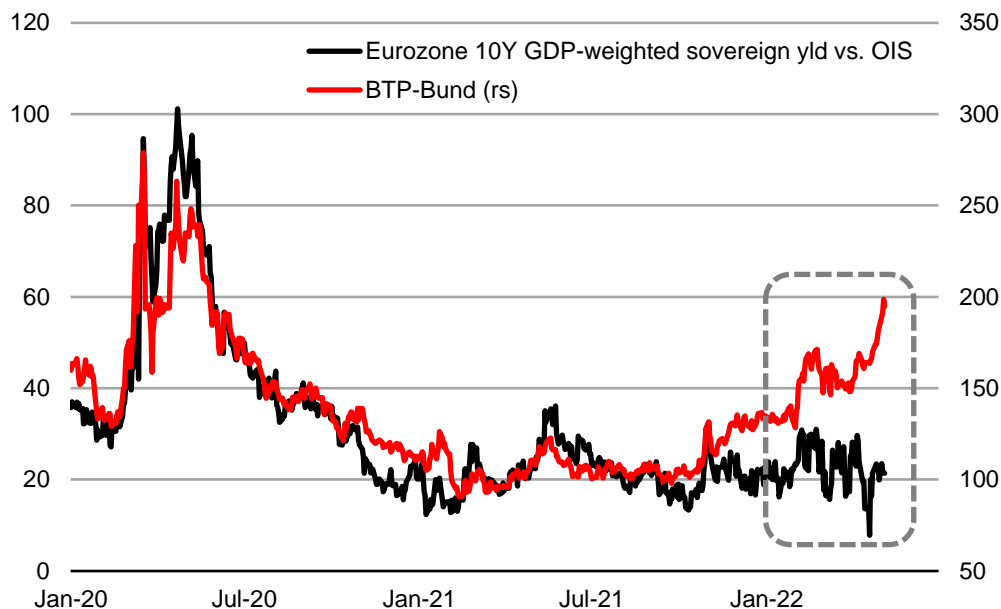


## Fragmentation or not? Yes, and the ECB should not dismiss it



Source: Bloomberg, UniCredit Research

- The spread between the GDP-weighted sovereign yields and the OIS curve has been frequently used by the ECB during the pandemic to assess the degree of market fragmentation. The PEPP was launched based on this indicator and the central bank used to monitor it closely. As our chart shows, the GDP-weighted 10Y yield spread vs. OIS has moved sideways so far this year. On the surface, this suggests that everything is fine in the fragmentation camp.
- However, such an average indicator hinders a tremendous heterogeneity at the country level. In the current risk-off environment, core EGBs have outperformed OIS, while traditional high-beta issuers (Italy for example) have widened versus OIS. This is reflected in a meaningful widening in the BTP-Bund spread, which has approached 200bp at the 10Y. Notably, BTP underperformance does not seem to be related to idiosyncratic issues (higher deficit or political uncertainty), as in past episodes, but mainly to the effect of a less supportive monetary-policy stance at a time when the Russia-Ukraine conflict is weighing on growth prospects.
- Widening in spreads to Bunds should be a flashing signal for the ECB because it is a stark reminder that sovereigns, banks and corporates in various jurisdictions are facing increasingly different funding costs. A one-size-fits-all approach is not appropriate in the current environment, and the ECB should not dismiss the latest developments in fragmentation.
- We are probably in for some more volatility in BTPs in the short term. First, the ECB may take some complacency from the fact that BTP widening versus OIS has been more limited than versus Bunds. Secondly, the ECB may be reluctant to abandon the gauge of fragmentation it endorsed during the pandemic. Lastly, the ECB is likely to be in a difficult position because sovereign risk repricing is not widespread, which would be a straightforward reason for intervening, but focused on a small subset of countries.

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