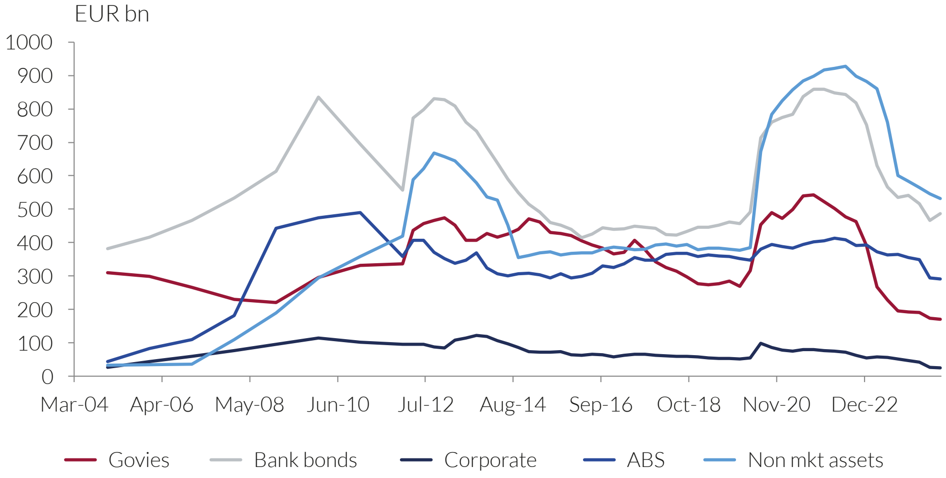
In total, since mid-2022, government bonds in circulation in the Eurosystem increased by more than EUR 800bn just from the discontinuation of long-term liquidity operations and of QE: the repayments of the TLTRO triggered an increase of government bonds in circulation of over EUR 370bn (**Figure 4**), while the phasing out of redemptions of the APP and the PEPP led to an increase of around EUR 450bn of government and supranational bonds (**Figure 5**).

We expect a decisive acceleration in the increase in high-quality collateral in the system compared to the last two and a half years (**Figure 5**). We estimate that the Eurosystem will free up an additional EUR 470bn of high-quality collateral only in 2025.

This transition from a massive scarcity of collateral to an abundance of collateral is also reflected by the increase in repo rates towards the depo rate (**Figure 6**).

FIGURE 4.

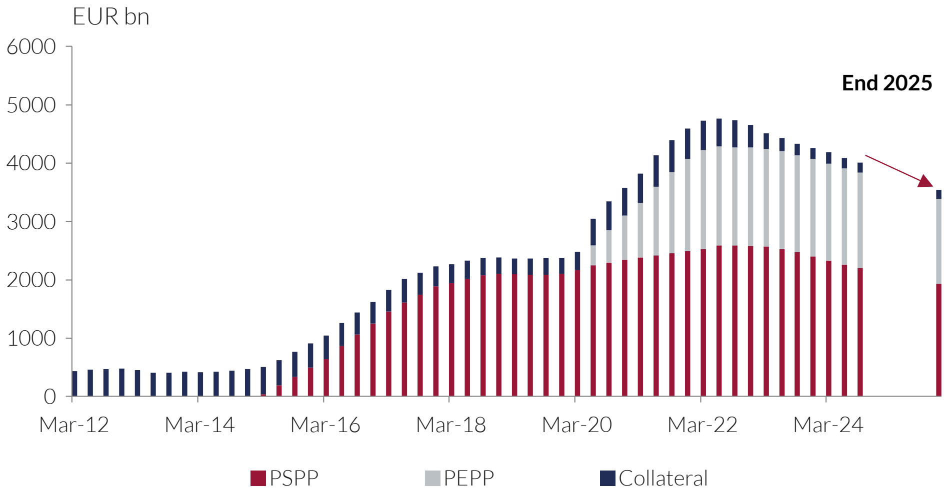
Development in collateral pledged at the ECB's liquidity operations



Source: Haver Analytics, Anima Research

FIGURE 5.

