Paying for Panic: How EUR/USD Skew Overprices Sovereign Stress

Introduction

In periods of financial and economic pressure, national governments' ability to service their debts, fund public operations and maintain economic stability may become significantly compromised. Sovereign stress affects FX rates in particular; in times of crisis, currency traders typically seek downside protection, which means demand for put options on the potentially weakening currency drastically increases.

Europe has been living through such a period again. In October 2026 France paid more than Italy to borrow for ten years for the first time in recent memory (5.07% vs 4.58% on 22 October), and the France–Germany spread reached 174bp, its widest since the euro crisis. Episodes like this raise a natural question for currency traders: does the EUR/USD options market see sovereign stress coming, and can that be traded?

We find that it does not see it coming, but it does overprice it. Using Bloomberg data from 2010 to 2026 and five episodes of eurozone sovereign stress, we show that EUR/USD skew moves together with spot rather than ahead of it, but that at the peak of each panic euro crash insurance becomes too expensive and its premium fades within weeks. We first review why sovereign spreads matter for the euro and how FX skew works, then test whether skew leads spot, document how it overshoots, and finally turn this into a trade and assess when it fails.

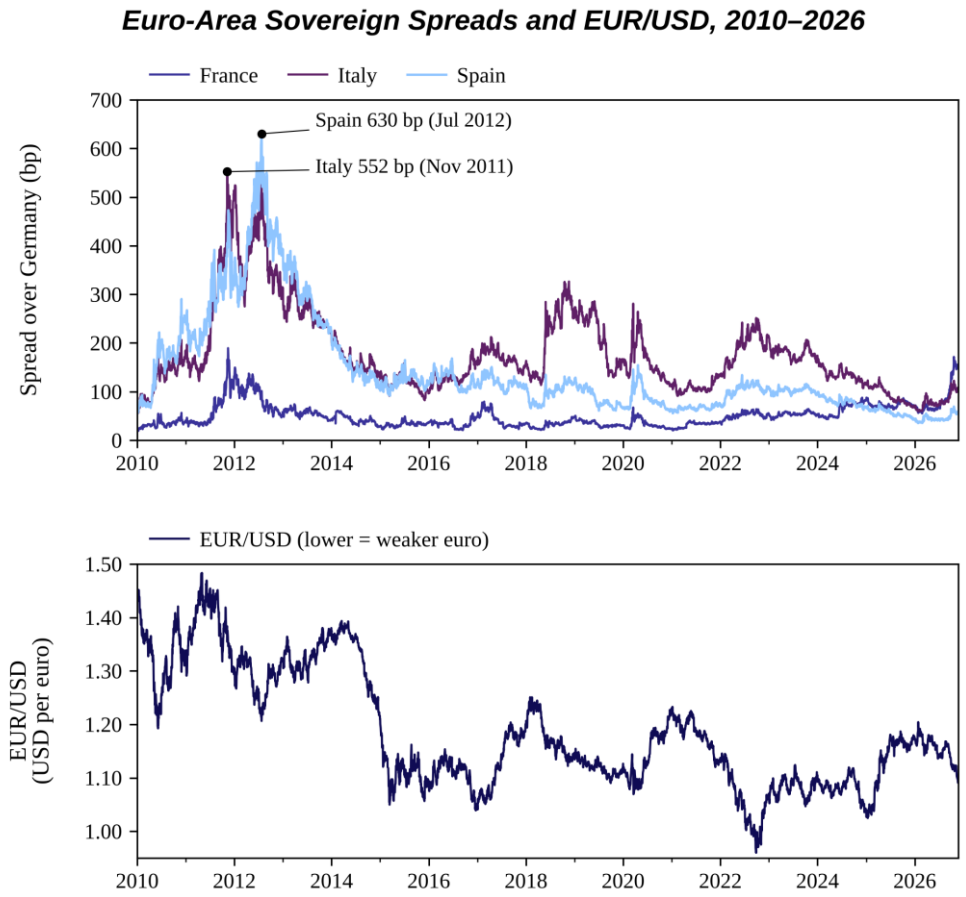
Sovereign Stress is Back: Why Spreads Matter for the Euro

Sovereign risk refers to the possibility that a government is unable to meet its debt obligations fully or on time. In this section, we would like to assess how changes in this type of risk across the Eurozone impact the EUR/USD exchange rate. The euro area comprises 21 EU member states that, despite sharing a common currency and central bank, borrow independently and thus at different rates. Consequently, creditworthiness differs between individual national governments, while fiscal concerns in one country may spread across the wider monetary union and affect the shared currency. The main instrument used in this section's analysis will be the spread between Italian, French and Spanish ten-year government-bond yields and the equivalent German yield. Spreads do not represent the direct probability of default; rather, they are an informative measure of the relative sovereign risk – the additional uncertainty that investors must be compensated for.

