# EU bonds and Bunds...mirror, mirror on the wall, who is the safest of them all?

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- EU bonds will become an important new component of the European sovereign market. In principle, they will establish the much desired common euro-denominated safe asset with a "political joint and several" structure.
- In reality, however, compared with the strongest eurozone sovereigns, their pricing will reflect two aspects: liquidity and the perception of the political strength of the EU project. As the EU budget is ultimately guaranteed by the member states, EU bonds should not trade tighter than its strongest member.
- The outperformance of EU bonds versus Bunds since the first SURE transaction reflects expectations that these assets will gain prominence and their liquidity will improve, making them more similar to sovereigns. We expect further tightening as a result.
- At current yield levels, we prefer EU bonds to small and medium-sized sovereigns. At the extra-long end, we regard EU bonds as expensive versus Bunds and prefer OATs, which offer a considerable yield pickup.
- The strong secondary-market performance of the EU SURE transactions was spread-supportive for other European supranationals. We expect EU bonds to trade more expensive than other E-Names.

## EU bonds: a growing pool of safe assets

The announcement of NGEU and the SURE plan in late May created significant expectations that EU bonds would challenge Bunds and become a new reference for risk-free rates in the euro area over time, establishing the much desired common euro-denominated safe asset.

This was reflected in good performance of EU bonds, which tightened from around 45bp over Bunds in April to the 30-35bp area by the end of May. Since the very successful launch of the first SURE-related transaction in October, EU bonds have further outperformed Bunds, with their 10Y yield spread now at just 18bp. The 5Y is trading even tighter; EU Nov25 is trading just 11bp over Bunds (compared to 45bp in April).

Should further tightening be expected? To answer this question, we consider that the pricing of EU bonds relative to Bunds reflects mainly two aspects: liquidity and the perception of political strength in the EU project.

Bunds will continue to enjoy better liquidity for some time, but there are reasons to expect this gap will shrink. As a result, the liquidity premium of EU bonds should tighten going forward.

Two key aspects are **1.** how fast the market grows and **2.** whether EU funding moves from being temporary to being more structural. This would make EU bonds more directly comparable to sovereigns and would encourage central banks and other foreign officials to hold them.

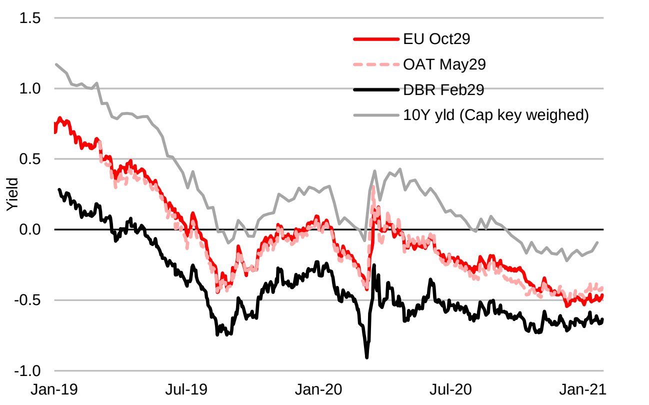
In this respect, we expect further tightening of the EU-Bund spread, with EU bonds possibly trading at the same level as Dutch government bonds.

At the same time, as the EU budget is ultimately guaranteed (not just legally but also politically) by the member states, EU bonds should not trade tighter than its strongest member. Hence we see Bund yields as a lower bound.

## Are EU bonds safer than Bunds?

EU bonds should trade with a positive premium over Bunds. Such a premium should reflect the perceived strength of political commitment to the EU project. The lower the premium, the stronger the political commitment to the EU project is perceived by the market.

**CHART 1: EU YIELDS RELATIVE TO OTHER EGBS**




Source: Bloomberg, UniCredit Research

To see why, let's leave liquidity aside for now and focus on the credit premium relative to Bunds. While EU loans are backed by the EU budget, the EU is not a sovereign and its budget ultimately comes from member states. Their political commitment to support the European project is therefore crucial. Compared to a country's willingness to honor its own debt, there is one extra layer of uncertainty that needs to be compensated by a positive risk premium.

To address the size of this spread, at least qualitatively, one needs to focus on risk scenarios and consider that, while not strictly the case from a legal perspective, guarantees to EU loans are de facto joint and several from a political standpoint.

