# Global Markets Daily: Sovereign Spreads Can Stay Tight (Freycenet)

- The recent tightening in sovereign spreads has attracted a lot of client attention, and with it, a healthy scepticism that such valuations can be justified.
- While we agree there is limited room for further spread compression, we are also less concerned about imminent widening risk. We argue that the combination of good performance of credit assets globally, resilient growth, and generally declining interest rates volatility should be a powerful anchor for sovereign spreads.
- On our macro valuation signal, Bonos and OATs screen broadly fair against Bunds, and BTPs slightly rich. Taking this into account, and embedding further macro-economic convergence between parts of Southern Europe and the semi core, we revise our end-24 10y BTP-Bund, Bonos-bund, and OAT-bund spread forecasts to 150bp, 75bp, and 50bp, respectively (from 175bp, 80bp, and 55bp before).

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## Sovereign Spreads Can Stay Tight

The recent tightening in sovereign spreads has attracted a lot of client attention, and with it, a healthy scepticism that such valuations can be justified. In ***today's GMD***, we place sovereign credit price action within broader market dynamics and update our views going forward. In short, we think the recent tightening can broadly hold even as we're not enthusiastic about the fundamental picture across countries.

Three factors are important when considering the sovereign spread tightening so far. First, it fits well into a broader market landscape that has generally seen a solid performance of risk assets, brought on by the relaxation of the inflation constraint globally. This is also true within the credit asset class where spread tightening has been very broad-based, and increasing with credit risk, as we show in Exhibit 1. Second, while the supply of fixed income securities has been close to record levels globally, demand has managed to keep pace. We emphasised this earlier this year, and so have our corporate and EM credit colleagues. Third, within the Euro area sovereign bond markets, tightening against Bund has occurred from both legs. Indeed, as the free-float of German debt increased from historical lows, Bunds have also cheapened meaningfully against swaps (Exhibit 2), compounding the tightening of periphery spreads.

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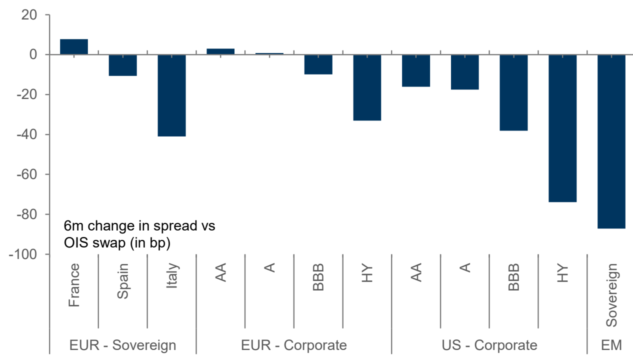
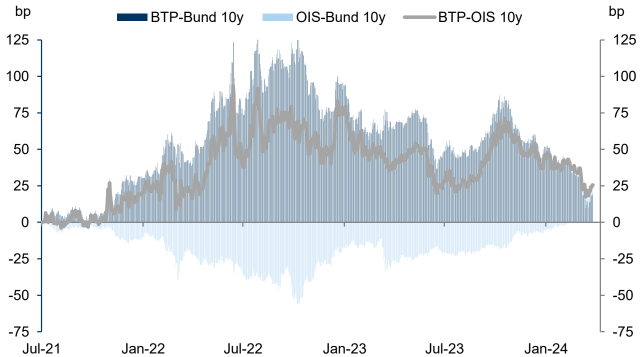
**Exhibit 1: The recent spread tightening in BTP-bund fits into a broader pattern of solid credit performance...**




