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# European bonds: plus ça change…

**James Klempster, portfolio manager, Momentum Global Investment Management discusses European bonds:**

"Last week the European Central Bank (ECB) President Mario Draghi issued a dovish statement which the market greeted positively. Yet, compared to a couple of years ago, the column inches dedicated to the European Government Bond market is modest. It is clear that the stress of 2012 has dissipated, but given the continued uncertainty over the strength of the European economy and the huge levels of liquidity being used as a prop, this is a good time to reflect on the European Bond market's recent history.

"To get a measure of the markets I have looked at yield spreads amongst 10-year European sovereign bonds. When all else is equal, including currency of issue, yield spreads are the prime method for markets to express a differing view over the creditworthiness of two debtors (bond issuers). To set the scene, if we look back over the past twenty years, there are four broad phases discernible in the data. The first phase (between 1995 and 2002) can be thought of as the 'convergence' period where over time European governments increasingly came to be treated as more or less *pari passu* as a result of the establishment of the euro. The second phase (between 2003 and 2007) may be considered to be the 'euro honeymoon' where yield differentials were extremely low and there were regular instances of 10-year debt issues having a lower yield than Germany (but then Germany was yet to shake off its reputation as the 'sick man' of Europe). The third 'crisis' period (2008 to 2012) spans the global financial and the euro debt crises which blew spreads out until Mario Draghi's landmark 'whatever it takes' speech in 2012. The fourth period (2013 to date) shows anxiety dropping once more leading to the return of convergence and gradually dropping yields, but crucially, differentials in yield remaining.

"These are very different regimes and the changes of spread, even for any individual issuer, have been substantial over the period. Greece is most notable with a low of 0.08 percentage points and a high of 35.30 percentage points, but even bonds that have avoided the limelight have followed a similar path albeit less spectacularly (e.g. France, whose maximum and minimum spreads are 1.90 and -0.19 percentage points, respectively). Indeed, looking at the evolution of France's spread over German bunds over the four identified regimes, the answer to whether France's debt was viewed as fungible with Germany's would be 'no', 'yes', 'definitely not' and 'not quite' respectively.

"While spreads are back to the sorts of levels seen before the convergence trade really kicked in, there is one key differential between the returns available today compared to two decades ago, which is a function of how low the German government bond's yield is today. I have referred to 'spread' repeatedly in this article and this refers to a premium over the prevailing Bund rate. It is important to bear in mind that twenty years ago the 10-year Bund annual yield was 6.55% and today it is 0.50%, so while the spreads are normalising back to levels seen 20 years ago, prevailing total yields are a long way off.

"A final interesting observation can be made when comparing the relative ranks between these various issuers in terms of the tightness of their spreads. Optically, the rankings are relatively static: despite some inevitable noise from month to month, those debtors deemed relatively low risk compared to their peers twenty years ago are, in the main, still viewed as such today. *Plus ça change, plus c'est la même chose,* as French bond holders might say."

**Ends**

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