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Euro Swap Spread Tectonics?

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The source for all data in this report is Candriam, unless otherwise noted.

Executive Summary.

Using Euro Swap Spreads to Optimize Allocation in Aggregate Fixed Income Portfolios

The spread of a corporate bond over its reference (eg, German Bund), often thought of as the credit spread, can include elements other than just the difference in credit risk. In the euro markets, this spread notably incorporates an element relating to the price of swapping fixed rates for floating rates: the euro swap spread.

Since 2008, the euro swap spread has been very volatile, while more recently, it has tightened dramatically. This volatility affects the optimal allocation among sovereign, quasi-sovereign, and corporate debt in managing aggregate bond portfolios. Affected by domestic (regional) factors as well as global ones, duration, credit risk, etc, the swap spread is sufficiently volatile to deserve much more analysis and attention than it usually receives from investors.

Changes in swap spread levels should prompt investment managers to reassess portfolio risk and asset allocation. In response, they may adjust their allocation among fixed income asset classes. On average, more than 30% of the yield spread over German government bonds arises from the swap spread for euro-denominated investment-grade corporate bonds, increasing to more than 70% for euro-denominated quasi-national bonds.[1] Understanding the drivers of the swap spread has been key to the performance of aggregate bond portfolios.

Based on the historical analysis, we conclude that the euro swap spread has likely entered a new regime with much lower - or even negative - spread levels than in the past, similar to that in the US markets following the Global Financial Crisis. This move mainly reflects the concerns about rising supply and less demand for safe haven government bonds, as fiscal deficits increase and central banks have shifted from quantitative easing (QE) to quantitative tightening (QT) policies to fight inflation.

The increasing role of German bunds as a global safe haven, potentially at the expense of US Treasuries, will be closely watched. This could lead euro swap spreads to widen again.

In any case, the development of **the euro swap spread is likely to remain an important valuation tool in managing euro aggregate fixed income portfolios.**

1 - During the period 2008 to 2024 month 20xx to month 20yy. Source: Own calculations based on Bank of America indices

Figure 1:

Figure 1 Euro Swap Spread Has Been Very Volatile for 20 Years

Important Factor in Managing Euro Aggregate Fixed Income Portfolios

Source: Bloomberg, as of 17/06/2025.

Introduction:

What's in the Spread?

When the Yield Spread is More than Just the Credit Spread: The Euro Swap Spread

Since the 2008 Global Financial Crisis (GFC), in Europe the spreads of corporate bonds over Bunds have included a significant and volatile element which can be attributed to the euro interest rate swap market. This 'euro swap spread' is the difference between the yield of a fixed-rate interest rate swap[2] and the yield of a benchmark bond, in this case a German government bond with a similar maturity.

In mathematical terms, the swap spread can be thought of as:
EUR Swap Spread = Yield on Fixed Rate EUR Swap - Yield on German Bond

Euro Swap Spread

The yield spread of euro-denominated corporate bonds over German government bonds includes not only the credit spread, but also a material euro swap spread. Figure 2 shows the proportion of the yield spread over German government bonds for euro-denominated investment-grade corporate bonds stemming from the issuer's credit risk (dark blue) and from the euro swap spread (light blue) since 2008. The change in the total spread, as well as in the proportional contributions of swap spread and credit spread, demonstrates that both components have been quite volatile over this period.

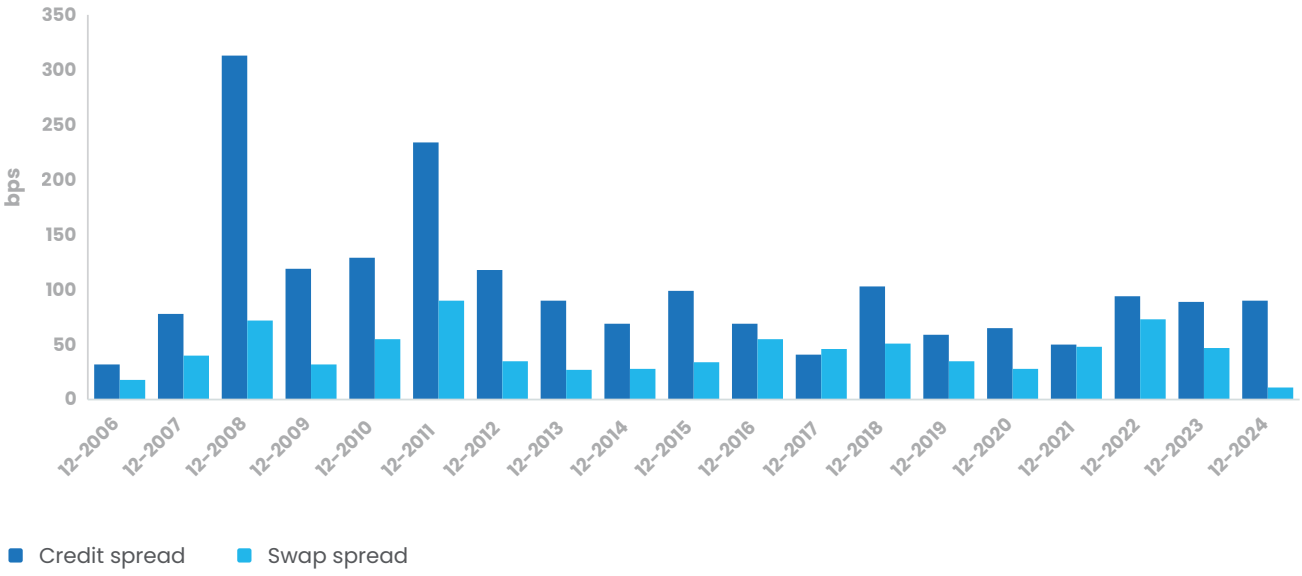
The Importance for Euro Aggregate Bond Portfolios

The relative value analysis whether to invest in investment grade (IG) corporate bonds, in German government bonds (Bunds), or other segments depends not only on the expected evolution of the creditworthiness and credit spread of the underlying issuers, but also on the expected evolution of the euro swap spread. For example, in case of an expected tightening of the swap spread, all else being equal, it makes sense to shift the allocation towards investment grade corporate bonds at the expense of sovereign bonds, and vice versa.