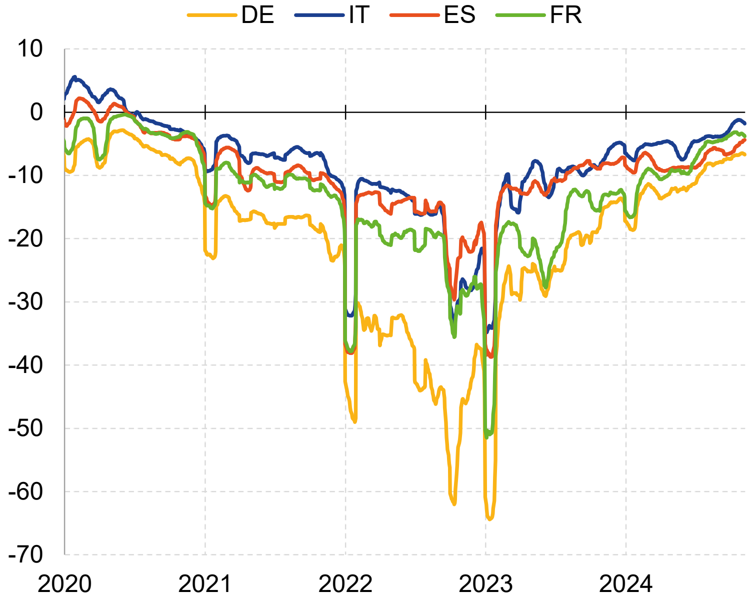
Government bonds on ECB's balance sheet



Source: Bloomberg, Haver Analytics, Anima Research

FIGURE 6.

Spread of repo rates to depo facility rate



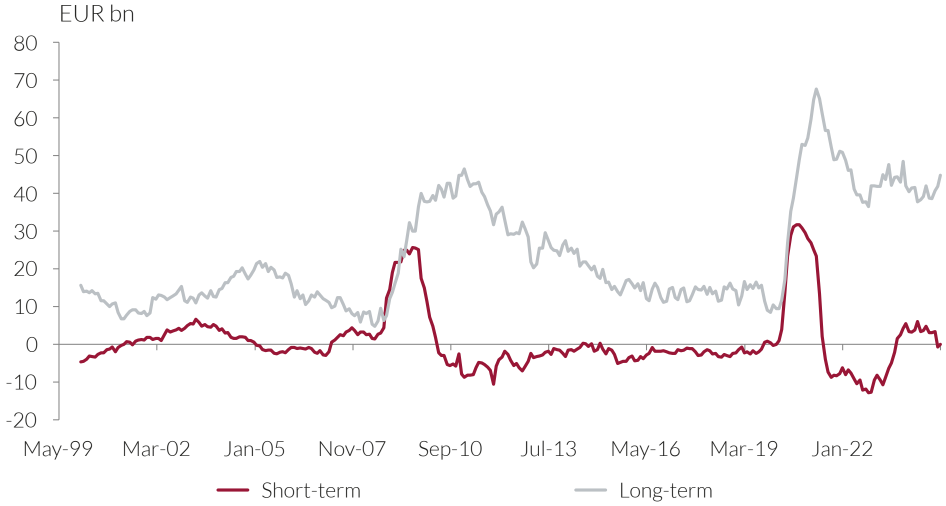
Source: MMSR.
Notes: Repo 1-day against government collateral – DFR, smoothed by 20-days moving average.
Latest observation: 5 November 2024.

2) Increased government bond supply, especially at the long end of the curve.

Concurrently to the increase in government bonds in circulation coming from the ECB, issuance of government bonds in the Eurozone has accelerated compared to the past, with the monthly average net issuance rising from around EUR 15bn pre-Covid to EUR 40-45bn in the last couple of years (**Figure 7**). Moreover, differently from the US, where the increase in net issuance in recent years has been mostly financed by short-term instruments, in the EA, the average maturity of issuance has remained quite long, well above 9 years including bills (**Figure 8**).

FIGURE 7.

