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AEGON Asset Management

Swap spreads on the move

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Swap spreads, the difference between the yield on daily collateralized swaps and benchmark sovereign debt, are observed for many reasons: amongst others as an economic risk indicator; a measure of investor preferences over time; and an important consideration in setting Liability Driven Investment (LDI) strategies.

This article summarises swap spread developments and considers the implications for pension funds and their interest rate hedging strategies. We examine what pension funds can do to their interest rate hedge to take advantage of this market development.

Executive summary

Swap spread is at historical peak	Since the start of the year the spread between the 10-year euro swap and 10-year German government bond has widened from around 40 bps to around 80 bps. It peaked at 86 bps in 2008. The current widening of the swap spread can be explained by the risk-off mode in financial markets amid concerns about geopolitical stability.
Expected swap spread narrowing	If and as these fears diminish over time, we would also expect the swap spread to narrow. In addition, supply and demand may impact the swap spread in the near term as the ECB's Pandemic Emergency Purchase Programme (PEPP) will be discontinued by the end of March.
Investors with interest rate sensitive liabilities can profit	For investors currently holding large allocations of highly rated euro government debt with the primary purpose to hedge interest rate risk, highly elevated swap spreads will give pause for thought, particularly in this long-running low yield environment. Current swap spreads (as of March 11, 2022) are offering German government bond investors the potential for additional return over the yield they are expecting from their bonds. In addition, investors who trade their exposure to these bonds for interest rate swaps can benefit significantly if and as swap spreads return to their historical average.

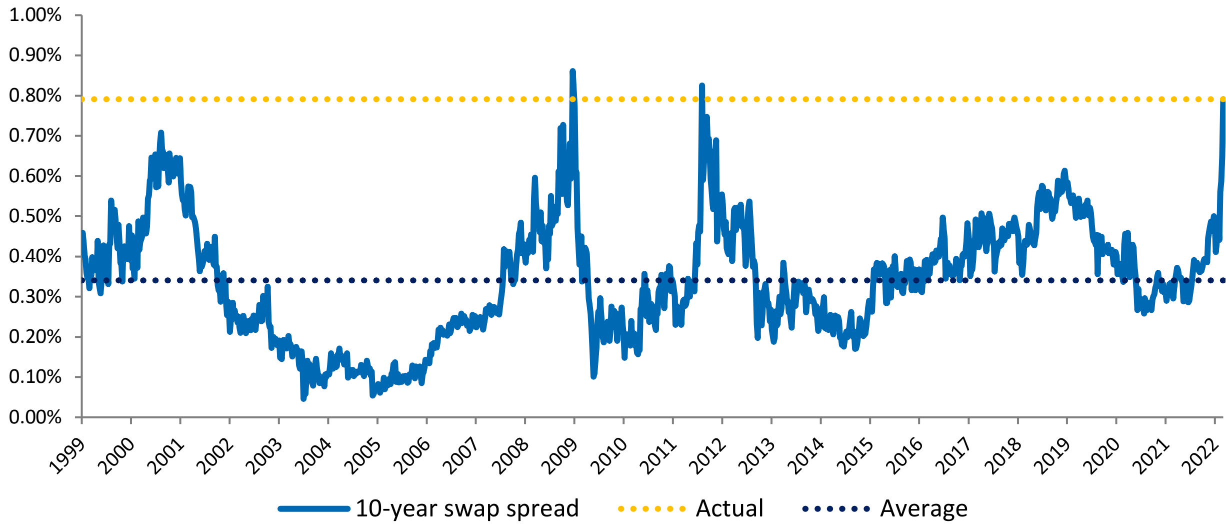
Swap spreads near all-time highs

With the Russian invasion of Ukraine now two weeks in, financial markets have moved into fear mode. With the Chicago Board Options Exchange's Volatility Index (VIX) climbing significantly, oil prices at levels only seen at the peak of the Great Financial Crisis, and gold prices near all-time records, investors are clearly very concerned about short-term and longer-term geopolitical stability.

One set of indicators which are unlikely to reach the front page headlines are swap spreads, but they too are telling a story, and one which may well influence how investors wish to hedge their interest rate sensitivity.

In the eurozone, the swap spread of most relevance is relative to the yield on German government bonds – AAA-rated, highly liquid and issued by the largest economy in Europe, these are normally viewed as representing the lowest risk euro sovereign debt benchmark. Chart 1 shows the development of swap yields (10-year Euribor 6m) versus German 10-year yields since 1999 when the euro was introduced.