2 – Interest rate swaps are contracts in which counterparties agree to exchange a series of fixed rate payments for a series of floating payments linked to a benchmark rate.

Figure 2:
Euro IG Bond Historical Spreads Over Germany Decomposed

Swap Spread vs Credit Spread



Source: Candriam calculations, BofA indices

Given that the level of the euro swap spread is the same for all issuers of a particular maturity. This means that the evolution of the swap spread is much more important for quasi-governments (supranationals) and investment grade corporate bonds than for high yield corporate bonds.

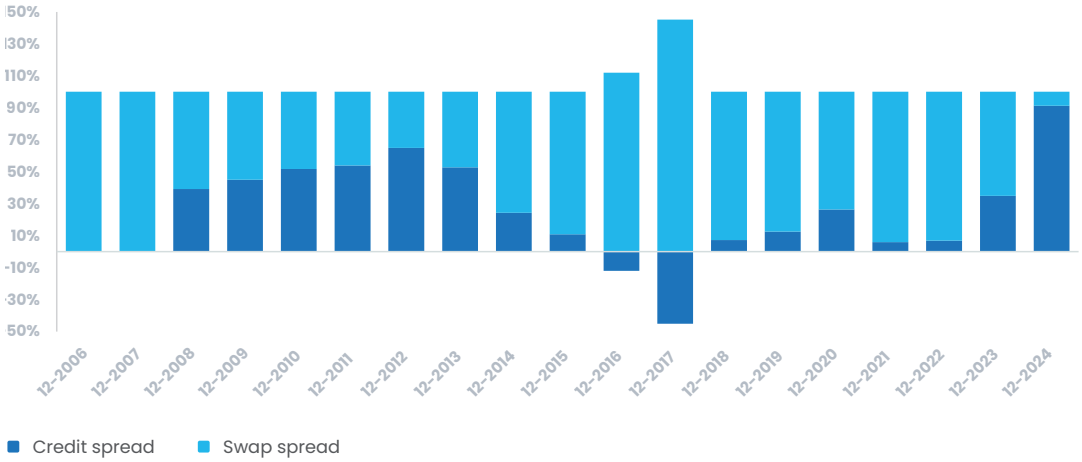
Figure 3 shows the proportion of the euro spread attributable to the issuer's credit risk versus that from the swap spread over time, for quasis, investment grade (IG) corporates, and high yield (HY) corporates. This clearly indicates that the evolution of the swap spread is much more important for the higher-rated asset classes compared to the lower-rated asset classes. Between 2008 and 2024, on average, the euro swap spread defines 70% of the total yield spread over German government bonds for quasi-government bonds. This compares to a still-substantial 30% for investment grade corporate bonds but only 10% for high yield corporate bonds.[3]

3 – For HY bonds, not only is the inverse true (that the credit spread is much larger than the swap spread), but with the credit spread for HY more volatile than for IG, the credit spread has been the greater factor in determining HY allocations in euro aggregate portfolios.

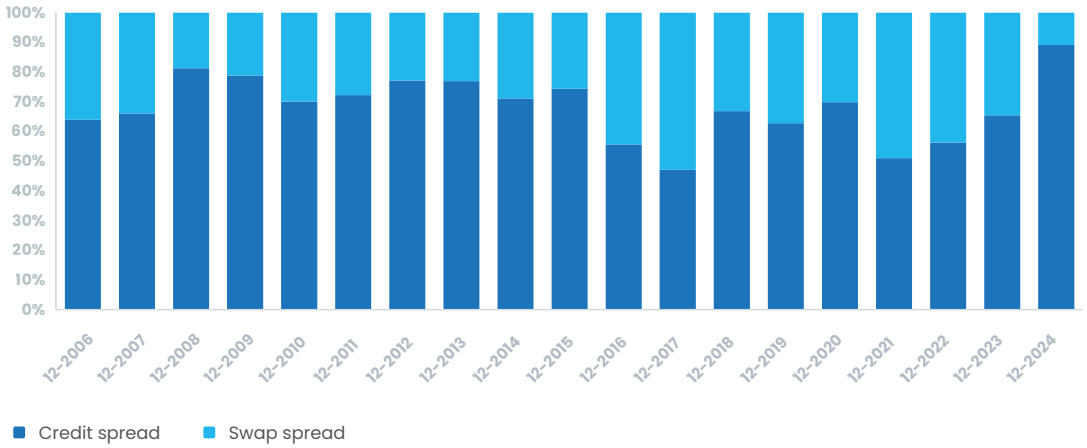
Figure 3:
Proportion of Spread Attributable to the Credit and Swap Spreads

