

July 10, 2024

## In Search of Eurozone Risk Premia

### **Eurozone assets have re-priced, but inconsistently**

- FX damage more apparent in rate relationships than options
- Sovereign premia are still present, but OATs generally resilient
- French credit is performing surprisingly well

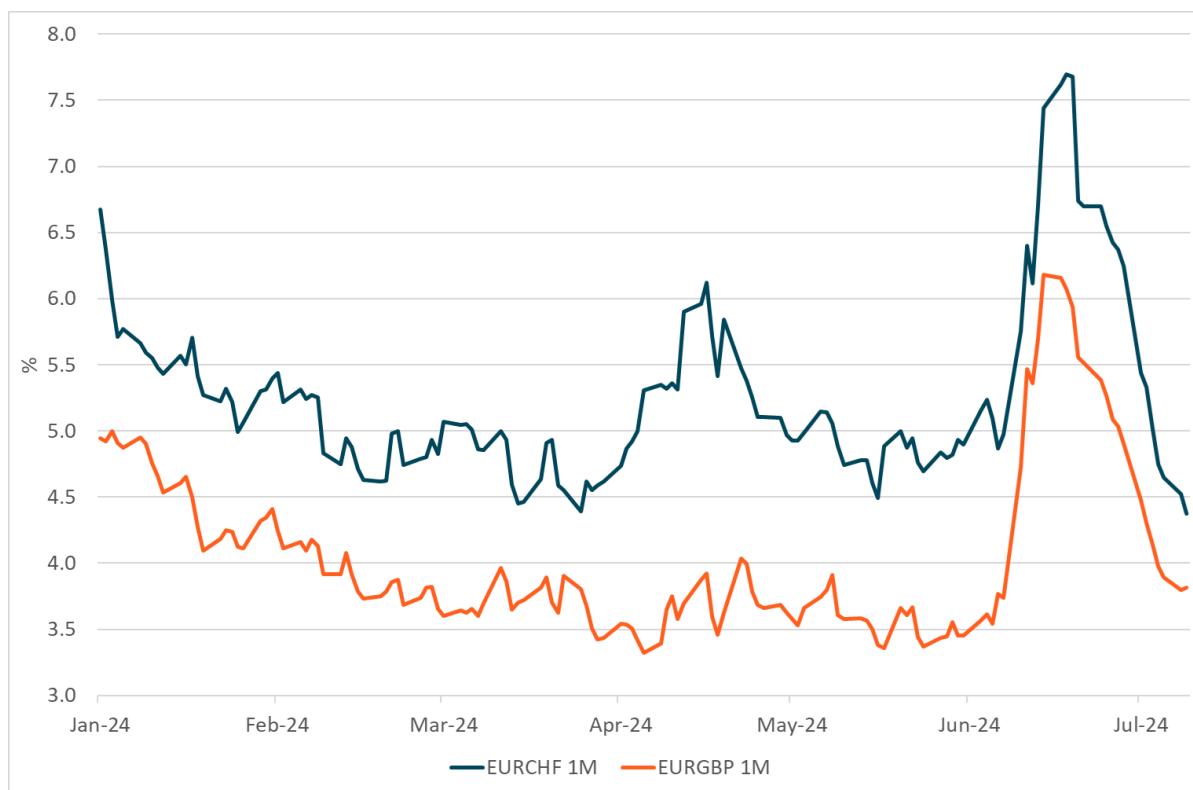
### **Stasis across Europe is not risk-free**

The market is in the dark regarding the timing and composition of France's new government. However the results are interpreted, initial fears surrounding a very large fiscal expansion in France look to be unjustified for now. While it is prudent for investors not to take a stronger view on positioning until the composition of the new government has been established, we believe that there are reasons to re-price fiscal and monetary policy risk in Eurozone assets. Given the scale of the political tumult witnessed since June, it is inconceivable that French and European politics can revert to the status quo. Looking across assets, there are some areas where re-pricing appears to have taken place, but also others where price action looks inconsistent with the direction of travel for the Eurozone / EU economy and policy.

