Helaba

Focus on: Covered Bonds
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The Spread Paradox in Covered Bonds



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While short-term interest rates are rising sharply, the long end is increasing less strongly, leading to a substantial flattening of the yield curve. Covered bond spreads seem unaffected by all of this. However, this apparent resilience at the current margin misleads about a fragile, technically driven equilibrium. While macroeconomic stress factors – first and foremost sharply risen commodity prices and a restrictive monetary policy – suggest a significant spread widening, an unprecedented seasonality stabilizes the primary and secondary markets. What happens next? Will the market remain calm, or is this just the calm before the storm?

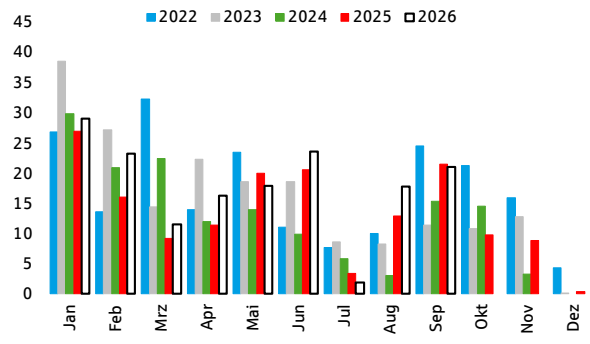
The Macroeconomic Paradox

The starting position is clear: the yield curve is flat. This is the result of the restrictive stance of central banks, which is pushing the short end sharply upward. But yields are not remaining stationary at the long end either: driven by the anticipation of ever-higher government debt as well as increasing political uncertainties, long-term interest rates have risen noticeably – even if less strongly than at the short end. At the same time, we are observing stable Bund-Swap spreads. **In theory, such a starting position leads to a "flight to quality" and thus to a widening of Bund-Swap spreads.** The fact that this movement is not occurring is due to the massive supply of new issuances in core European countries. This pushes bond yields up relative to swaps and keeps spreads tight.

In this area of tension, covered bonds showed themselves for a long time as a rock in the surf. Compared to SSA securities, which have come under severe pressure, they offer higher absolute nominal yields with a comparable risk profile due to their collateralization. They are therefore an attractive investment target, which institutional investors made ample use of after the summer break.

Benchmark Covered Bonds

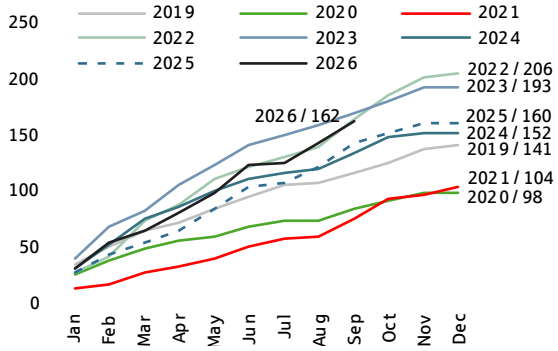
Isolated monthly issuance data (EUR bn)



Sources: Bloomberg, Helaba Research

Benchmark Covered Bonds

Cumulated monthly issuance data (EUR bn)



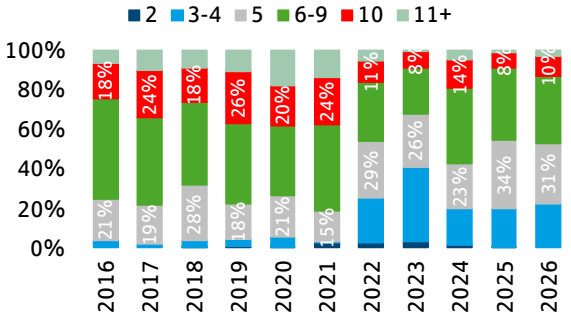
Sources: Bloomberg, Helaba Research

Front-loading Effects: Better Safe Than Sorry

The immense primary market activity since mid-August is, in our view, the result of a **deliberate, proactive strategy by the issuers**. After the relatively long summer break, issuers utilized the current "window of opportunity" to cross the finish line early with their funding for the entire year. We recognize in this behavior a deep-seated risk aversion with regard to the fourth quarter:

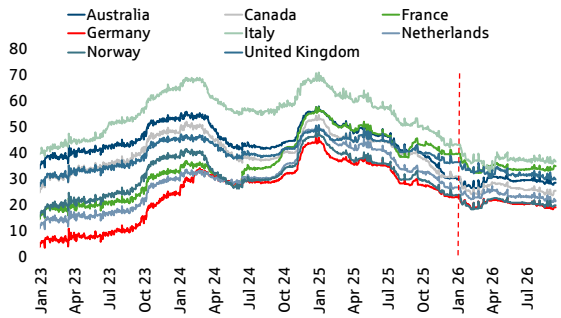
- **US Midterms:** The upcoming political shifts in the US hold the potential for massive spikes in volatility along global govie curves, which could directly impact European swap markets.
- **German Domestic Politics:** Fiscal tensions and changing political majorities in the aftermath of regional elections have increased the fiscal risks for core issuers.
- **General Macroeconomic Situation:** The combination of persistent commodity inflation and the ongoing restrictive monetary policy of the central banks is dampening growth expectations.

Short-term Tenors Dominate



Sources: Bloomberg, Helaba Research

End of Convergence – Is Softening Next?



5Y Constant Duration Covered Bond Spread Indices
Sources: Bloomberg, Helaba Research

Are We at a Tipping Point?

Practice now shows that this collective "better safe than sorry" approach is reaching its capacity limits. The market is suffering from acute indigestion:
Following the massive volumes of recent weeks, the cash ratios and predefined pockets of many real-money investors have thinned out. The 5-year segment, in particular, appears overstretched. The EUR 2.25bn tranche from the Royal Bank of Canada was ultimately just the icing on a EUR 14.25bn cake since mid-August. In total, a good EUR 40bn in benchmark bonds were placed over the last five weeks. Recent transactions especially tended to show lower oversubscription ratios, smaller spreads between the initial price talk and final pricing, as well as higher new issue premiums (NIP). On the secondary market side, this development was tolerated relatively well until recently. However, the wind seems to be shifting: a technically induced repricing is occurring, where existing curves appear to follow the increased NIPs of the latest primary market deals

What Happens Next? Two Storylines Until the End of the Year

The future development of the covered bond market will heavily depend on how quickly issuers close their books. The most likely scenario relies on the upcoming ECBC conference in Seville, which traditionally marks the seasonal turning point of the issuance year.

Scenario A: The Quiet Late Phase (High Probability)

- **Primary Market Dynamics:** The primary market merely trickles along after the conference in Seville, as the funding plans of most institutions are already largely fulfilled.
- **Secondary Market Impact:** In the absence of new benchmarks and new issue premiums (NIPs), the catalysts for repricing are missing. Inflowing liquidity (e.g., from coupon payments) tends to lead to a slight technical tightening instead.

Scenario B: The Adverse Stress Scenario (In the Event of Political Escalation)

- **Primary Market Dynamics:** Political shocks block the long end of the curve. Laggards who still need to become active on the funding side are forced to issue and minimize execution risk by shortening duration toward the safe 3-year segment ("safe play"). Alternatively, they utilize the emergency exit in the form of retained covered bonds.
- **Secondary Market Impact:** A curve shortening occurs alongside a negative spillover from the Bund and SSA spectrum. Covered bonds widen slightly against swaps, but can achieve a slight outperformance compared to Bunds and SSAs.

Conclusion

Supply has been exceptionally heavy over the last five weeks, and perhaps not every issuer is entirely satisfied with the primary and aftermarket performance of the latest new issuances. However, this should take a backseat to the fact that having is better than needing – especially considering the consolidating negative macroeconomic trends and political uncertainties. On the secondary market side, we remain constructive. This is, however, under the premise of a significantly more cautious issuance activity in October and November compared to the period after the summer break.



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