Three Euro Fixed Income Segments

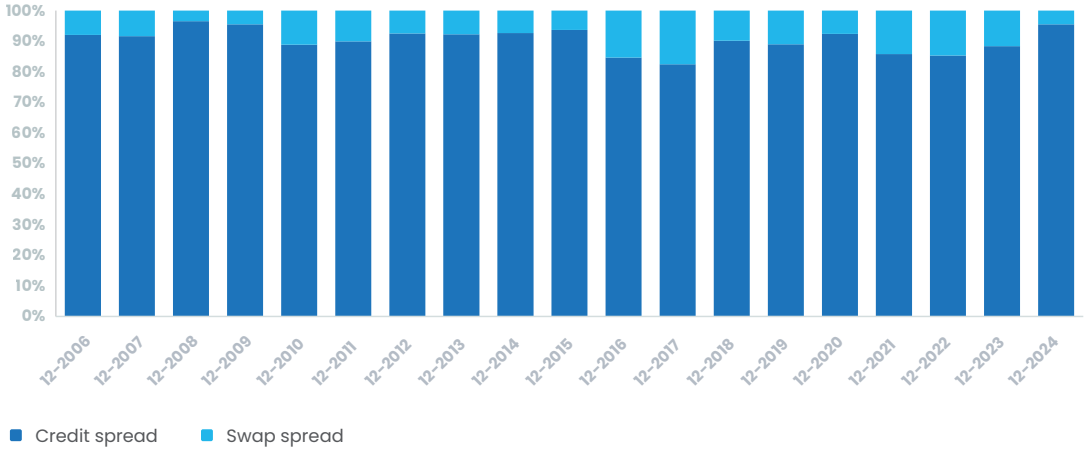
Euro Quasi-government Bonds/Supras



Euro Investment Grade Corporates



Euro High Yield Corporates



Source: Bloomberg, as of 31/12/2024

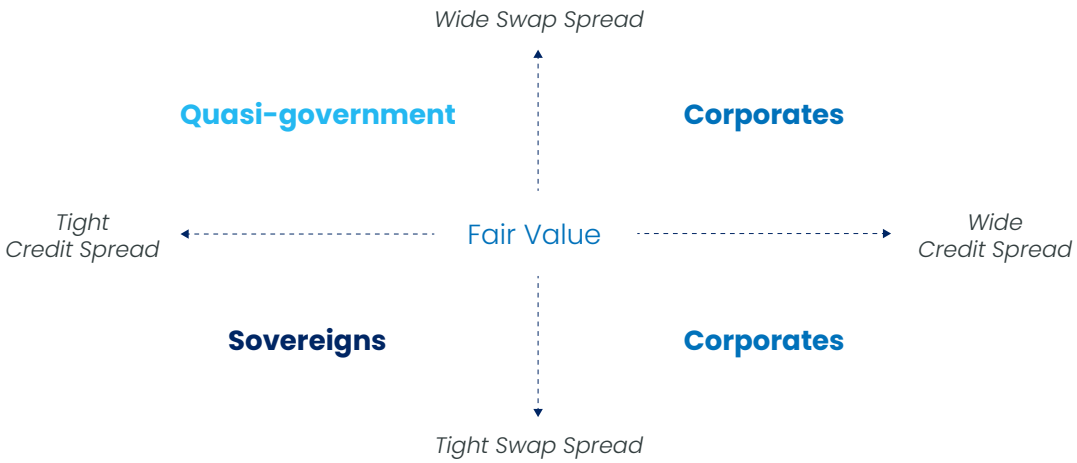
Use in Segment Allocation

Depending on the expected evolution of the swap and credit spreads, managers can reallocate among sovereign, quasis, and corporate bonds in euro aggregate bond portfolios.

As Figure 4 shows, allocations can be shifted towards sovereign bonds when the swap and credit spreads are (too) low and are expected to widen. Conversely, portfolios can benefit from overweighting quasi-government bonds when swap spreads are (too) high and credit spreads are (too) tight. In the case where credit spreads are (too) high, however, it makes sense to overweight corporate bonds, as these should benefit from a tightening of the credit spread independent of whether the swap spread is wide or tight, given that the evolution of the credit spread has been the most important driver of the total spread evolution relative to sovereign bonds.

Figure 4:
Optimised Allocation Matrix

Credit and Swap Spreads in Fixed Income Segment Allocation



Source: Candriam calculations, BofA indices

Euro Swap Spread Drivers Shift as Markets Change

The drivers of euro swap spreads reflect both market dynamics and broader macroeconomic factors. Over the last 20 years, changes in the importance of these drivers can be most easily understood by analysing three major crises which have caused the euro swap spread to widen significantly -- the Global Financial Crisis (GFC) of 2007-2008, the Euro Sovereign Debt Crisis of 2010-2012, and the Covid-19/Energy/Inflation Crisis of 2020-2022.

To envision the future of the swap spread and its usefulness in allocating among fixed income classes, we outline the main theoretical drivers of the swap spread, pages 12 and 13. In practice, these drivers vary in importance over time, depending on the market environment. We demonstrate some of these developments by analysing these three crises.

In late 2024 we began to see the opposite -- a tightening of the euro swap spread, to tight levels not seen since the GFC. In mid-2024, the euro swap spread even fell into negative territory for some maturities. We will look into the specific drivers of these moves and provide some guidance on what to expect going forward.

Euro Swap Spread Drivers Shift as Markets Change

Credit risk

- **Sovereign Credit Risk:** If the market perceives an increase in Eurozone sovereign risk, German government bond yields might decline relative to other government bonds and swap rates, widening the swap spread.

- **Bank Credit Risk**: With swap rates are partly driven by interbank lending rates (eg Euribor), worsening bank credit risk can increase swap spreads, as it raises the cost of borrowing in the interbank market. This risk has been reduced via the switch in reference rates in swaps away from Libor benchmark interest rates to so-called risk-free rates, based on €STR OIS (Euro short-term rate overnight index swap).

Interest rate expectations

- **Central Bank Policies**: Expectations about future actions by the ECB (European Central Bank), such as policy rates or quantitative easing, can significantly impact swap spreads. Expectations of rate cuts typically cause swap spreads to tighten, while expectations of rate hikes can push them wider.

- **Yield Curve Dynamics**: Changes in the Eurozone government bond yield curve, particularly the benchmark German Bunds, are closely watched by bond markets. If the yield curve steepens, swap spreads typically tighten, as steeper yield curves mostly refer to better economic growth forecasts and lower spreads**.**

Supply and demand dynamics

- **Bond Issuance and Supply**: Large-scale issuance of government bonds can put downward pressure on bond prices (upward pressure on yields), potentially narrowing swap spreads. Conversely, if there is strong demand for bonds, yields could decline, and swap spreads could widen.