Source: Haver Analytics, Markit, Goldman Sachs Global Investment Research

**Exhibit 2: ... and is due in no small part due to Bund cheapening against swap**




Source: Goldman Sachs Global Investment Research, Goldman Sachs

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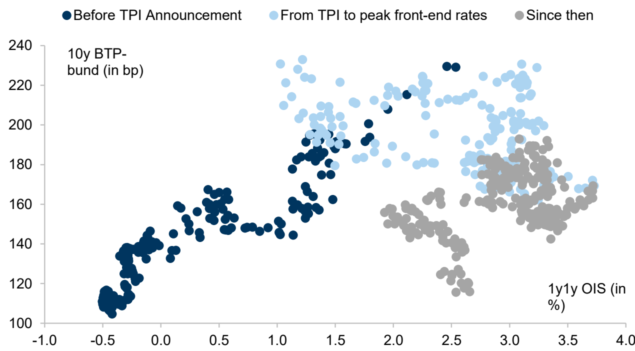
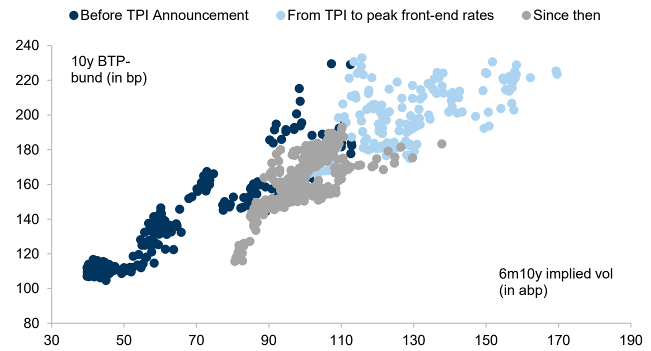
Can this tightening hold? One aspect of price action that has garnered particular attention is that sovereign spreads have remained resilient even as central bank cuts have been pared back meaningfully since the start of the year, in Europe and globally. On this front, it is important to recall that while cut pricing has diminished in part due to upside surprises to inflation, less pessimism on growth has also played a role, leaving the net effect on risk assets *a priori* ambiguous. To be sure, elevated policy and core rates are *all else equal* negative for sovereign credit, insofar as they would push up all-round funding costs. But while markets have revised their expectations vis-à-vis the speed of ECB cuts since the start of the year, neutral rate views (proxied by 5y5y OIS) rates have remained largely unchanged in the Euro area. Analysing the patterns of BTP-Bund widening and tightening in this cycle (see Exhibit 3 and Exhibit 4), we find that core rates *volatility* rather than *level* has been the most reliable guide to price action in sovereign credit. Crucially, we think that the trend lower in rates volatility can extend, even as some questions in European rates - such as the pace of ECB cuts (i.e. meeting-by-meeting or quarterly) - remain unsettled. This is because we see the data process itself as low-vol. On the one hand, accumulating evidence should assuage the residual ECB concerns about profits and wages dynamics and confirm the shift towards rate cuts. On the other, the tentative rebound in manufacturing mitigates downside risk to euro area activity, and lowers the odds of seeing large moves in policy rates.

**Exhibit 3: The level of near-term expectations for ECB policy rate has not been a reliable guide to sovereign credit pricing...**




Source: Goldman Sachs, Goldman Sachs Global Investment Research

**Exhibit 4: ... in contrast to interest rates volatility**

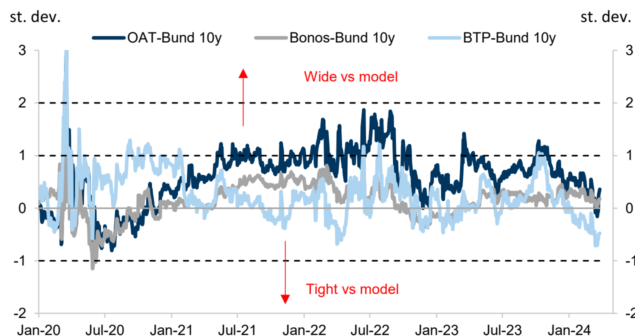



Source: Goldman Sachs, Goldman Sachs Global Investment Research

We can also investigate sovereign spreads pricing more formally. To do so, we rely on our valuation framework, which benchmarks sovereign spreads on: macro fundamentals, ECB policy, and global and euro-area specific credit risk appetite (see here for more details). As we show in Exhibit 5, this exercise suggests that while spreads have indeed tightened against fair values, price action has not been obviously excessive. OAT and Bonos screen fair, whereas BTPs are 5-10bps richer than our valuation signal implies.

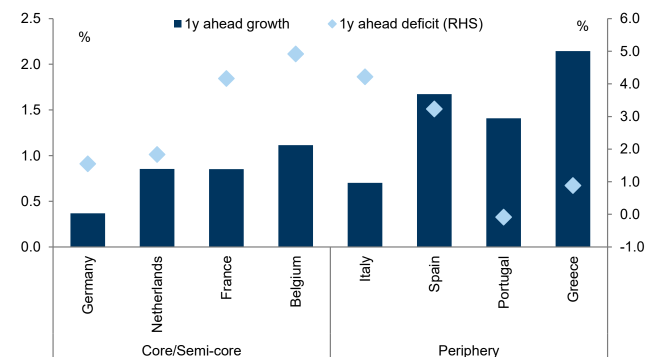
We think the upside to sovereign credit is limited at this juncture, and are not looking for further (broad-based) tightening from here. This echoes the analysis of our asset allocation team showing that in late-cycle type of environments credit generally has asymmetric risk reward. But as per the above, current valuations are not at odds with our macro baseline, and thus can be expected to broadly hold in our mind, especially if interest rates vol continues to settle lower. This view is also supported by the muted reaction to recent fiscal news out of Italy and France, where 2023 deficits were revised up, and which points to a high hurdle for sharp spread widening in the near-term.

**Exhibit 5: Sovereign spreads have richened against macro fair values but don't screen as excessively tight**




Source: Goldman Sachs, Goldman Sachs Global Investment Research

**Exhibit 6: There is scope for convergence between the semi-core and parts of southern Europe**




Source: European Commission, Haver Analytics, Goldman Sachs Global Investment Research, Consensus Economics

The above does not preclude a modest widening within the European sovereign

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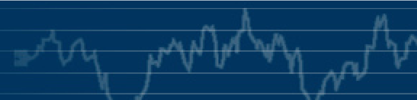
complex, however. In particular, as we have highlighted previously, there has been a significant economic convergence between good performers of southern Europe (e.g. Spain and Portugal), and the relatively poor performers of the semi-core space (France and Belgium) – see Exhibit 6. Portuguese and Greek bond yields have declined meaningfully on the back of that economic trend, Bonos not so much. We continue to think conditions are in place for Bonos to outperform, especially against the semi-core.

