# Lower rates for even longer? How to navigate peripheral government bonds

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Prior to the Covid-19 crisis, investors were anticipating that central bank rates would eventually rise from the ultra-low levels we have witnessed for a number of years in Europe but the tables turned very quickly in the first quarter of 2020. Safe-haven Sovereign bonds such as those issued by Germany are now offering yields of -0.41% for 10-year debt1 and has been below 0% for the most part of 2020. In a landscape where an investor pays a premium for safety, can there be a better way to try to balance the risk and rewards inherent in European Sovereign bonds amid the current economic backdrop. Sovereign debt issued by peripheral countries typically offer a higher yield than Sovereign debt issued by core countries since they are deemed as being more risky but the risk may not materialise and an investor may stand to benefit from the higher yield offered. In this blog, we review correlations between some of the key core and peripheral countries pre the 2008 Global Financial Crisis (GFC) and since the 2008 GFC in addition to reviewing historically how the Sovereign debt of these countries performed on average when equity markets were showing positive average monthly performance.

**What differentiates the core versus the periphery?**

When we think about some key fundamental factors that can help an investor understand the strength of a Sovereign's debt, one could look to their debt to gross domestic product ratio (Debt-to-GDP). According to Statistica2, considering data published on January 2020 for the reporting period 3Q 2019 the Debt-to-GDP ratio for Germany was only 62.6%, considerably lower than that of Italy which reported a ratio of 137.3%, a level at the higher end of most European countries and only below Greece. Slightly above the Euro area average one can note Spain's levels which were at 97.9% and similarly France which reported a level of 100.9%. Interestingly though, while France's Debt-to-GDP levels sit above Spain, it is considered by many as a core exposure and along with Germany a more creditworthy Sovereign than what is known as the peripheral countries under which Spain and Italy fall. When investors flock to safety in Europe, this typically involves a strong demand for German government bonds and a resulting drop in those bond yields which has led to 10-year German government bonds offering negative yields, having generally remained negative since March 2019. Meanwhile 10-year French government bonds (OATS) went negative in January 2020 and have moved in and out of this territory for much of 2020. For investors that maintain a benchmark exposure to European Government Bonds using a market cap weighted index such as the Bloomberg Barclays Euro Treasury Yield Bond Index, their portfolio exposures rely on Sovereign issuance patterns ignoring other key factors. As a large portion of European Sovereign debt is offering negative yields, these types of singular focused market cap exposures are likely to face a tougher road ahead. As an example, the

Bloomberg Barclays Euro Treasury Yield Bond Index has around 42% of the index exposed to government bonds issued by France and Germany where we note that the full German yield curve offers yields below 0% as of 23 June 2020 with France in a similar position for maturities below 10 years.

**If the current economic backdrop of lower bond yields for longer holds true, how can investors potentially boost the overall yield level within their core fixed income holdings?**

Investors may have forgotten that the correlation of returns between Italy and Germany was relatively high prior to the 2008 Global Financial Crisis (GFC) and furthermore the correlation between France, Germany, Spain, and Italy was generally quite high during this period. On the other hand, when one looks at the data, it is also interesting to note that the correlation between Italy and Germany fell drastically after the 2008 GFC. For an investor looking for assets that do not exhibit a high correlation to each other to enhance portfolio diversification, exposure to peripheral Sovereign bonds such as Italy and Spain could be a useful tool to consider. Italy, for example, is one of the few European Sovereign bonds offering a strong yield pick-up relative to other European Sovereign debt with the Italian Sovereign yield curve sitting well above German Sovereigns as of 23 June 2020.

**Figure 1: Correlation Matrix Pre 2008 Global Financial Crisis (GFC) and Since 2008 GFC**

| Pre 2008 Global Financial Crisis | Bloomberg Barclays EUR Treasury Germany TR Index | Bloomberg Barclays EUR Treasury France TR Index | Bloomberg Barclays EUR Treasury Spain TR Index | Bloomberg Barclays EUR Treasury Italy TR Index |
|---|---|---|---|---|
| Bloomberg Barclays EUR Treasury Germany TR Index | 100.0% | 99.8% | 98.9% | 96.6% |
| Bloomberg Barclays EUR Treasury France TR Index | 99.8% | 100.0% | 99.6% | 97.7% |
| Bloomberg Barclays EUR Treasury Spain TR Index | 98.9% | 99.6% | 100.0% | 98.0% |
| Bloomberg Barclays EUR Treasury Italy TR Index | 96.6% | 97.7% | 98.0% | 100.0% |
| | | | | |
| **Since 2008 Global Financial Crisis to present** | Bloomberg Barclays EUR Treasury Germany TR Index | Bloomberg Barclays EUR Treasury France TR Index | Bloomberg Barclays EUR Treasury Spain TR Index | Bloomberg Barclays EUR Treasury Italy TR Index |
| Bloomberg Barclays EUR Treasury Germany TR Index | 100.0% | 92.4% | 31.1% | 20.1% |
| Bloomberg Barclays EUR Treasury France TR Index | 92.4% | 100.0% | 42.7% | 36.6% |
| Bloomberg Barclays EUR Treasury Spain TR Index | 31.1% | 42.7% | 100.0% | 78.9% |
| Bloomberg Barclays EUR Treasury Italy TR Index | 20.1% | 36.6% | 78.9% | 100.0% |

*Source: Bloomberg, WisdomTree. "Pre 2008 Global Financial Crisis" correlation analysis includes period from Jan 2000 to August 08. "Since 2008 Global Financial Crisis to present" correlation analysis includes period from September 08 to May 2020, marking the collapse of Lehman Brothers as a notable period in the crisis. Calculations have been done using monthly returns in EUR.*