- **Demand for Hedging**: Corporations and financial institutions use swaps to hedge interest rate risk. Changes in the demand for such hedges (eg, due to changes in corporate debt issuance or capital spending and corporate investment) can affect swap spreads.

Liquidity Conditions

- **Market Liquidity:** The overall liquidity in both the bond and swap markets influences spreads. During periods of high market stress or low liquidity, swap spreads can widen due to increased demand for liquidity or risk aversion.

- **Collateral Availability:** The availability of high-quality collateral, particularly German Bunds, can impact swap spreads. If Bunds become scarce their yield might fall, causing swap spreads to widen.

Regulatory and structural factors

- **Regulatory Changes:** Regulations affecting bank capital and liquidity requirements can influence swap spreads. Regulations that increase the cost of holding government bonds or swaps can impact demand and, consequently, spreads.

- **Clearing and Margin Requirements:** The move toward mandatory clearing of swaps and the associated margin requirements can affect the cost and demand for swaps, thereby impacting spreads. The move in the US towards benchmarks based on collateralised rates, such as the SOFR (secured overnight financing rate) has resulted in lower swap rates and thus lower swap spreads.

Economic and geopolitical events

- **Economic Data Releases:** Economic indicators, such as inflation rates, unemployment figures, and GDP growth, can influence expectations about interest rates and credit risk, thereby impacting swap spreads.

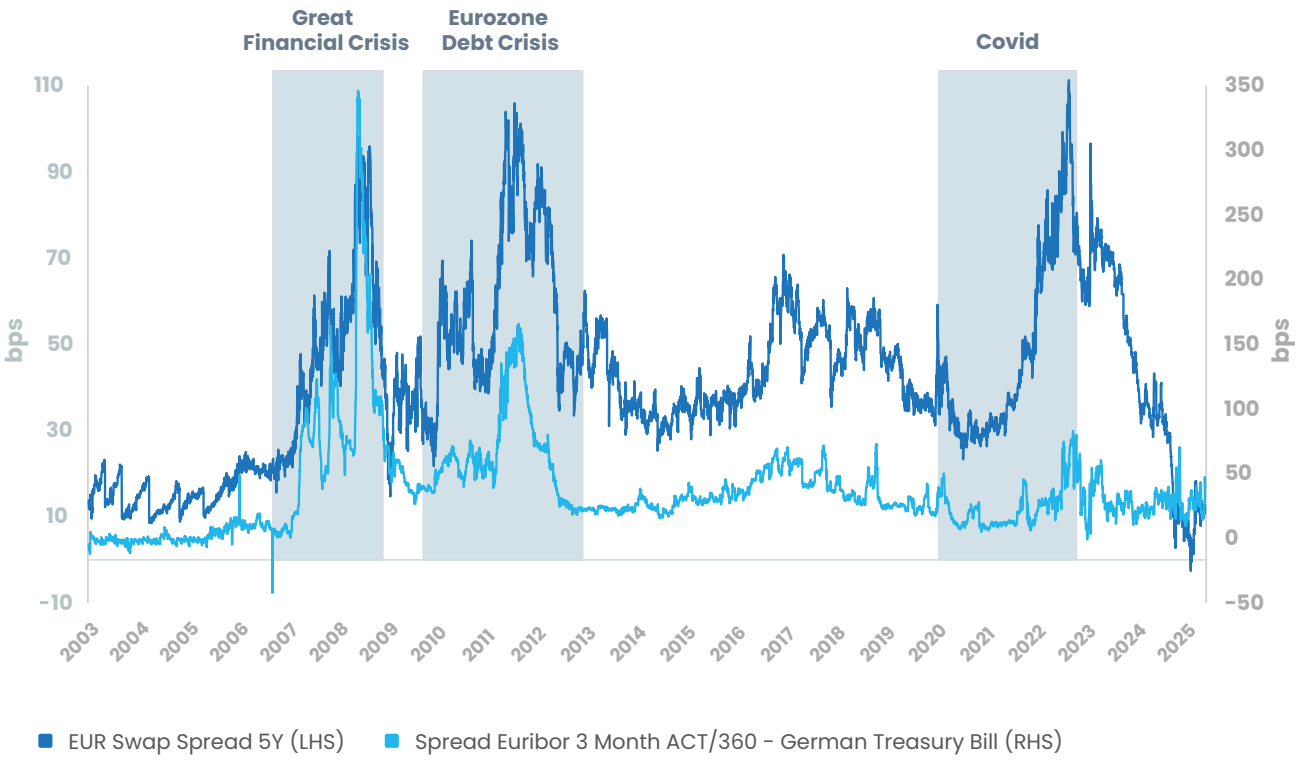
- **Geopolitical Uncertainty**: Political instability, trade disputes, or geopolitical developments can increase risk aversion, affecting bond yields and swap spreads.

At Candriam, we consider 4 key drivers for Euro Swap Spreads, Banking Sector Credit Risk, Sovereign Credit Risk, German Yield Curve and Supply and Demand Dynamics for Sovereign bonds. We will explain how these drivers have driven the Euro Swap Spread during the last three major crises, the Global Financial Crisis, the Euro Sovereign Debt Crisis, Covid-19/Energy/Inflation Crisis.