Chart 1: Spread 10-years swap vs. German bonds

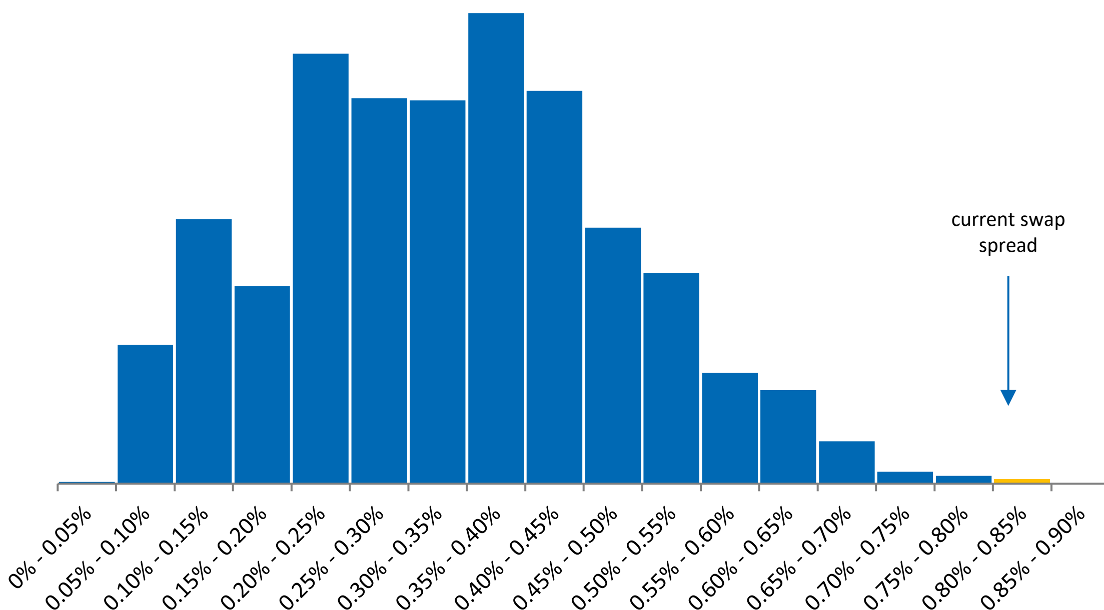


Source: Bloomberg, Aegon Asset Management. Using daily data from January 1999 to March 2022

Since the start of the year, the spread between the 10-year euro swap and 10-year German government bond has widened from around 40 bps to around 80 bps. It peaked at 86 bps in 2008. It is immediately clear from this chart that swaps spreads as an indicator of market fear are at elevated levels, comparable with levels seen during the dotcom crash, the Great Financial Crisis and the eurozone crisis, when German government bonds were seen as the ultimate safe haven in the euro system. In contrast, although we see a limited spike, the onset of the Covid pandemic was more muted for swap spreads.

In order to highlight the current situation from a historical perspective, Chart 2 below shows the distribution of daily 10-year swap spreads. There have been only a handful of days in history where the swap spread was higher than at present. The median and average swap spreads are both 34 bps.

Chart 2: Historical distribution of 10-year swap spread



Source: Bloomberg, Aegon Asset Management. Using daily data from January 1999 to March 2022.

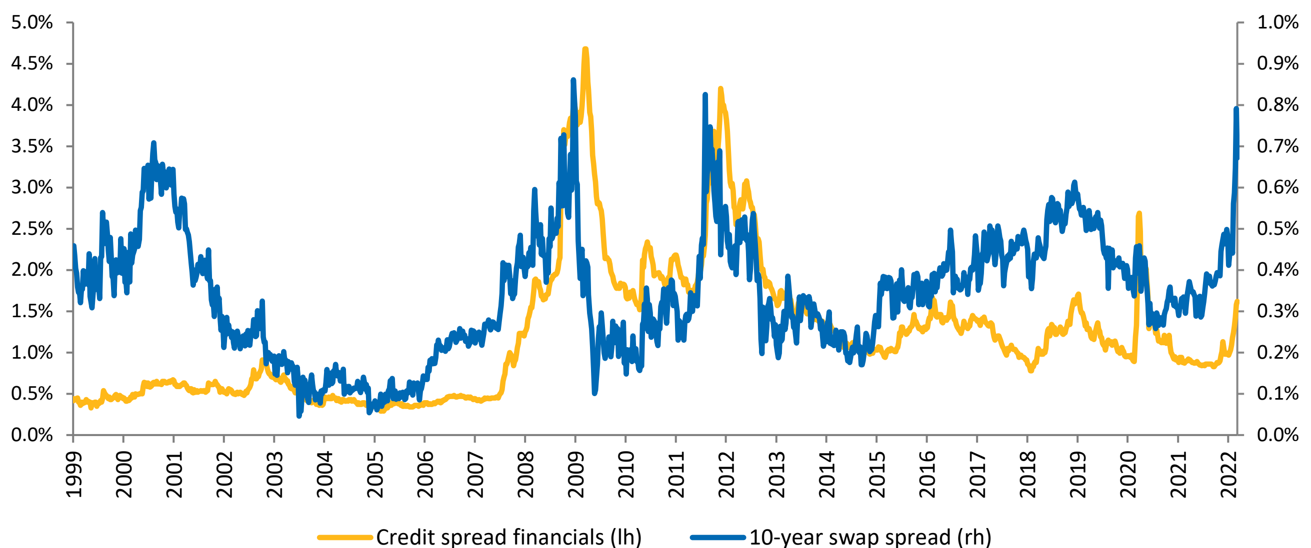
Causes of swap spread fluctuations

The question then is what moves the swap spread – how do markets decide on a price difference between holding daily collateralized swaps and German government debt.