Starting with currencies, we can see that some of the largest moves generated in June were in FX options markets. Eurozone risk premia increased sharply based on the 1m implied volatility in EURCHF and EURGBP (exhibit 1), mostly to reflect the risks of an adverse outcome in France. The SNB decision and UK election were additional events which could have triggered surprises in price action. As of this week, in both pairs short-dated volatility has fully normalized. This is not necessarily due to the lack of event risk, as France's government formation will take place in the near term, but FX options markets appear to have fully priced out any disruption to the EUR per se, likely under the assumption that the status

quo in France will continue because the government will be gridlocked. Therein lies an intrinsic contradiction, as gridlock itself was not the status quo, and is almost certainly a more adverse outcome, at least for growth. Even so, we understand the view that any adverse effects will only be felt over the medium term, and summer trading conditions in the near term preclude strong views in options markets.

### Exhibit #1: EURCHF and EURGBP options



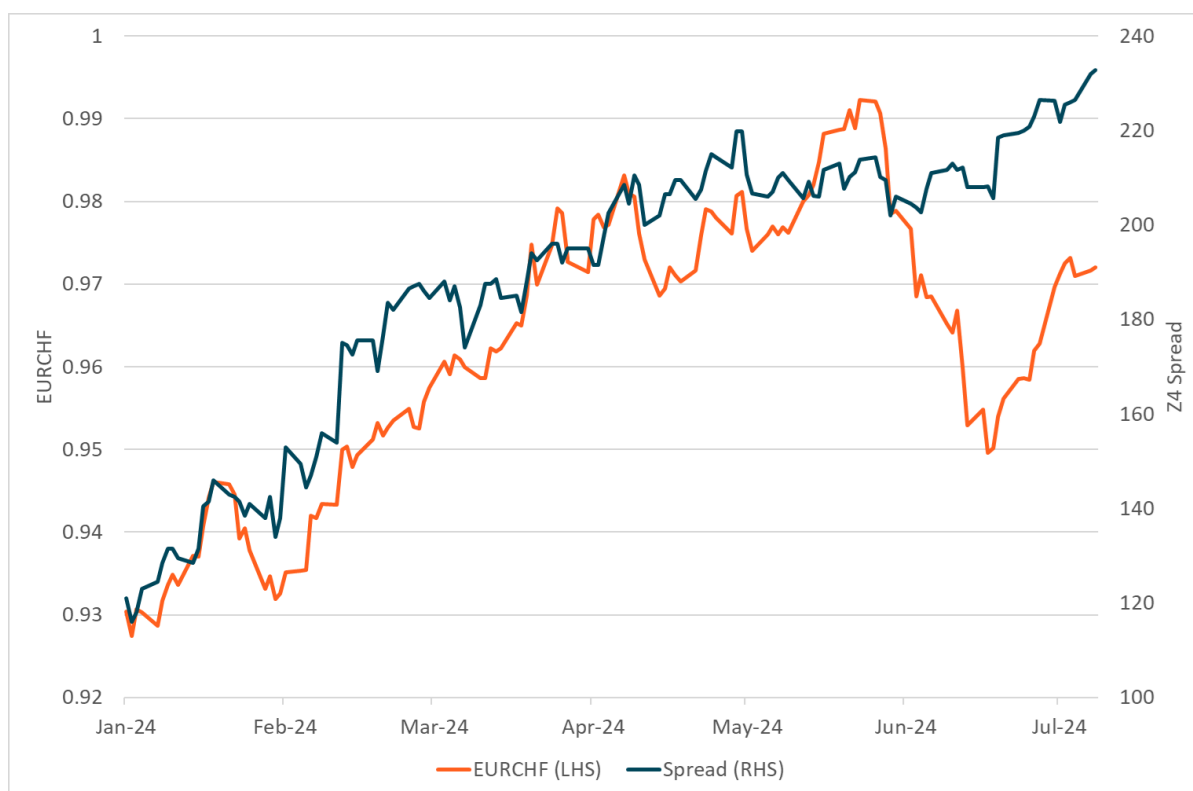
Source: Bloomberg, BNY

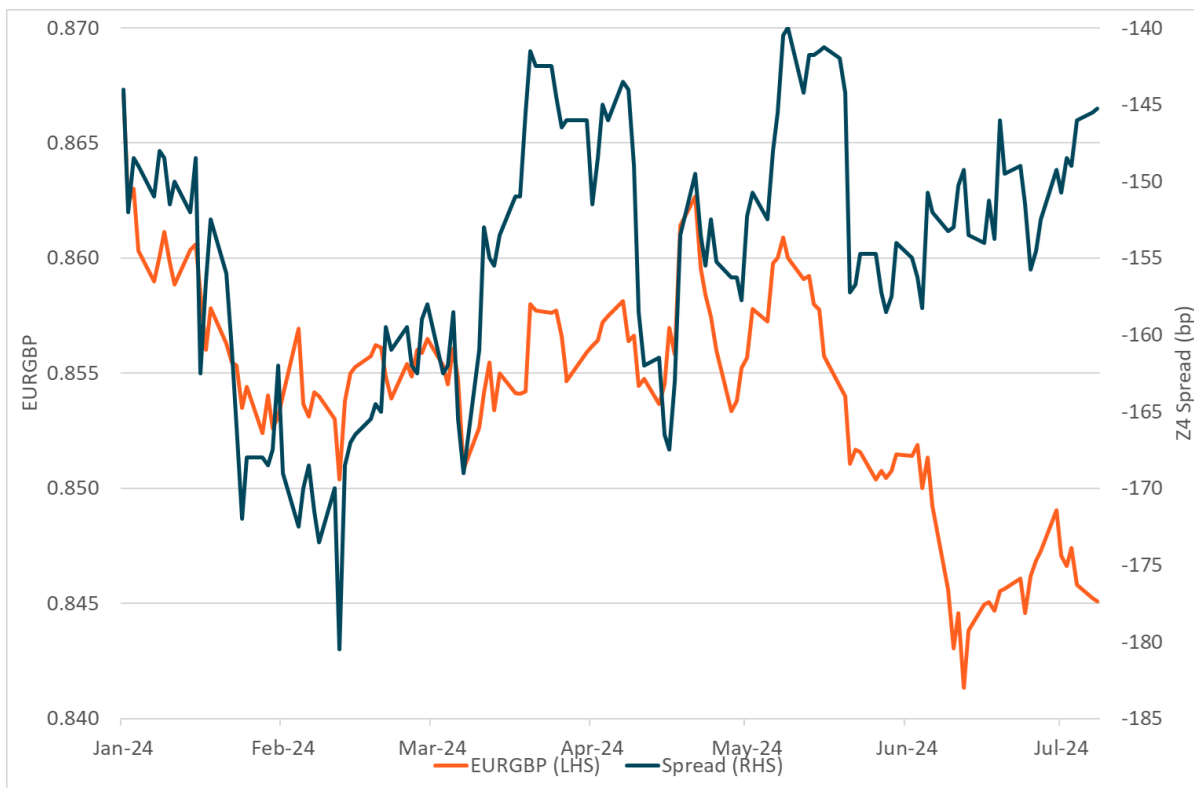
FX options may have fully normalized, but the EUR's relevant correlations have not. EURUSD may have attracted significant attention lately, but with the Fed and US politics playing a larger role for the rest of the year, the burden of adjustment for the pair will likely not be on the EUR leg. As such, looking at the same widely traded euro crosses and their respective 'conventional relationships,' with interest rate expectations for example, we can see that there has been a break in co-movement over