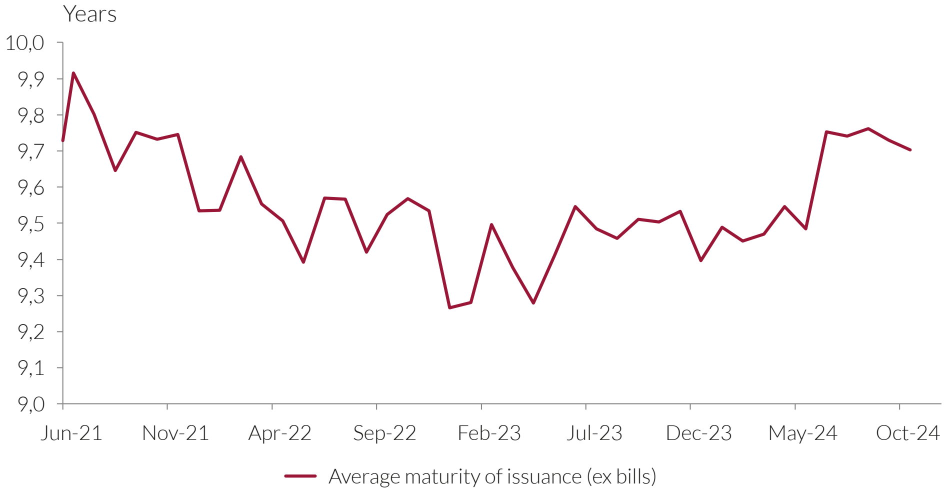
Net issuance of government debt in the EA has accelerated compared to the past, especially in long-term instruments (1-year rolling average of monthly net issuance of govies in the EA)



Source: Haver Analytics, Anima Research

FIGURE 8.

Average maturity of gross issuance in the Euro area (including T-bills)



Source: Haver Analytics, Anima Research

3) Change in the ownership structure of EGBs.

Figure 9 shows the evolution of government debt ownership in the Eurozone. QE led to a sharp decline in the ownership of government debt by the most price sensitive investors (foreign banks and foreign non-banks went from holding 31% of EA government debt to just 21%), which was offset by a sharp increase in holdings by the most price insensitive investors (central banks and foreign officials). Since the end of 2022, the opposite process has been at work, with the portion of EA government debt held by the most price-sensitive investors growing from 21% to 26%.

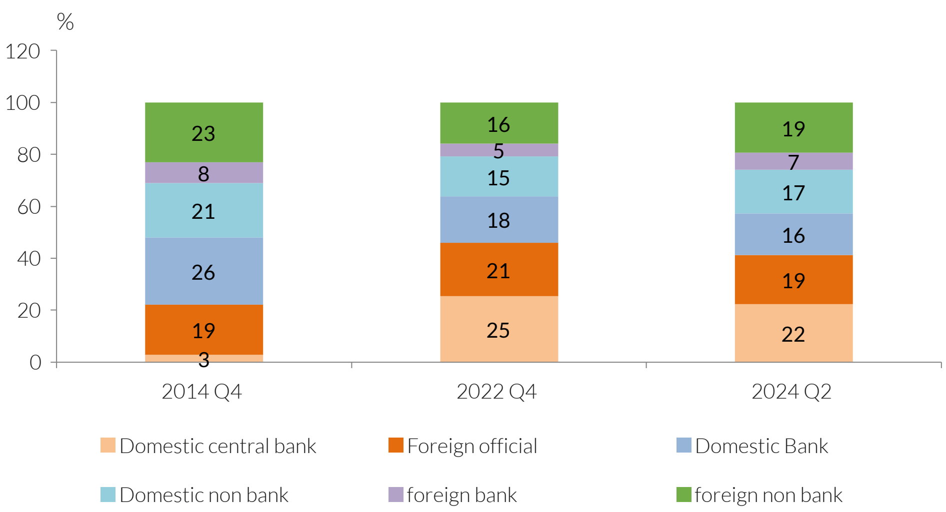
4) Expectations of fiscal easing by Germany.