Taking into account the above, we revise our end-24 10y BTP-Bund, Bonos-bund, and OAT-bund spread forecasts to 150bp, 75bp, and 50bp, respectively (from 175bp, 80bp, and 55bp before).

# TRADE IDEAS



### Best Trade Ideas Across Assets

For pricing, charts, and a list of previous recommendations, please visit our Trade Ideas page.

1. Receive SGD 2Y SORA OIS vs. pay a basket of global 2Y rates, opened on April 14, 2023, at -8bp, with a target of -100bp, and a stop of 40bp, currently trading at 8bp.
2. Stay long 1y CGB, FX hedged, opened on November 10, 2023, at 2.25%, with a revised target of 1.65%, and a revised stop of 2.10%, currently trading at 1.74%.
3. Stay long USD bonds of revised group of distressed credits (Argentina, Ecuador, Egypt, Ghana, and Pakistan), opened on December 4, 2023, at 0%, with a revised target of 30%, and a revised stop of 20%, currently trading at 28.24%.
4. Stay long FX-unhedged 3Y MBONOs, opened on December 14, 2023, at 9.35%, with a target of 8.70%, and a stop of 9.80%, currently trading at 9.56%.
5. Stay long FX-unhedged 10Y INDOGBs, opened on December 14, 2023, at 6.62%, with a target of 6.00%, and a stop of 7.00%, currently trading at 6.64%.
6. Stay long THB 3Y bonds vs. paying 3Y THOR swaps, opened on January 10, 2024, at -20bp, with a target of 30bp, and a stop of -60bp, currently trading at -11bp.
7. Stay short EUR/INR, opened on January 12, 2024, at 90.91, with a target of 88, and a stop of 93, currently trading at 89.873.
8. Stay short 30y UST vs OIS, opened on January 12, 2024, at -0.75, with a target of -0.87, and a stop of -0.68, currently trading at -0.77.
9. Stay short 95.75/96.25 SFRZ4 strangle, opened on January 19, 2024, at 69bp, with a target of 40bp, and a revised stop of 90bp, currently trading at 67bp.
10. Stay long PLN/CZK, opened on January 19, 2024, at 5.69, with a revised target of 5.95, and a revised stop of 5.73, currently trading at 5.89.
11. Stay long a basket of Pemex 1–3-year maturity bonds, opened on January 25, 2024, at 0%, with a total return target of 10%, and a stop of -5%, currently trading at 1.53% (Fabius).
12. 5s30s JGB flatteners, opened on February 2, 2024, at 1.47, with a target of 1.20, and

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a stop of 1.60, currently trading at 1.47.

13. Stay long SFIZ4, opened on February 9, 2024, at 4.40%, with a target of 3.75%, and a stop of 4.65%, currently trading at 4.40%.
14. Sell USD 3m 2y2y midcurve straddle, in bp of notional, opened on February 9, 2024, at 0bp, with a revised trailing end-of-day pnl stop of -10bp, currently trading at 33bp.
15. RBA June-24 vs June-25 OIS flattener, opened on February 9, 2024, at -0.51, with a target of -0.90, and a stop of -0.40, currently trading -0.65.
16. Stay long 2y2y SOFR/UST swap spreads, opened on February 16, 2024, at -0.38, with a target of -0.20, and a stop of -0.46, currently trading at -0.37.
17. 6m6m/3y2y CAD OIS steepener, opened on February 23, 2024, at -1.40, with a target of -1.00, and a stop of -1.65, currently trading at -1.40.
18. Stay long MSCI EM ex-China, opened on February 28, 2024, at 0%, with a target of 14%, and a revised stop of 1%, currently trading at 2.98%.
19. Stay long 2y IGBs (FX-unhedged), opened on February 29, 2024, at 7.02%, with a target of 6.50%, and a stop of 7.30%, currently trading at 7.03%.
20. Stay short USD/EGP, opened on March 8, 2024, at 0%, with a revised total return target of 8%, and a revised stop of 1%, currently trading at 5.66%.
21. Buy 3m USD/SEK 10.85 call, opened on March 15, 2024, at 10.361, with a target of 10.85, currently trading at 10.800.
22. Stay short EUR/CAD, opened on March 15, 2024, at 1.475, with a target of 1.44, and a stop of 1.49, currently trading at 1.458.
23. Stay short THB/KRW, opened on March 15, 2024, at 37.17, with a target of 34, and a stop of 39, currently trading at 36.89.
24. Stay long Brazilian private-sector companies and short Brazilian SOEs, opened on March 22, 2024, at 0%, with a target of 28% and a stop of -14%, currently trading at -5.10%.

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