**You cannot invest directly in an index. Above numbers include backtested data. Historical performance is not an indication of future performance and any investments may go down in value.**

**How can peripheral Sovereign bond exposure help investors play the recovery?**

The nature of the 2008 Global Financial Crisis changed investors perception of European government debt and provided investors with a precursor to some of the challenges that Sovereigns would face during the 2011-12 European Sovereign debt crisis. This led to the distinction of the weakest economies in the Eurozone which at the time would be designated as the PIIGS (Portugal, Italy, Ireland, Greece, and Spain). If we move forward to the current Covid-19 crisis, we note that the European Commission has shown a

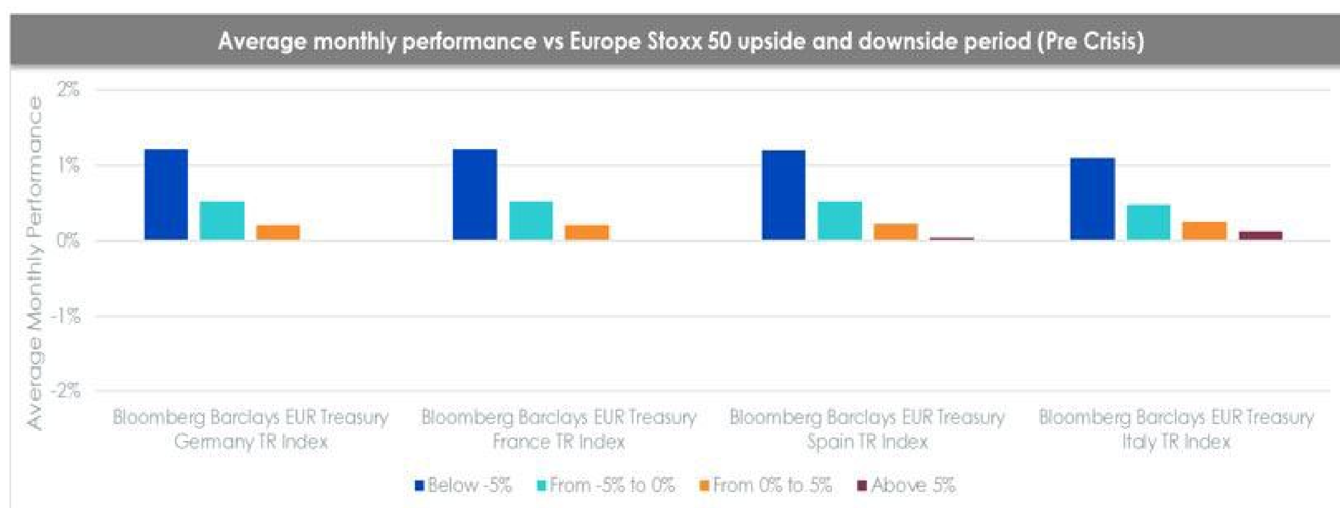
commitment to a unified European Union by putting forward a proposal for an economic recovery fund called "Next Generation EU". In its current state, it is aimed at providing strong support for countries such as Italy and Spain and could potentially help safeguard these Sovereigns from a significant deterioration in the strength of their fundamentals.

Given the high correlation of returns among the European Sovereigns in our sample prior to the 2008 GFC, it is not a surprise to see the similar average monthly performance profile among these Sovereigns under different equity market regimes.

Please refer to Figure 2 for reference.

The chart legend highlights four return profiles for the Europe Stoxx 50 index and the bar charts indicate how each Sovereign performed during these four return profiles considering average monthly performance.

**Figure 2: Average Monthly Performance Under Various Equity Market Regimes – Pre 2008 Global Financial Crisis**




After the 2008 GFC to present, we note that having exposure to the "core" such as German and French Sovereign bonds exhibited positive performance when equity markets were down. However, if history is our guide, the other side of the recovery has been more favourable for peripheral government bond exposures if we consider the monthly average performance of Italian and Spanish Sovereign bonds when equity markets are in positive performance territory, considering the period since the 2008 GFC (September 08 to May 2020).

Since the correlation between the core and peripheral Sovereign bonds in this analysis fell after the 2008 GFC, the performance differentials also increased between these two groups when equity markets were in positive territory. During this more recent period, Italian and Spanish Sovereigns provided higher average monthly returns than Germany and France when equity markets had positive average monthly performance. Please refer to figure 3. One way to potentially explain this difference could be to return to the simple principles of investing that indicate that investors should be compensated for the risk they take. As such if an investor can obtain a higher yield for taking on a certain level of risk and that risk

does not materialise then an investor could stand to benefit from the higher yield during the investment horizon if the issuer does not default on their coupon or principle repayment at maturity. Investors may want to reconsider their allocations within European Sovereigns and not forget about the yield enhancement potential in peripheral European Sovereign bond exposure.

**Figure 3: Average Monthly Performance Under Various Equity Market Regimes – Since 2008 Global Financial Crisis to present**

*Source: WisdomTree, Bloomberg. "Since 2008 Global Financial Crisis to present" includes period from September 08 to May 2020, marking the collapse of Lehman Brothers as a notable period in the crisis. Calculations are based on monthly returns in EUR.*

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1 Bloomberg, as of 23 June 2020

2 Debt to GDP ratios: https://www.statista.com/statistics/269684/national-debt-in-eu-countries-in-relation-to-gross-domestic-product-gdp/

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