EU bonds favoured over swaps as hedge for European debt

Hedge funds are increasingly using the bonds to hedge Bunds and OATs as swap correlations decline

By Rebekah Tunstead

15 Nov 2024

Bonds issued by the European Commission are increasingly being used as proxy hedges to European government bonds rather than using traditional euro interest rate swaps, with correlations shifting thanks to quantitative tightening and liquidity improvements in EU debt.

Traders say the moves have been driven by falling premiums on Bunds as the European Central Bank (ECB) unwinds its bond

EU bonds favoured over swaps as hedge for European... https://www.risk.net/markets/7960387/eu-bonds-favou...

buying programme, and increased secondary market liquidity for EU bonds.

"The implication long term is that we will see a drop of EU bonds trading as a proxy to swaps, and more as a proxy to other European government bonds. So, I think you'll see a higher correlation with French government bonds and Bunds than you do with swaps. You're already starting to see this transition as of now," says Olivier Lecoutre, a sovereign, supranational and agencies trader at Natixis.

For instance, correlation of 10-year German government bonds versus the same tenor euro swaps were at nearly 0.97 at the start of July, above 0.93 for Bunds versus a 10-year EU bond issued under the Next Generation programme, according to Bloomberg data. But this had flipped in late October: by November 14, EU bonds showed 0.96 correlation with Bunds, with swaps versus Bunds at 0.93.

Bunds have long traded at a premium as the ECB was a big debt holder, reducing supply in the secondary market. But the central bank's unwinding of its position has seen a flood of paper enter the market, taking the premium off and helping them decouple from swaps prices, says a euro rates trader at one large dealer.

The trend has accelerated in recent weeks, as end-of year balance sheet issues for dealers come into view. The 10-year euro swap spread has fallen sharply since October 9, moving from 23.6 basis points to -6bp as of November 14.

At the same time, EU bonds are said to have become more liquid in the secondary market – nearly as liquid as EGBs, according to some traders. The inflows from the hedge fund community have meant "bid/offers [on EU bonds] have tightened dramatically", says the head of European government bond trading at a US bank.

According to Bloomberg data, the average seven-day rolling bid/offer spread on yields for an EU bond expiring in April 2034 was 1.39bp on July 7, which declined to as low as 0.99bp on October 17. It had retraced to 1.22bp by November 14.

Traders say that in turn, this has meant more hedge funds are acting on divergences of EU bonds versus EGBs, reinforcing their correlation and mean reversion tendencies.

Investors have been increasingly using EU bonds in basis trades against EGBs this year. Currently EU bonds are priced off the euro swap curve. While they have an AAA credit rating, the same as German Bunds, EU bonds typically trade cheaper to European government bonds.

One popular trade has seen traders go long EU bonds and short French government bonds (OATs), with a view that the country's elections in the middle of the year would create political instability. They were correct, with 10-year OAT yields going from trading 2.71bp below EU bonds on March 8 to 22.8bp above by November 14.

Another popular trade was to be long the front end of EU bonds against the front end of German bunds, on the assumption that the premium on Bunds drops away and converges toward EU bonds.

Sovereign remedy

The European Commission has been clear in its ambitions to have EU bonds treated as sovereign issuance, but the target remains elusive.

At the start of 2023, the commission implemented a unified funding approach, allowing it to issue EU bonds and collect the proceeds into a centralised funding pool to support various policy programmes. Previously, the EC had issued multiple policy-specific bonds, such as the Support to Mitigate Unemployment Risks in an Emergency bond and the Next Generation EU bonds (NGEU).

In November last year, the EC introduced a framework incentivising dealers to begin quoting prices for EU bonds on

EU bonds favoured over swaps as hedge for European... https://www.risk.net/markets/7960387/eu-bonds-favou...

electronic platforms. And in October it launched its repo facility for EU bonds.

As of October, the EC has issued €410 billion ($433 billion) of EU bonds under its unified funding approach and has a total debt outstanding of roughly €577 billion.

Traders say one thing that would improve the alignment of EU bonds with European government bonds would be the launch of a futures contract on EU bonds.

"I think the future will push further this alignment of EU bonds with other European government bonds. People are looking at OAT-Bund – they will start looking at the OAT-EU and Bund-EU," says Natixis's Lecoutre.

Eurex has previously stated it would launch an EU bond future but it has failed to materialise, telling **Reuters** on November 13 that it was waiting for the right market conditions to launch the contract.

Ice announced on November 8 that it will launch a long EU bond index futures contract based on its 8-13 year European Union bond index on December 9.

Others say more involvement by hedge fund players in trading of EU bonds is needed to push the issuer towards true sovereign status.

"Whenever a specific sector in, let's say Belgium, gets out of line, is too expensive or too cheap, I will see several hedge funds come in and take the other side of the trade looking for a mean reversion correction. That kind of flow is not happening in the EU," says the euro rates trader at the large bank.

"And I think for the EU bond market to evolve to the next step, you need those relative value accounts to provide liquidity in the issue and to limit the volatility in specific sectors of the curve," he says.

But uncertainty around what will happen after the NGEU programme comes to an end in 2026 is a major hurdle.

"So, no new issuance coming into the market – the issuance volume is going to drop dramatically after 2026 unless there's some continued common issuance by the EU name going forward," says the euro rates trader.

"We're effectively facing a cliff edge in two years' time," he says.

Editing by Lukas Becker
