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| Figure 1  Yields and Spreads goes hand in hand… |  | Figure 2  …As shown by Z-Scores metric |
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This report seeks to investigate the relationship between European credit spreads and bond yields between the years 2001 and 2015. Specifically, the study aims to shed light on the nature and magnitude of the association between these two variables, and to offer insights into the implications of this relationship for the investment process. By conducting a comprehensive analysis of the historical data on credit spreads and bond yields, this study seeks to inform and guide investment decisions.

In Fig. 1, Yields (Advanced by 8M) and Credit Spread evolution, and in Fig. 2, the corresponding Z-Scores. The Z-Score is a measure of how many standard deviations a data point is from the mean. Second figure shows better synchronization in the evolution of both time series since the units are identical.

At first glance, yields and credit spreads appear to evolve in sync with each other. Empirical testing supports this observation, with a moderated correlation coefficient (approximately 40%) and a validated cointegration test (95% confidence that these two series are cointegrated by Engle-Granger test). Correlation measures the strength of the short-term relationship between two variables at a specific point in time, while cointegration tests for a long-term relationship or co-movement between two time series. Correlation can fluctuate over time, but cointegration suggests that the two series will converge to a common long-run equilibrium. In simpler terms, we found that lagged 8M Treasuries yields and Credit Spreads are indeed related and that there is a strong chance that this synchronized evolution will be maintained over time.

This result is not just a numerical fact,the relationship between government bond yields and credit spreads is driven by the underlying economic environment affecting both types of securities.

An increase in the average yield of government bonds is typically driven by two main factors. Firstly, it can be a response to rising inflation expectations and the need to cool off an overheating economy, serving as a signal for a restrictive monetary policy stance by central banks. Secondly, it can reflect heightened country risk, such as concerns over debt sustainability or geopolitical risks. Thus, an increase in the average yield typically precedes an uncertain economic environment and a restrictive monetary policy. Government bond yields are considered leading indicators of economic conditions. This, in turn, leads to an increase in the yield spread between investment grade (IG) and high yield (HY) bonds, as investors demand higher returns from lower credit quality firms in the face of an uncertain economic environment. This situation is clearly observable in the graphs for the years 2008 (GFC) and 2012 (European debt crisis).

Conversely, a decrease in interest rates typically precedes a period of lower financing costs and lower credit risk, leading investors to perceive lower credit risk for lower credit quality firms and therefore demand a lower premium over investment grade firms.