A first risk scenario would be if one country decides to leave the EU without honouring its share of loans (unlike the UK did with the Brexit agreement). This could occur because, as the amount of loans increases going forward, there will be a higher incentive not to pay in the event of an exit.

A second risk scenario would be if a EU country becomes unable to repay the loans.

The exit/insolvency of one small country would not pose a big problem, so the relevant risk scenario for an EU bondholder would be that a group of countries (or one large country) leaves on bad terms or become insolvent and that the burden on the remaining members is great enough to become politically unpalatable.

For reference, assuming that the maximum amount of NGEU and SURE resources are disbursed (EUR 850bn), this would represent almost 15% of German and French GDP combined, a figure that would test their political commitment.

The probability of such an event occurring may be very low, but it is not zero. Taking this into account, EU bonds should not trade tighter than the lowest yield observed at the country level (Bunds). A more conservative approach is that EU yields should not be lower than the average yield of Germany and France, the two largest and safest issuers needed to preserve the EU project.

The EU credit spread to Bunds will vary over time, reflecting changing investor confidence in the EU project.

We have identified a floor for the EU bond yield. Can we also find a level beyond which the yield would be too high? The GDP-weighed yield of member countries should represent a rough indication of EU yields under a strict interpretation that loan guarantees are split proportionally across countries. EU yields should never trade above this level, especially in quiet markets.

Indeed, we think that EU yields should trade lower than the GDP-weighted average of individual countries' yields, because of the strong institutional setting that creates de facto joint and several support. It should be noted, however, that there is no explicit language that creates joint and several guarantees.

Box: EU loan guarantees

EU borrowing is a direct and unconditional obligation of the EU, which it is legally bound to service by the Treaty on the functioning of EU (Article 323).

The EU's debt service is ensured by multiple layers of debt-service protection. The debt is paid, in the first place, with loan-redemption payments received from loan beneficiaries that have always serviced their debt.

In the unlikely event of non-payment by a loan beneficiary, the EU budget guarantees that the EU will honor its obligations in a timely fashion. To this end, the European Commission can make available its cash buffer, re-prioritize budgetary expenditure and, if needed, draw on additional resources from EU member states.

The budgetary margin (difference between own-resources annual ceiling of the multi annual financial framework and the actual payment appropriations of the EU budget) serves as protection to investors by providing coverage against unexpected payment obligations.

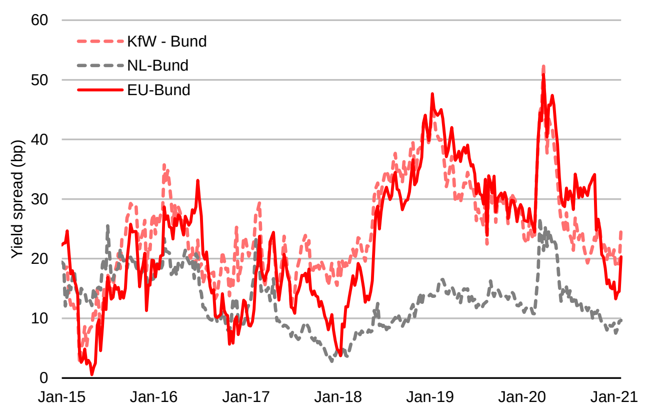
For the SURE programme, member states provide additional guarantees of EUR 25bn to protect the EU budget in times of stress, when loans cannot be repaid by member states.

## EU bonds: the liquidity premium

We now turn to the liquidity premium offered by EU bonds. Chart 2 shows the yield spread to Bunds of EU, KfW and Dutch government bonds.

These issuers have a broadly comparable credit risk: KfW bonds enjoy an explicit, direct and unconditional guarantee by the German government, and Dutch bonds are an asset with a high credit standard. They all enjoy a high rating – if anything the EU has a slightly lower rating than the other two (AAA by Fitch and Moody's while AA with a positive outlook by S&P). Hence, their yield spread to Bunds should mainly reflect differences in liquidity and the difference related to belonging to the sovereign space versus being and Agency.