German Chancellor Scholz resignation at the start of November led to speculation that the next government (which will most probably be a Grand Coalition led by the leader of the CDU/CSU, Merz) will deliver fiscal easing in order to boost investments and support the growth potential of the economy, that according to some analysts could currently be as low as 0.4%.

While it is far from certain that a sizeable fiscal package can be approved by the next government (a 2/3 majority in Parliament is needed both to amend the constitutional debt brake and to approve another special funds outside the federal deficit perimeter), if a fiscal package were to be approved, it could lead to a positive shift in markets' sentiment towards Germany.

FIGURE 9.

Price-sensitive investors have sharply increased their holdings of EA government debt



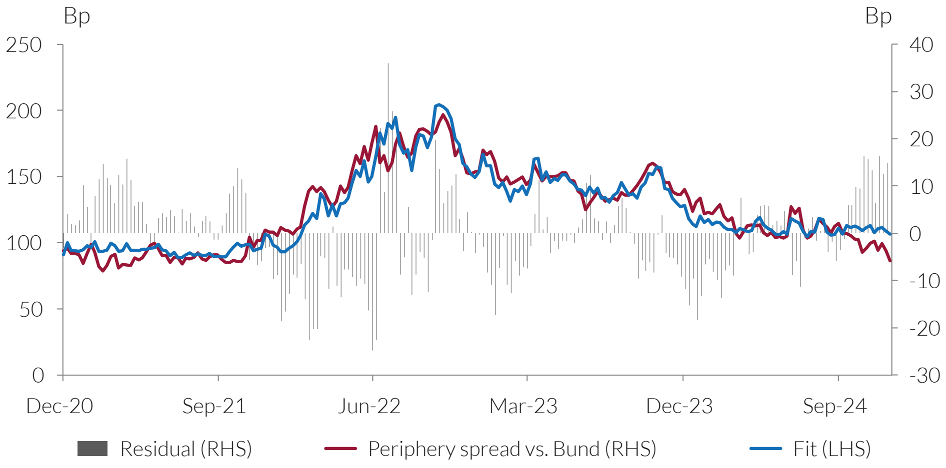
Source: IMF, Anima Research

5) A Change in investors' perception of Germany's safe-haven status

Bunds have long benefited from a safe haven and scarcity premium, due to their better position in economic and debt metric terms compared to the rest of the Eurozone and a general fragmentation in EA markets. Since the war-related energy-crisis, the gap between Germany and the rest of the EA in terms of macro fundamentals, especially the periphery has been reducing, reflecting in a reduction of sovereign spreads. **Figure 10** shows that this factor has probably played a role in explaining the last leg of swap spreads cheapening. Indeed, since the start of October, periphery spreads have outperformed credit spreads.

FIGURE 10.

Since October, periphery spreads have tightened more than credit spreads performance can explain



The model regresses a periphery spread (constructed as an average of Spain, Italy, Portugal and Greece spreads weighted by their respective capital keys) on Itrx Main 5Y.
Source: Bloomberg, ANIMA Research

WHAT NOW?

Going forward, we expect Bunds to remain cheaper vs. swaps compared to the past, for the following reasons:

1) **Availability of high-quality collateral in the Eurosystem will accelerate.** Firstly, Schnabel has made it abundantly clear in her recent speeches that QE is to be considered an emergency tool and carries significant risks when used. This reflects a willingness on the part of a significant percentage of the ECB's Governing Council (GC) to continue reducing government bonds on its balance sheet. Secondly, the ECB opted for a demand-driven framework for liquidity management, but at the moment banks are bidding very little liquidity at regular operations due to the stigma attached to it, while they prefer to recur to markets to bid for liquidity. This will continue to exert cheapening pressure on repo rates.

2) **The change in ownership of government debt will continue to shift in favour of price-sensitive investors.**

While we expect Bunds to remain historically cheap vs. swaps, **we do not expect Bunds to cheapen further and move towards UST or UK swap spreads levels** for two reasons:

1) We expect Eurosystem's holdings of Bunds to reach 17% by end-2025, higher than 14% of USTs held by the Fed and 5% of Gilts held by the BoE.
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