

Global Rates Watch

EGB spreads: opportunities on 10y

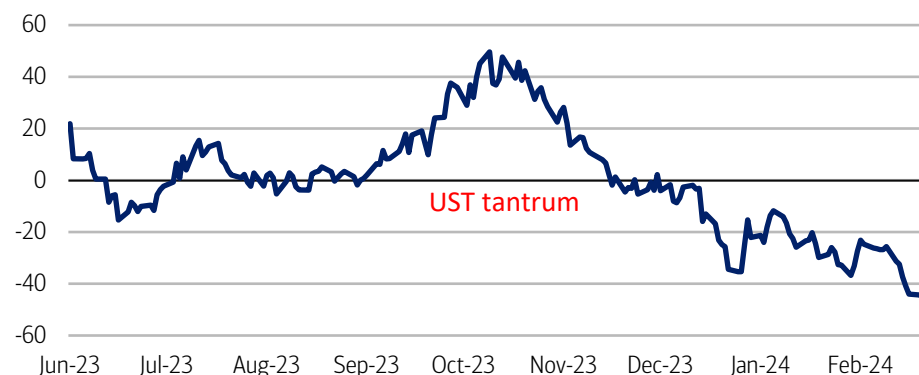
Risk optimism supporting EGB spread tightening trend

Market pricing of risks is quite constructive (complacent?) and Eurozone sovereign spreads tighten further from stretched levels (Exhibit 1). 10y OAT spreads for example, at 45bp, trade at the tighter end of the range since the start of the pricing in of higher rates in early 2022. Same applies to 10y Bonos, currently trading at c.85bp vs Bunds.

The tightening trend is not something specific to our market. It looks very similar across asset classes. Rates vol shows that, even if markets went through a sizeable repricing of central bank cut expectations, the narrative (bottoming macro, turning of monetary policy cycle) has not changed: risk pricing remains very limited across the board.

Exhibit 1: 1st principal component of Euro Area Sovereign bond spreads to Germany in the 10y

Common driver of Eurozone sovereign spreads continues the tightening trend



Source: Bloomberg, own calculations (sklearn package Python)

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Overall this leaves our markets very exposed to the risk scenario of an inflation U-turn.

In a context of deteriorating market liquidity, relative value dislocations across Euro Government Bonds (EGBs) remain orderly on a one-year perspective (Exhibit 3).

The charts below show the deviation of 10y spread to Germany from their main common factor. We note Belgium, Austria and Finland being particularly rich relative to directionality since mid 2023: that's by 2-4bp (Exhibit 4).

These three countries stand out also in terms of recent history with the bulk of the move happening last week (Exhibit 5).

For a list of all outstanding trade recommendations please refer to [Global Rates Weekly](#)

23 February 2024

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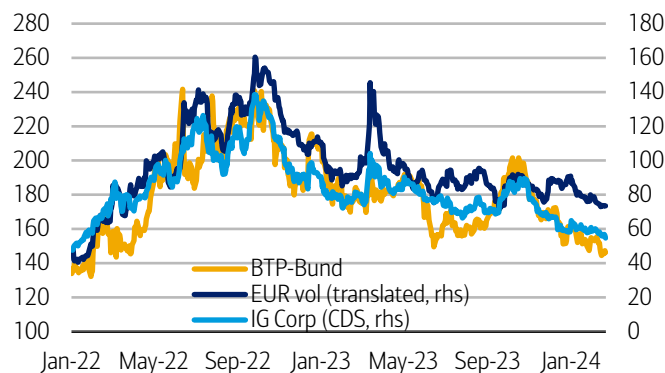
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We would not emphasize Italy's cheapness (at over 4bp) on this exercise. BTPs will likely keep trading in a relatively de-correlated way given the specifics of its macro narrative. Growth is surprising positively and BTPs should benefit from lower core rates during a soft landing but at the same time they remain the most sensitive asset to a potential change in global risk propensity, possibly in an asymmetric way from current levels. Given the likely scenarios from here, we like the 5s10s BTP steepener on ASW (now at 53bp) as a soft short expression, geared towards risks of a U-turn in inflation data.

Exhibit 2: 10y BPT-Bund, EUR 5y IG CDS, EUR rates vol

Rates volatility and market risk pricing are almost the same chart



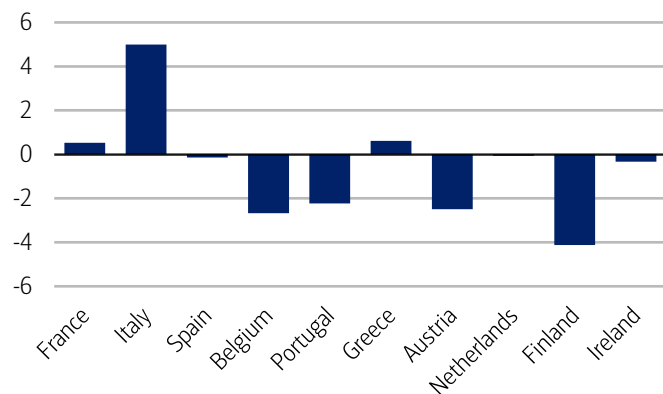
Source: Bloomberg

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PGBs remain relatively rich also on this metric but that is no news and we would not necessarily be looking to fade it in the short-term (also given possible rating upgrade).