the past month. The ECB's outlook has been resolutely unchanged since the June cut, as each meeting will decide on policy based on data – which for now is not showing any clear sign of price deceleration. If anything, a shift toward stronger fiscal impulse in Germany and France could even push up wage expectations in the public sector and represent a new headache for the ECB. Meanwhile, the SNB's recent dovish decision appears to be justified based on the June inflation outlook.

As such, rate expectations for year-end have widened 40bp in the EUR's favor, but EURCHF itself is softer on the month. Similarly, EURGBP is faring even worse, although there has

been material improvement in the EUR vs. GBP year-end spreads, too, which is still only 5bp off the narrowest levels seen in May. In both cases, the EUR's value has 'reset' since political turmoil began. Perhaps more consequential for the ECB is that even after the 'reset,' EUR is reacting positively to rate differentials. However, these are relationships which need to be monitored closely. EURGBP is of particular interest to us, as the UK and France are both 'resetting' their fiscal outcomes, but for now the former is looking less aggressive compared to the latter and there has been no disruption to the Bank of England's policy path. Furthermore, the new Labour government's growth and productivity focus could be seen favorably in an inflation context and allow the Bank of England more room to act. On the other hand, if the ECB is suddenly seen as needing to hold rates higher due to fiscal expansion but without corresponding productivity offsets, there may be a stagflation scenario, in which the EUR would struggle even if rate expectations were to remain elevated due to inflation – as was the case in 2022.

