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Curves (part 4) – the premium, or spread, is the clincher

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The interest rates, or coupons, that bonds pay differ due to a variety of parameters. If bond A pays a higher interest rate than bond B, this premium is referred to as spread.

In part 3 of this blog series, "Peaks and troughs", we were looking at the interest rate differential arising from the difference in the remaining time to maturity (i.e. the so-called term spread). In this article, we want to analyse the spread between euro government bonds of equal remaining time to maturity. In case of equal maturity, different yields are usually due to different ratings (i.e. the so-called credit spread).

German vs. French government bonds

The chart shows the yield for German government bonds with a remaining time to maturity of 10Y (blue) as compared to the yield for their French peers with equal remaining time to maturity (black, dotted). We are not interested in the absolute yield, but in the difference between both bonds (credit spread).

The German bond clearly pays a lower yield than the French one. It is also apparent that the yields move pretty much in sync and parallel to each other. But the interest rate differential (i.e. the green area) illustrates the real difference between both issuers:

- The interest rate differential fluctuates over time, i.e. it is not fixed.
- There are periods when the spread is narrowing and others when it is widening.
- Whereas Germany commands the top rating of AAA, France's rating is AA. The connection is obvious: a lower rating means higher interest rates!

The effect of changes in spreads

A zoom into the change in spreads over the past 12M in the chart above reveals the following interesting picture:

During the observation period, the interest rate differential widened from 0.27% (as of 19 April 2016) to 0.73% (as of 18 April 2017).

This means that the interest rates (i.e. yields) of French bonds increased relative to those of German bonds. Rising interest rates translate into a negative performance for existing investors (i.e. bondholders).

In order to establish the difference in performance, we need two bonds with remaining time to maturity of 10Y. We have chosen the 6.50% Federal Republic of Germany (1997/27) and the 2.75 % France (2012/27). Both come with the same remaining time to maturity.

In order to simplify the illustration and to make the two investments comparable, we have standardised the initial value for both bonds at 100% and taken into account coupon payments. This means that the chart shows the total return. The lower part (green area) indicates the development of both investments (including interest rates) relative to each other.

The interest rates (i.e. yield) of the French bond increased relative to those of the German bond (by close to 0.5%). As a result, the performance of the French bond was almost 3.5% worse.

Why do investors need this information?

We compared two European government bonds with the same remaining time to maturity and high, but different ratings (AAA vs. AA). Interest rate differentials (spreads) fluctuate over time. This results in different developments of bond prices on account of widening or narrowing credit spreads. During the observation period, issuer ratings (as awarded by external rating agencies) remained constant. The widening of spreads reflects the higher risk associated with the French bond, which investors may have seen. A possible and plausible explanation for this development that we saw in particular over the last three months of the observation period could be the presidential elections that were held in France during that time and the risks associated with it.

Conclusion:

When it comes to bond investments, the interest rate differential (or credit spread) and its development over time is crucial for the performance during the observation period. There may be times when it can pay off to rely on lower ratings (i.e. higher yields). And there may be times, as shown above, when investing in higher ratings yields the higher rate of return.

In our example, the return on the investment in a German government bonds was superior to that on a comparable French government bond. But this can easily change into the opposite, given that credit spreads are volatile.

Credit spread management is part of the active management of the funds of Erste Asset Management.

For more information on the product range of Erste Asset Management, please visit our homepage at www.erste-am.com

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Johann Griener has worked at Erste Asset Management in Sales Retail since 1 January 2001. In this function he supported for example the Sparkasse banks in Austria, with a current focus on Upper Austria. His scope of duties includes the servicing, training, training and education of Sparkasse employees who work in the securities field. This means creating and holding presentations in the local branches and in Erste Asset Management for the purpose of promoting sales of Erste Asset Management GmbH and Erste Immobilien KAG funds. He also supports the Sparkasse banks (Austria-wide) in their own investments (nostro business). In addition, Griener is developing numerous publications for internal and external use. The "1x1 of Investment Funds" that he wrote is found in all of the branch offices of Erste Bank and the Sparkasse banks as basic reading and an introduction for customers on how investment funds work.

Griener began his career in 1988 as an employee at the bank counter in a local Sparkasse bank. There he learned the banking business, from a savings book to loans to investment operations. After a few years at the Sparkasse, he decided to continue his studies at the Vienna University of Economics and Business, with a focus on "banks" and "securities". After completing his master's degree, he remained loyal to the Sparkasse sector and has been working at Erste Asset Management since.

His motto: "Only a day with laughter is a good day"