**CHART 2: 10Y YIELD SPREAD VERSUS BUND**



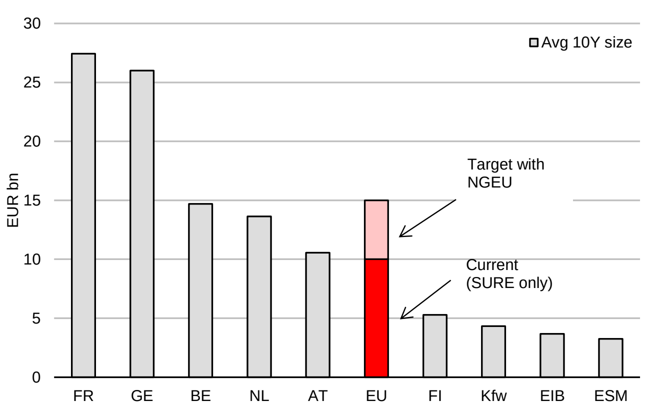

Source: Bloomberg, UniCredit Research

There are two variables that could provide an indication of liquidity: the total amount of bonds outstanding or the size of a relevant benchmark (say the 10Y). We prefer the latter because it already captures the growth of EU bonds (recent SURE bonds have a target outstanding of EUR 10bn), while the total market size (still only around EUR 100bn) would not reflect the recent developments.

EU bonds currently have a maximum target size of EUR 10bn, because of the restriction that redemptions will not exceed 10% of the maximum amount of financial assistance (EUR 100bn with respect to SURE). As Chart 3 shows, this is higher than Supras/agencies and lower than most sovereign issuers. However, once funding for NGEU begins, a higher target amount will become feasible.

With respect to EU bonds we can hence say that current liquidity is still lower than mid-size sovereigns, such as Belgium and the Netherlands, but expected to grow significantly as NGEU plan unfolds.

**CHART 3: SIZE OF 10Y BENCHMARKS AS A LIQUIDITY PROXY**




Source: Bloomberg, UniCredit Research

Taking the last three years as a reference, 10Y Dutch government bonds reach an outstanding amount of EUR 10-15bn, much higher than the EUR 3-6bn reached by KfW or EIB benchmarks. As a result, Dutch bonds should offer a relatively low liquidity premium, and this explains their tight spread.

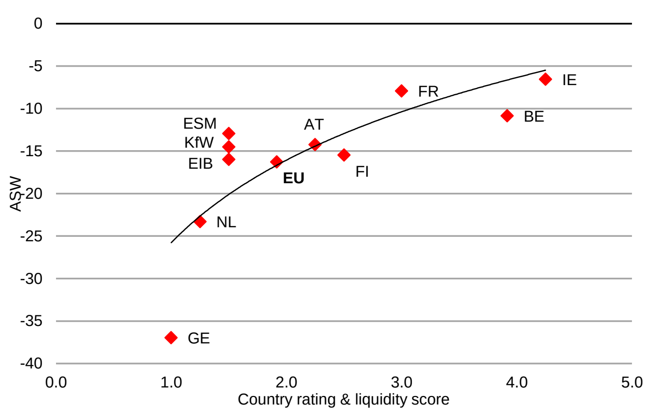
The current EU-Bund ten-year yield spread already reflects expectations that the market will grow and that EU bonds will become more prominent. Based on Chart 2 and Chart 3, we think that EU bonds have the potential for further tightening of their liquidity premium and could trade as tight as Dutch government bonds and possibly tighter, but this will require : **1.** a concrete further growth of the market size and **2.** EU funding moving from being temporary to being more structural and **3.** the setup of efficient hedging instruments, similar to what is available for Bunds

## EU bonds: modelling the spread with rating and liquidity

In this section we describe how to obtain a score for various issuers and to match it with market valuations. This can be useful to assess relative value opportunities reflected by current market levels.

We used ratings as a measure of credit quality and the size of ten-year benchmarks as a proxy for liquidity. We assign ratings a linear score so that AAA=1, AA+=2 and so forth. We also divided issuers into three liquidity classes ("low" for issuers with a target size of up to EUR 6bn, "medium" for issuers with a target size of between EUR 6bn and EUR 15bn, "high" for issuers with target size of above EUR 15bn). We then placed these two indicators into a regression model, with rating entering in logs to allow for some non-linearity. The two variables account for 85% of the observed asset-swap dispersion.

