Why Did German Bunds Selloff and What Opportunities Are There in European Sovereign Bonds

Why did German bunds selloff so violently?

When the ECB announced QE, traders attempted to front run the program. The program would buy bonds according to the capital subscription of the national central banks to the ECB. On that count, bunds would see an 18% allocation of the budget, France 14%, Italy 12% and Spain 9%. Traders reasoned that bunds would see the biggest allocation not only in absolute terms but relative to the stock of bonds available. The problem with this thesis was the investors who had over 2 years of profits ready to crystallize.

A less volatile trade expression for QE was to realize that with risk mutualisation, 20% explicitly and 100% implicitly through TARGET2, it made sense to sell protection on Italy, Spain, Portugal and to buy protection on Germany and France.

When the Maastricht treaty was signed, peripheral spreads over bunds were much wider than they are today, some 4%-5%. They spent the best part of a decade converging, in the case of Italy, to a negative spread to bunds… In 2012, spreads widened to pre Maastricht levels as country risk reasserted itself in the European sovereign bond market. Since the ECB's "all it takes" policy, spreads have converged again. We are currently still well wide of zero and convergence remains a logical trade.