**Exhibit #2: EURCHF and EURGBP rate relationships change**

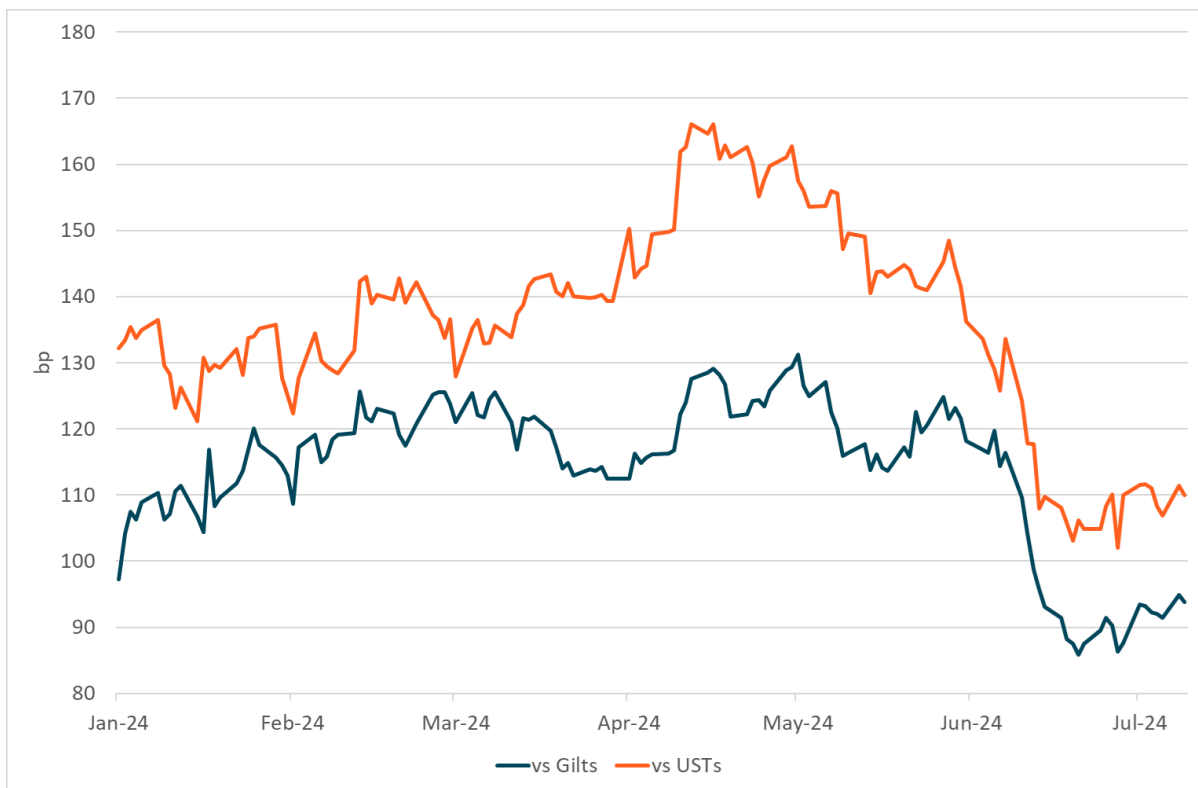




Source: Bloomberg, BNY

In fixed income, the market is still closely tracking OAT-Bund spreads. We are already surprised that there has not been much additional widening based on hitherto favorable flow trends for OATs despite political risk. In a political sense, markets may take the view that the ECB is now in the business of ‘closing spreads’ after the experience of 2020, and with other facilities in place, such as the OMT, there is not much risk-reward in pushing for additional widening. OAT-Bund spread ruptures would be existential for the euro itself, so authorities would react extremely aggressively well before spreads even approach whatever red lines may exist. However, even if the spread is protected, it would mean core Europe using their own balance sheets to support France (or any other member state) and entail a re-rating of Eurozone debt. If we compare spreads of US Treasuries and UK gilts over OATs, assuming that inflation differentials are starting to converge, then term premia will need to reflect new fiscal realities. Paper in both countries has seen spreads tighten against OATs in recent weeks, and the recovery has been limited. We believe the market is likely underpricing US fiscal risks, but purely in the context of the French and Eurozone situation, we can see that risk differentials have moved against Europe.