First, to establish the mechanism through which sovereign risk increases, we need not look far – currently, out of all Eurozone countries, France is arguably experiencing the heaviest pressure. Weak economic growth, coupled with persistent deficits and rising interest costs, undermines the credibility of future adjustments, which drives investors to reassess risk. The European Commission's recent forecast estimates French growth of 0.4%, a deficit of 5.5% of GDP and a public debt of 119.2% of GDP this year, which is projected to rise to 123.2% by 2028. The country's ten-year spread thus rose from 70.8bp on 31 December 2025 to 150.6bp on 17 November 2026, peaking at 174.1bp on 22 October – the highest level since late 2011 in our Bloomberg data. Italy and Spain also widened over the year but significantly less so than France.

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Sources: BSIC, WSJ

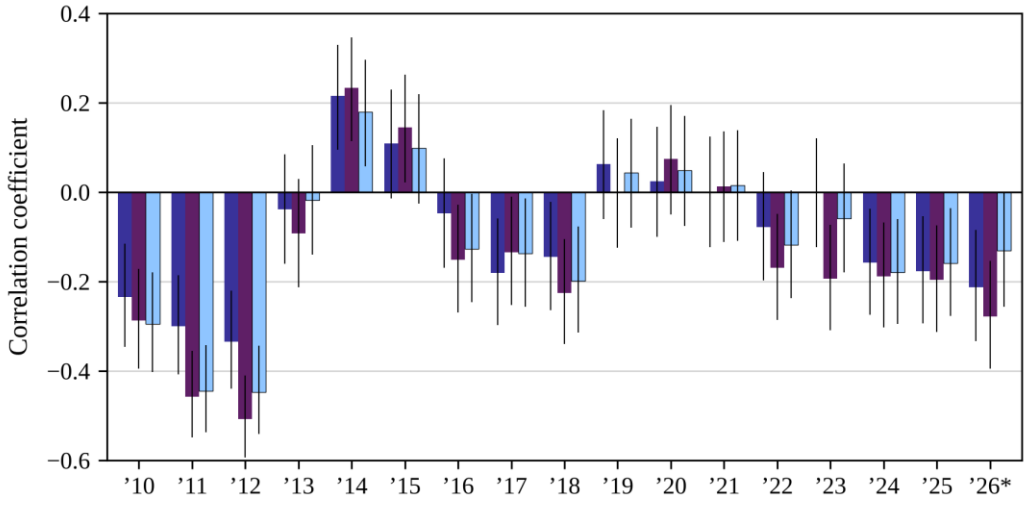
Now, how do these pressures change the relative attractiveness of holding euros and dollars? On the one hand, weaker European output growth alone could lower the ECB's expected policy path – in an attempt to stimulate the economy – as compared to that of the Federal Reserve. Facing a consequent potential depreciation of the euro against the dollar, investors would be driven to reduce their euro holdings or, alternatively, try to increase their "insurance" against the fall. At the same time, in the case of fiscal concerns in an individual state, say France, investors rather want to convert specifically from French bonds into German Bunds. That operation can take place entirely in euros, and, in that case, a wider French–German credit spread would have no major implications for the euro as a wider euro–US policy-rate differential would.