Banking Sector Credit Risk: During the Global Financial Crisis and the Euro Sovereign Debt Crisis, the widening of the euro swap spread was very closely related to the changes in both bank credit risk as well as sovereign credit risk. One of the best ways to gauge the bank credit risk, or health of the banking sector, is to measure the difference between the interest rate on Overnight Index Swap (OIS) or short-term German government bills, and the interest rate on interbank loans. This measure showed a particularly strong correlation with the swap spread during the Global Financial Crisis and the Euro Sovereign Debt Crisis. However, during the Covid-19/Energy/Inflation crisis – which of course was not a credit crisis -- this particular indicator demonstrated more stability, yet markets witnessed huge fluctuations in the swap spread.

Figure 5:
Banking Sector Health and Swap Spread

Spread Between German Government Bills and Interbank Lending Rate

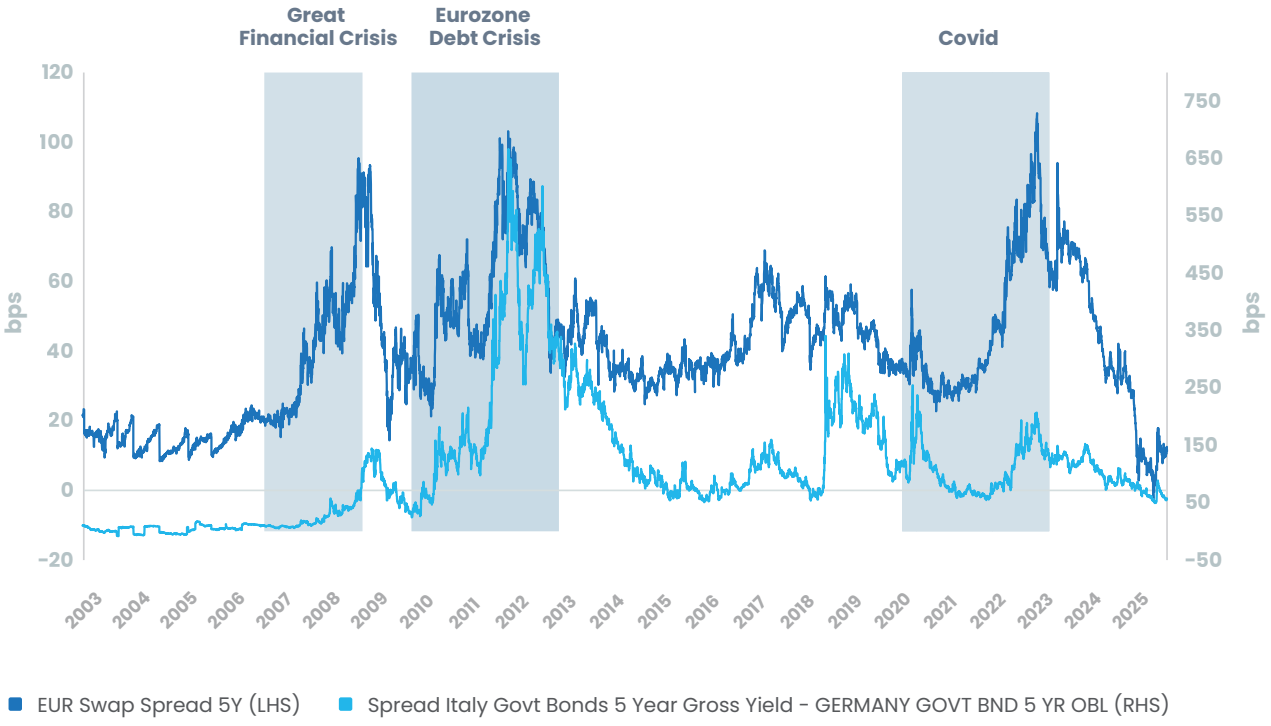


Source: Bloomberg, as of 17/06/2025

Sovereign Credit Risk: Another important driver of the euro swap spread is the sovereign credit risk, which was particularly relevant during the Euro Sovereign Debt Crisis. Although involving many peripheral countries, Italy is often seen as the best proxy to measure sovereign risk in the Euro Area, given the size of its economy and the liquidity of its debt market. The spread between the German Bund and Italian treasury, or BTP, has been a very strong indicator of this risk. This was less the case during the Global Financial Crisis or the Covid-19/Energy/Inflation crisis, when the Bund/BTP spread remained much more stable.