**CHART 4: RELATIVE VALUE FOR TOP RATED FIXED INCOME**




Source: Bloomberg, UniCredit Research

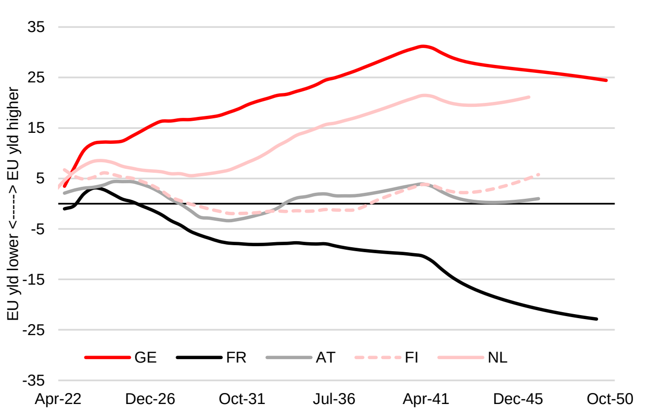
Our analysis suggests that EU bonds are currently close to fair value (1.5bp cheap). The analysis supports the idea that EU bonds have further tightening potential relative to Bunds related to an improvement in liquidity. It also indicates that a rating improvement would lead to further richening of EU bonds.

## EU: relative-value considerations along the curve

Chart 5 shows a comparison of EU bonds relative to other sovereign issuers across the maturity spectrum. EU bonds are trading very close to small / mid-sized sovereigns. We prefer EU bonds, which offer better (perspective) liquidity and a better rating. Relative to Bunds, EU bonds offer better value in the 10-20Y area. Moving towards the extra-long end, there is probably an issue of scarcity, which is reflected in the comparatively lower yield pickup offered by EU bonds relative to Bunds.

A comparison with the OATs curve is quite interesting. The relative pickup that OATs offer versus EU bonds becomes very large at the 30Y tenor, a signal that investors in 30Y EU bonds have some institutional/rating constraints that prevent them from moving all the way up to OATs. This is consistent with the allocation statistics of recent EU deals that show that a large portion of the EU Nov50 (37-47%) went to investors based in Germany and the Benelux.

**CHART 5: EU BONDS RELATIVE TO SOVEREIGNS**

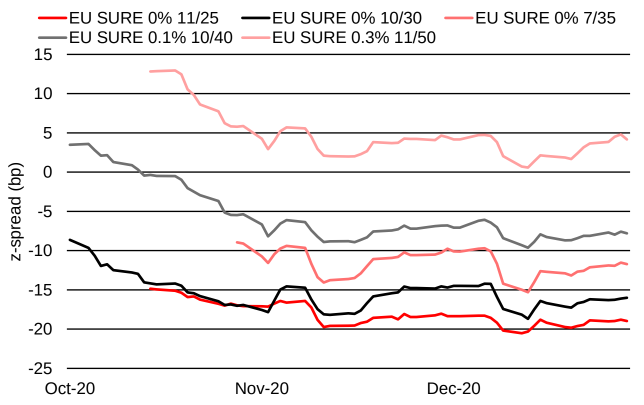



Source: Bloomberg, UniCredit Research

## EU: relative to other SSA names

As chart 6 illustrates, the first EU SURE deals performed well in the secondary market after their pricing and the whole EU curve tightened. Furthermore, the strong secondary-market performance of the EU SURE transactions was spread-supportive for other European supranationals and led to spread tightening across the supranational universe. Overall, EU bonds are expected to trade the tightest, even below EIB bonds, which has been the tightest E-Name so far.