Exhibit 4: Actual 10y spread to Germany minus fair*

Belgium, Austria and Finland richer than directionality would suggest



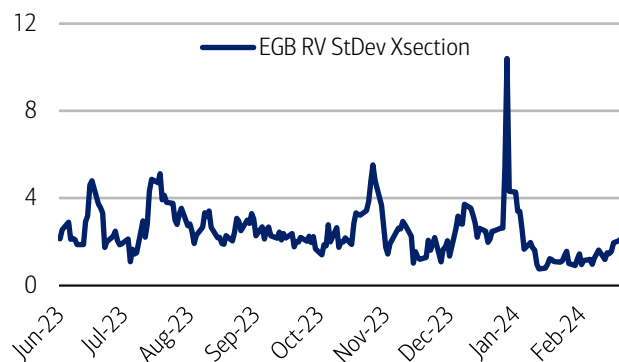
Source: Bloomberg, own calcs in bp. *fair value defined as value expected from PCA 1-comp

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Flows from here likely are particularly supportive for France (albeit supply offsets that for OATs), Italy, Greece and Germany. This latter also sees significant duration increases in ICE indices. Flows story may be conducive for RAGB cheapening back towards fair in the short-term while the Belgian and Finnish one likely still need a catalyst.

Exhibit 3: Average deviation of 10y EGB spreads from fair value*

EGB spread dislocations in the 10y rose but remain orderly

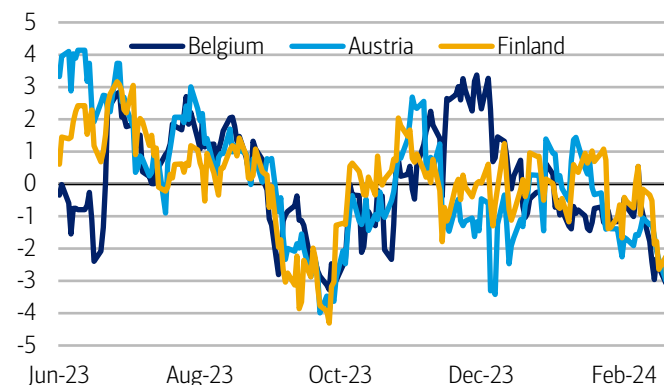


Source: Bloomberg, own calculations. *fair value defined as value expected from PCA 1-comp.

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Exhibit 5: Actual 10y spread to Germany minus fair* (time series)

Belgium, Austria and Finland richer than directionality would suggest

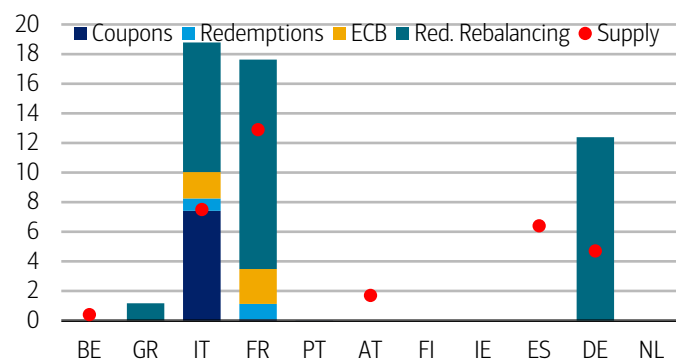


Source: Bloomberg, own calcs in bp. *fair value defined as value expected from PCA 1-comp

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Exhibit 6: 2-week ahead flows in DV01 €mn by member state

Supportive flows concentrate on Italy, France, Germany and Greece

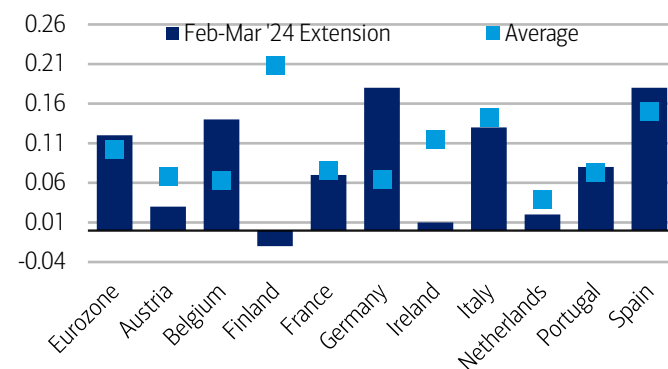


Source: Bloomberg, ECB, national treasuries and own calculations

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Exhibit 7: Month-end bond index duration changes

Germany, Spain top the charts of duration extensions for ICE indices



Source: ICE Bond Indices

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