Figure 6:
Sovereign Credit Risk and Swap Spread

Spread Between German and Italian Bond Yields

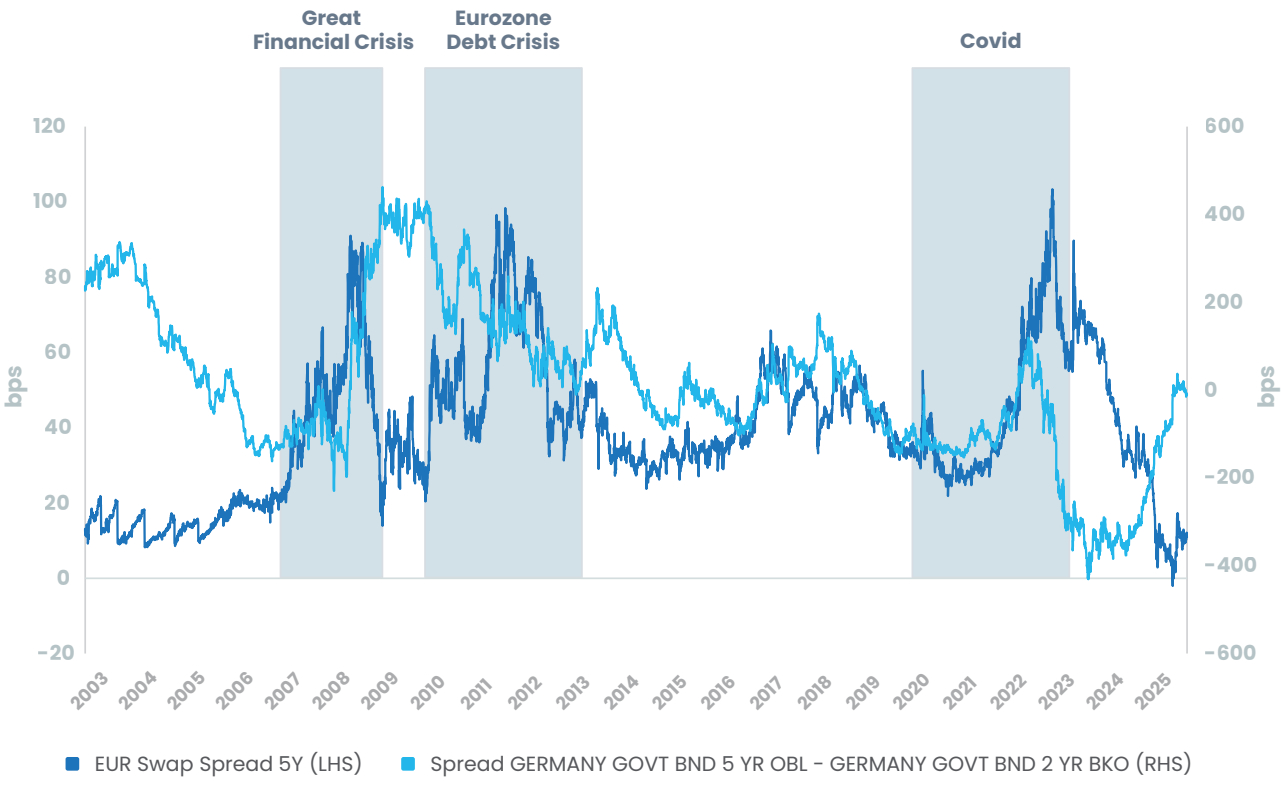


Source: Bloomberg, as of 17/06/2025

The German Yield Curve: Apart from the health of the banking and public sector, the slope of the yield curve is often seen as an important driver of the swap spread. Typically, a steep yield curve reflects a stronger growth outlook and hence, tighter swap spreads. In the period since 2008 till now, this indicator has however provided inconsistent signals. We are therefore quite cautious but nevertheless take the expectations regarding the slope of the yield curve into account when analysing the expected evolution of the swap spread.

Figure 7:
Shape of German Yield Curve and Swap Spread

Spread between German 2-year and 5-year Yields



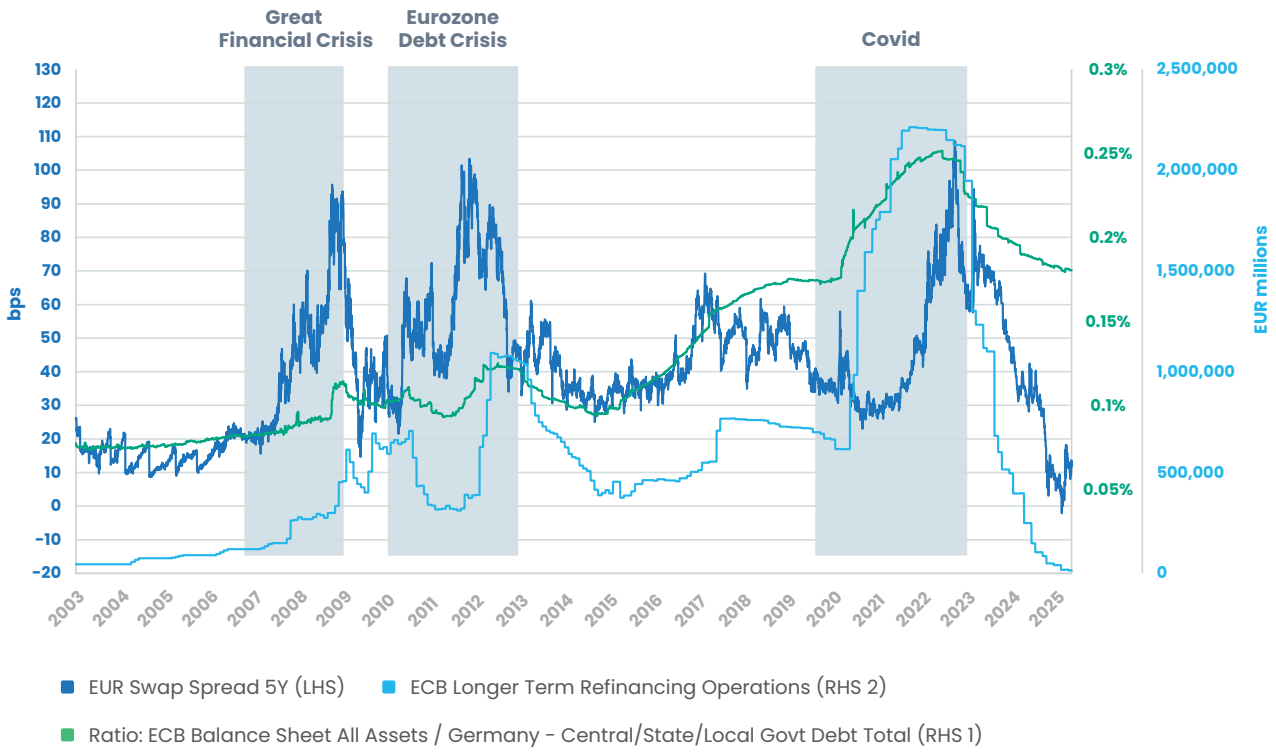
Source: Bloomberg, as of 17/06/2025

Supply and Demand Dynamics: These have gained in importance over the past years, as we may have reached a tipping point here. During the past crises, demand for safe haven bonds was increased significantly by the measures taken by the central banks, and regulators (capital requirements and definitions), to fight the crises. The ballooning of the ECB balance sheet relative to the amount of German debt outstanding resulted in a widening of the swap spread because of the increased scarcity value for German debt. This effect has been felt most strongly during the most recent Covid-19/Energy/Inflation Crisis. During this period, the faster the ECB balance sheet grew in comparison to German debt, the greater the scarcity value of German debt and the wider the swap spread.