**CHART 6: PERFORMANCE OF EU SURE TRANSACTIONS**

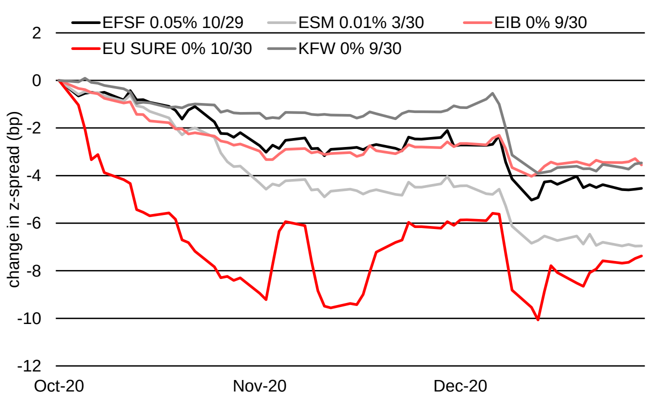



Source: Bloomberg, UniCredit Research

Currently, with EUR 240bn, the EIB has the largest outstanding volume of euro-denominated bonds, followed by the European Financial Stability Facility (EFSF), with EUR 196bn; the EU, with EUR 106bn, and the ESM, with EUR 82bn. The EFSF will only refinance its maturing debt, but due to the high outstanding volume of his debt, we do not expect EFSF liquidity to be endangered in the near future.

Comparable 10Y transactions from European supras show that, since its issuance in mid-October, the new SURE 10Y bond has been trading below those of the ESM/EFSF and even outperforming those of the EIB and KfW (a benchmark SSA issuer, its bonds are often referred to as safe-haven assets).

**CHART 7: PERFORMANCE COMPARISON: SURE VERSUS SUPRAS AND KFW**




All series normalized to zero as of 22 Oct 2020

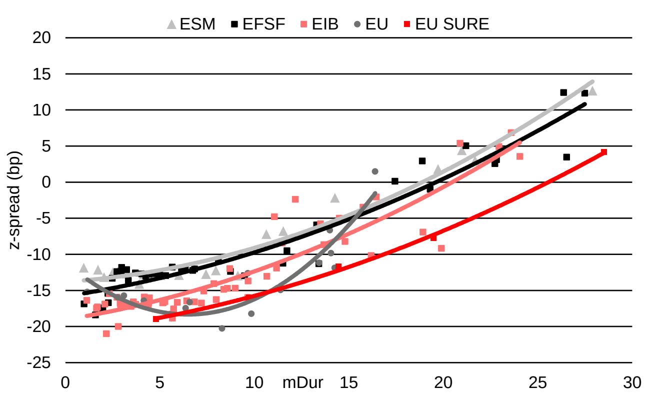
Source: Bloomberg, UniCredit Research

The new EU SURE bonds have an average outstanding volume of EUR 8.9bn, which is already significantly higher than that of comparable issuers, such as the ESM (EUR 3.6bn), the EFSF (EUR 4.1bn), the EIB (EUR 3.5bn) and former EU bonds (EUR 2.5bn).

This thereby increases their attractiveness for investors. The size of a SURE bond cannot exceed EUR 10bn, as the amounts due in a given year are not to exceed 10% of the maximum amount of financial assistance under the programme (EUR 100bn). NGEU bonds will be even more liquid, especially the conventional bonds. We expect these to be associated with higher outstanding volumes, as 70% are planned to be issued as conventional bonds and 30% as green bonds. Although the EU will become a key player in the primary market for EUR-denominated SSA debt, we do not expect EU bond supply to negatively influence demand for other supras and agency issuers, that are still actively issuing bonds. In the medium term, we expect the EU to be treated more as a sovereign issuer. Therefore, competition from EU supply might be higher for small and mid-sized sovereign issuers.

In our view, the high investor demand for safe-haven assets, and for ESG investments in particular, will lead EU issuance to be easily absorbed and will limit the impact on the spreads of other supras/agencies. Furthermore, the ECB is likely to act as an active buyer in the short-to-medium term. In the short term, we expect conventional EU bonds to trade in line with those of the EIB, but in the medium term, and especially when the total outstanding volume of EUR-denominated EU bonds (currently EUR 106bn) surpasses that of EIB bonds (currently EUR 240bn), we expect the EU's curve to be slightly below the EIB curve thus becoming the tightest E-name. Furthermore, we expect green and social EU bonds to trade slightly tighter than conventional bonds due to their ESG linkage. We estimate the ESG premium of SURE bonds to be at 2-3bp, which is comparable to the greeniums associated with the green Bunds. Given the above-mentioned guarantee associated with SURE, market participants might distinguish between the three formats, and we might see three slightly different EU curves – one for each conventional, green and social bond.

**CHART 8:**
**EU AND EU SURE BONDS VERSUS EUROPEAN SUPRAS**




Source: Bloomberg, UniCredit Research

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