Flight to liquidity pushes eurozone bond yields apart

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By Joanna Chung
Published: February 27 2008 02:00 | Last updated: February 27 2008 02:00

For almost a decade, yields on bonds issued by different governments in the eurozone have moved closer together. Investors who bet on the story of continued convergence profited handsomely.

But that trend has reversed in recent months. As the credit global crisis gathered in intensity last year, yields started to diverge. Investors became more selective, and started demanding higher rates for some government debt.

Now, spreads diverge more widely than they have done since the creation of the euro nearly a decade ago, with Germany at the top of the pecking order and Italy and Greece at the bottom. Even bonds issued by AAA-rated countries such as France and Spain are being shunned - relatively speaking - by investors.

For example, the risk premium of 10-year Italian government bonds has risen 12 basis points to 43bp over comparable German Bunds since the beginning of the year, while that of 10-year Greek government bonds rose 14bp to 44.5bp over Bunds. Meanwhile, the spread of Spanish 10-year bonds over Bunds has added 8bp during the same period.

The phenomenon highlights the degree to which the global credit turmoil is causing strains in markets that are traditionally seen as safe, and raises questions over how long spreads will continue to widen.

"The unfolding credit crunch is a catalyst, but spreads between Europe's sovereigns [have been] set to widen for the past few years," says Louis-Vincent Gave, who runs GaveKal, a money management and research firm based in Hong Kong.

"Why should Italy borrow at the same rate as Germany. Why should Greece borrow at the same rate as Ireland? That shouldn't happen." In other words, he says, investors should be demanding higher premiums for bonds from governments that are seen as fiscally lax, such as Italy and Greece.

Mr Gave says one reason why rates converged in recent years was the fairly indiscriminate buying of eurozone government debt by central banks and other sovereign entities in Asia and elsewhere as they rebalanced their reserves away from dollars.

Now these governments have indicated that they have enough bonds and are looking at other investment targets, in part through sovereign wealth funds, he says. So the fundamental differences among eurozone issuers have begun to reassert themselves.

Together with Corriente Capital, which reaped millions from correctly calling the fallout in the US subprime market, GaveKal launched its European Divergence Fund in November. The fund, which closed to new investors after raising $450m, rose 20 per cent between November and end January, says Mr Gave, who expects divergence in the eurozone to continue.

But the causes of the divergence are many, experts say. One reason for the spread widening is the existence of a liquid futures market in Germany, which traders use to hedge investments and which has created a natural demand for German Bunds over other eurozone debt, particularly during recent months of market uncertainty.

"The high volatility and uncertainty in the market is prompting investors to cover their exposures," says one French debt management official. "The Bund futures contract is the most liquid debt instrument in Europe and that is causing a natural demand for Bunds on the cash side."

The so-called liquidity premium has become just as important as credit risk premium in setting the spread between the most popular and least popular European government bonds.

"It is more a liquidity story than a credit story," says Erik Wilders, head of the Dutch State Treasury Agency. "Germany is the biggest and most liquid market, and that is what investors want right now."

Meanwhile, some countries, including Belgium and Italy, have suffered political uncertainty, while other specific factors, such as housing market worries in Spain, have also affected sentiment for particular bonds.

But Stan Malek, analyst at Bank of America, says "there is no reason why countries like Austria should trade 10bp over Germany or why Belgium should trade about 20bp over Germany".

"We are in a very, very risk-averse mode," he says. "The consensus belief is that spreads will stay elevated for some time but if there is a positive event for bonds, like a rate cut, yields could converge again."

Ciaran O'Hagan, head of Paris fixed income strategy, at Société Générale, says: "Many investors are asking if Italy and Greece are seriously sick, or if the recent asset price moves are just driven by global risk aversion."

"The answer for us is firmly the latter . . . both Greece and Italy will be around in 30 years' time and will probably be much more prosperous than what is reflected in today's repricing of sovereign risk."

But movements in credit default swaps markets indicate investors' perception of risk is rising. For example, the five-year CDS on Greek sovereign debt has risen 28.8 per cent to 56.7 basis points in the past month, according to Markit prices. That means it costs investors €56,700 annually to protect €10m worth of debt against default over a five-year period.

"It is a difficult environment in which to put on a contrarian trade because there is so much risk aversion right now," says Sean Maloney, strategist at Nomura International.

Mr Wilders of the DSTA says: "It took a while for spreads to converge after the euro was launched, and it might take a few years for them to reconverge because a lot of people got burnt in the last few months. Basically the question is, how long will it take people to forget?"