In a similar vein, the increase and later drop in the amount outstanding in the ECB Longer Term Refinancing Operations, has first caused and later eased scarcity concerns regarding German government bonds, as these are mostly used as collateral for these operations.

Figure 8:
ECB Balance Sheet, LTRO Operations, and Swap Spread

Shown Versus Stock of Outstanding German Debt

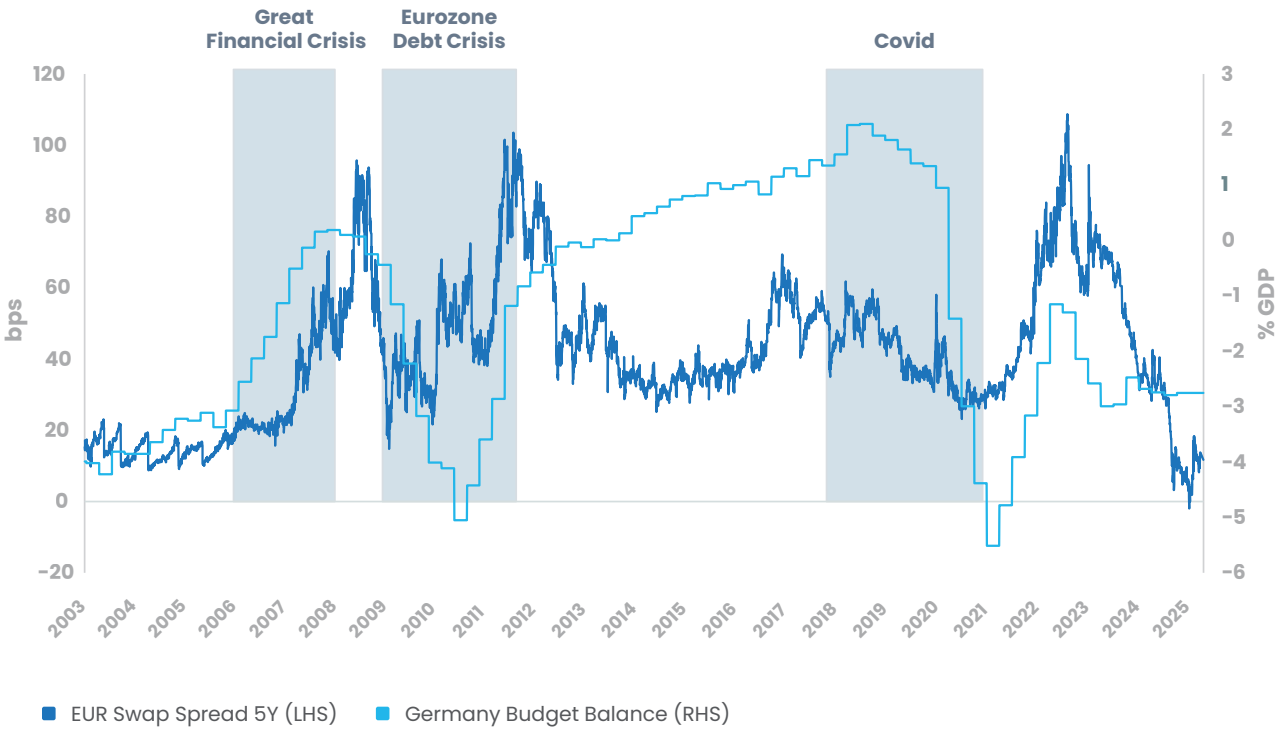


LTRO = Long-Term Refinancing Operations (quantitative easing and reversal)
Source: Bloomberg, as of 17/06/2025

In addition to the demand factor, the supply factor has also been gaining in importance recently, bringing us to Euro zone and German fiscal policy. With budget deficits increasing again, the supply of German government bonds has been larger and has contributed to a tightening of the swap spread. Indeed, the higher the supply of Bunds, the higher their yield should be relative to swaps. The relationship is therefore negative. The higher the German deficit as a percentage of GDP as a proxy for supply, the tighter the asset swap spread.

Figure 9:
Supply of Bunds and Swap Spread

German Deficit as Percent of GDP (RHS)



Source: Bloomberg, as of 17/06/2025

The Future Starts Now.

The change in the demand and supply factors impacting German government bonds can also be seen in the repo market. Indeed, to monitor the underlying scarcity or abundancy of German government bonds as collateral, we monitor the developments in the repo market. Significant changes have been taking place in 2024, suggesting that German government bonds are losing their so-called 'special' status.

There are some reasons to believe that German government bonds could be losing their 'special' status in a more structural way:

- The increased EU solidarity with the issuance of NGEU[4] bonds has both decreased the chances of a Eurozone break, and therefore put a limit on intra-EMU government bond spread movements and also the euro swap spread.

- The outperformance of the German economy compared to the rest of Eurozone may have ended with the loss of access to cheap Russian gas, the challenges in the automotive sector, and the impact of the structural slowdown in China. German budget deficits are likely to be much closer to those elsewhere in the Eurozone compared to the past, especially now that the new German government has relaxed the debt brake.