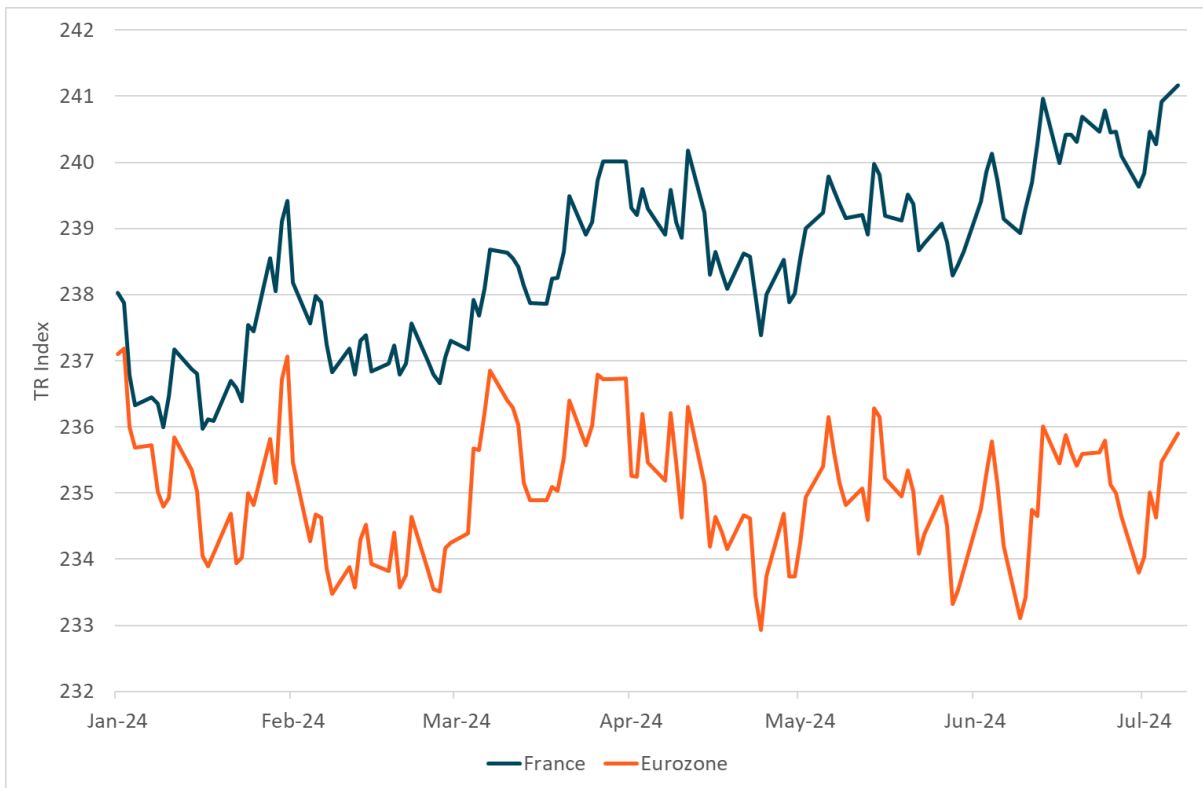
### Exhibit #3: USTs and gilts spreads over OATs



Source: Bloomberg, BNY

One area where French assets are surprisingly outperforming European peers and beyond is in credit (exhibit 4). Total return indices show almost no impact on French corporate issues in recent weeks, whereas performance in the Eurozone has been far more volatile. The composition of indices may have played a role, but the sovereign-corporate credit link in the Eurozone has been well documented in the past and the importance of the state sector driving growth and demand in France should have amplified any such effects. Furthermore, in a 'higher for longer' environment, corporate paper has struggled globally. The heavy presence of financials in the index and potential for re-rating through higher net interest margins may have played a role, and sovereign solvency for now is perhaps not on the agenda yet. Even so we are surprised at the relative calm in the market. Moves in the Itraxx Crossover, which tracks credit risk in non-investment grade credit, were also very contained. This is also perhaps the best market to track if markets are looking for the first signs of de-rating in Europe and insert risk premia.

#### Exhibit #4: Credit indices in Europe



Source: Bloomberg, BNY

## Disclaimer & Disclosures

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