Government bonds are issued to finance government debt and so there is a fundamental link to how much government debt is in issuance and being issued (the supply) and the need and desire for institutional investors and others to buy this debt. However, for very highly rated debt, where there is an assumption (based on historic economic and fiscal performance and debt management) that it will be repaid, short- and medium-maturity debt is also representative of views about economic growth of the wider economy. In times of crisis, such debt is also seen as a liquid safe-haven, depressing yields, and giving an indication that markets expect lower economic growth in the upcoming period.

Interest rate swaps are instruments that do not require upfront payment (except for initial margin to cover the risk of default) and where collateral or margin is regularly exchanged (normally daily) between the parties to ensure financial positions are mark to market. Institutional investors traditionally traded interest rate swaps on a bilateral basis with banks as the counterparty but, since the Great Financial Crisis, Central Counterparty Clearing – where a central counterparty institution act as the counterparty to all contracts – represents an increasingly significant part of the market. Credit risk from banks (the indirect counterparties to most swap contracts) remains observable in the swap spread, as we can see from Chart 3 which shows the 10-year swap spread and the credit spread on the Euro Financial Corporates Index.

Chart 3: 10-year swap spread and credit spread on financials



Source: Bloomberg, Aegon Asset Management. Using daily data from January 1999 to March 2022.

For short-to medium-term contracts, the swap market is also extremely liquid. A swap contract is therefore well protected: the risk of loss (and extent of potential loss) is limited, and the main risk would be having to renegotiate replacement contracts at an inopportune time. This implies that any oversized differences between swap yields and the most highly rated government bond yields, would, in theory, be subject to rapid market arbitrage opportunities. However, this does not prevent limited swap spreads persisting, varying, and, in some markets, becoming negative.

German government debt supply/demand balance

Supply/demand balance can have an impact on the swap spread. On the supply side, after years of stable net issuance, Germany issued government debt of around €400bn net in 2020 and 2021 combined to fight the pandemic. Now that the effects of the pandemic seem to be stabilizing, it is also expected that net issuance of German debt will decline. However, the geopolitical uncertainty and consequential necessary commitments to defence and energy spending may cloud this picture.

On the demand side, the ECB has been a large buyer of public debt over the past two years as part of the €750bn Pandemic Emergency Purchase Programme (PEPP). In December 2021, the ECB decided to discontinue the PEPP from

the end of March 2022. This could lead to a short-term imbalance in supply and demand for German government bonds as demand will fall, and result in a tightening of the swap spread.

Investors with interest rate sensitive liabilities

Many investors' liabilities are tied to changes in interest rates with swap yields or government bond yields the most common benchmarks used. They may also have capital requirements based upon the risk of their assets relative to the value placed on those liabilities. Aside from basis risk, which is very low compared to interest rate risk in general, in many countries in the eurozone, protecting against interest rate movements can be readily achieved via interest rate swaps or AAA-rated euro government bonds (with Germany and the Netherlands the largest euro government bond markets retaining AAA ratings currently).

For investors currently holding large allocations of highly rated euro government debt with the primary purpose to hedge interest rate risk, highly elevated swap spreads will give pause for thought, particularly in this long-running low yield environment. More specifically, to the extent that investors have used AAA-rated government bonds in their interest rate hedge, they will have benefited from the widening in the swap spread versus using swaps for this hedge. However, at a level of around 0.8%, swap spreads are offering German government bond investors the potential for additional return over the yield they are expecting from their bonds. Investors who trade their exposure to these bonds for interest rate swaps can benefit significantly if and as swap spreads return to their historical average of 34 bps. As an example, assuming an interest rate hedge of 50% and a duration of the liabilities of 18, this results in an additional return of approximately 4%.

Of course, there are many accompanying considerations, such as trading costs, set-up costs (if not already using swaps), and ongoing collateral management and maintenance of swap portfolios. There will also be the choice of how the capital realised by moving the hedge from government bonds to swaps should be invested. Safe, short-term money market instruments would be the low risk option but for investors who have available risk budget, higher risk options may be suitable, potentially with a “cash plus” target. More specifically, the return on low risk short-term money market instruments will be around 10-15bps lower than 6-month Euribor (the floating leg of interest rate swaps), which will reduce the additional return from switching to interest rate swaps.

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