- In situations where the ECB Quantitative Easing policies contributed to the scarcity and the 'special' status of German Bunds, QT is likely to reverse this move. The euro swap spread is likely to look much more like the period before the three major crises since 2008, and more similar to the US where the swap spread has already been much lower or even in negative territory than in the euro area

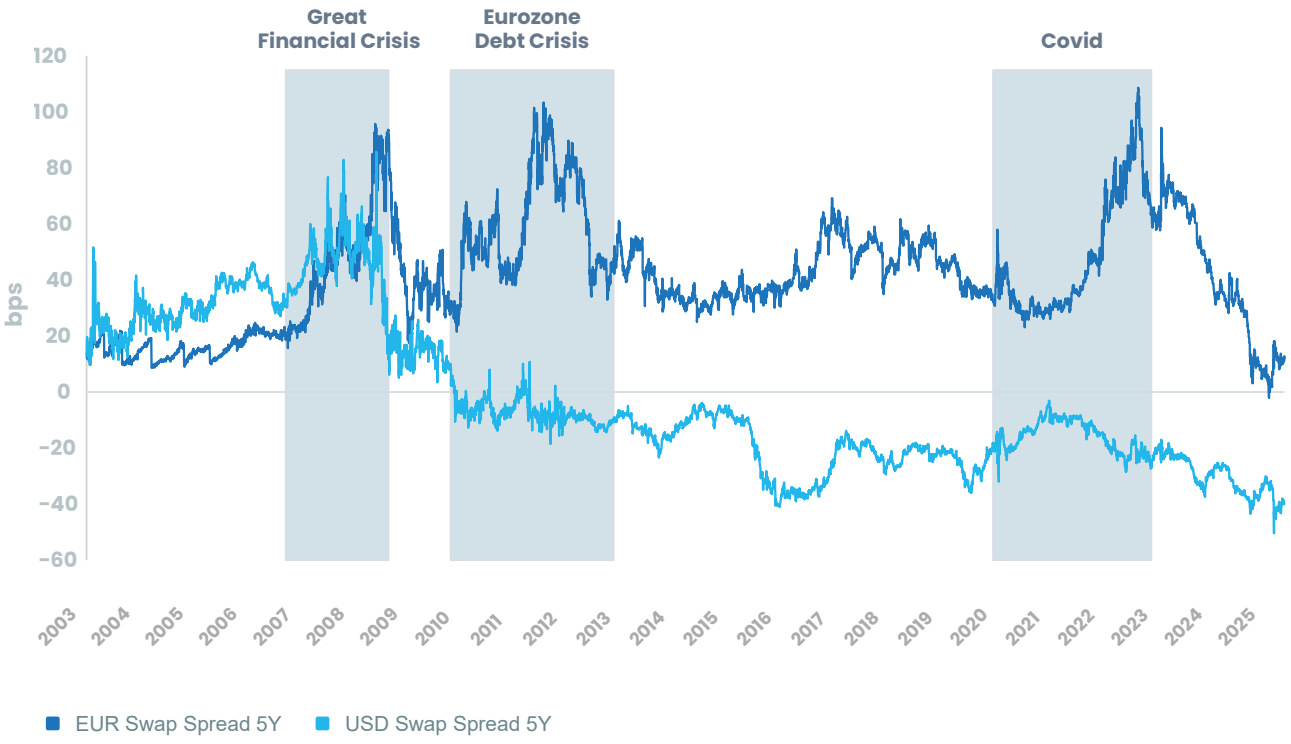
A potential counterargument may be the potential for German bonds to become safe havens in global bond portfolios. With the US losing some of its policy credibility, Bunds could attract additional interest from global investors as a hedge against market turmoil. This increased demand could lead to wider euro swap spreads than we otherwise might expect.

Finally, there are also technical reasons for structural lower or even negative swap spreads. This is mainly related to the shift in reference rates in swaps away from Libor benchmark interest rates to so-called risk-free rates. In the US, the reference rate has been moved towards SOFR and in the euro zone to €STR. Before the switch away from Libor, the swap rate was the fair price at inception of a series of expected future rates that embodied credit risk. Now that swap contracts are referenced to (nearly) risk-free rates in the floating leg, the swap rate itself is lower, which means that swap spreads also will be lower or even more negative. The above-mentioned developments will probably lead to a further convergence of the euro and US swap spreads at lower or even negative levels.

4 – Next Generation EU, since 2021.

Figure 10:
Euro Swap Spread versus US Swap Spread

Converging Again Towards Lower Levels?



Source: Bloomberg, as of 17/06/2025

Going forward, it will remain important to monitor the developments in the swap spread in different regions to see whether it are mainly global or domestic factors that are driving the swap spreads. Similar movements in the swap spread may point to global factors, such as the banking sector health during the Global Financial Crisis, while more idiosyncratic moves point to dominating domestic factors.

Conclusion

From History to Horizon

Since 2008, the euro swap spread has been very volatile driven by very different factors, such as bank credit risk, sovereign credit risk, ECB monetary policies as well as fiscal policies.

A good understanding of the swap spread is essential in managing aggregate bond portfolios, where the evolution of the swap spread can have a major impact on the optimal allocation between Sovereign, Quasi-sovereign and corporate bonds (particularly for the Quasi-sovereign/Sub-sovereign segments). For example, in case of an expected tightening of the swap spread, it makes sense to shift the allocation towards quasi-sovereign and/or corporate bonds at the expense of sovereign bonds. In this paper, we looked at the different factors driving the euro swap spread and how these have been impacting the swap spread during the recent crises. This has shown that every crisis can be very different in nature and that different factors need to be monitored closely.

Recent developments suggest that we may be entering a new regime with the euro swap spread returning to its pre-GFC levels, similar to the US. The supply of safe haven euro government bonds is increasing due to expansive fiscal policies, while demand is shrinking as central banks having shifted from QE to QT policies to fight inflation.

The potential role of German bonds as a safe haven at the expense of US Treasuries will need close monitoring, as it could lead to a re-widening of euro swap spreads.

The crises and factors we have analysed will help us to confront future crises with higher conviction, and to better integrate the developments in the euro swap market into the allocation decision and management of our aggregate bond portfolios.

€155 Bn

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