Distinguishing between these mechanisms is helpful in explaining why sovereign stress can cause the euro to depreciate without creating a rigid mechanical one-for-one relationship. Our daily data from 2010 to 2026 are consistent with such a connection being present in the current year. Spread changes and EUR/USD returns have correlations of approximately -0.21 for France, -0.28 for Italy and -0.13 for Spain. Between 30 June and 24 November, France's spread widened by 81.7bp, while EUR/USD fell from 1.1422 to 1.0964 – a decline of 4.0%. This confirms a parallel movement but does not establish a strict mathematical rule on how much euro depreciation sovereign stress caused. Across the whole period considered, the same daily correlations are only about -0.05, -0.06 and -0.03, while between the spread peak on 22 October and 24 November, the French spread narrowed by 21.4bp but EUR/USD did not follow and fell a further 2.25%. While the Bundesbank's November analysis attributes part of the currency's developments since September to French fiscal risk, broader sovereign risk remains only one of

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the factors affecting the EUR/USD exchange rate. Expectations about US monetary policy, energy prices and global risk appetite can all move the currency alongside sovereign stress in the Eurozone. We should also note that the latest widening does not establish a systemic crisis. The ECB's November Financial Stability Review reports orderly functioning of sovereign markets and current average Eurozone spreads are still low as compared to some of the past stress episodes.

Spread Changes vs EUR/USD Returns: Yearly Correlation, 2010–2026



Daily change in spread over Germany (bp) vs daily EUR/USD log return. Whiskers: 95% confidence interval.
* 2026: 1 Jan–24 Nov.

France Italy Spain

Sources: BSIC

A Primer on EUR/USD Skew

Renewed sovereign stress is thus among the reasons that lead investors to seek protection against a potential depreciation of the euro. A decline in EUR/USD, which represents the number of US dollars received for one euro, means that the euro is worth less in dollar terms. An investor with euro holdings and exposure to this decline may purchase a EUR put/USD call, which provides a contractual right to sell euros for dollars at a predetermined exchange rate. If concerns over euro depreciation suddenly rise, demand for this "insurance" can increase too, leading to growing premiums required to compensate option sellers for the additional risk. FX options are commonly quoted in terms of implied volatility (IV) rather than monetary value. IV is the volatility input that makes an option-pricing model reproduce the observed market premium, and holding all other pricing inputs fixed, a higher IV corresponds to a more expensive option.

Options with the same expiry date can have different strikes and thus also different IVs. Plotting the volatilities of a collection of calls and puts against their strikes, we get a volatility smile. The at-the-money (ATM) quotation is our central reference point that is generally related to a strike near the forward exchange rate, depending on the market convention used. The smile's wings – representing out-of-the-money (OTM) EUR puts to the left (low

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strikes) and OTM EUR calls to the right (high strikes) – describe options that provide protection against more extreme downward or upward currency movements.

For our analysis, it is essential for us to distinguish between the overall level of IV and the relative pricing of the two wings. The smile is not necessarily symmetric and, while ATM volatility is at its center, skew concerns asymmetries between the wings. Therefore, uncertainty can increase without a corresponding increase in the relative price of euro downside protection. A widely used measure of FX skew is the 25-delta risk reversal, which, under the EUR-call-minus-EUR-put convention used here, is the difference between the IVs of a 25-delta EUR call and a 25-delta EUR put with the same expiry date:

$$RR_t^T = \sigma_t^T\left(\Delta_{25}^{\text{call}}\right) - \sigma_t^T\left(\Delta_{25}^{\text{put}}\right)$$

The superscript *T* represents the expiry at tenor, while *t* identifies the observation date. A negative quotation means that euro puts carry higher IV than the corresponding euro calls, while a positive quotation means the reverse. The risk reversal therefore represents the relative pricing of the euro downside and upside protection using two points on the volatility smile. It is, of course, not a complete description of the smile or the statistical skewness of the future exchange-rate distribution.

Another distinction for us to make is between the level of the risk reversal and its change through time. A negative risk reversal means the downside IV currently exceeds the upside IV, while a negative change in risk reversal means the difference has moved further towards downside pricing. A more negative quotation can arise because put IV increases, call IV decreases or both change by different amounts. The risk reversal alone therefore does not identify an increase in the absolute price of euro puts. The daily change is:

$$\Delta RR_t^T = RR_t^T - RR_{t-1}^T$$

Sovereign concerns may influence these relative prices when investors become more willing to pay for "insurance" against euro depreciation. However, option quotations reflect an equilibrium between buyers and sellers, so a shift in skew could also reflect changing underlying risks, reduced willingness to supply protection or constraints on intermediaries. We therefore interpret a more negative risk reversal as greater relative pricing of euro downside in IV terms.

Is Skew a Leading Indicator?

Question and method

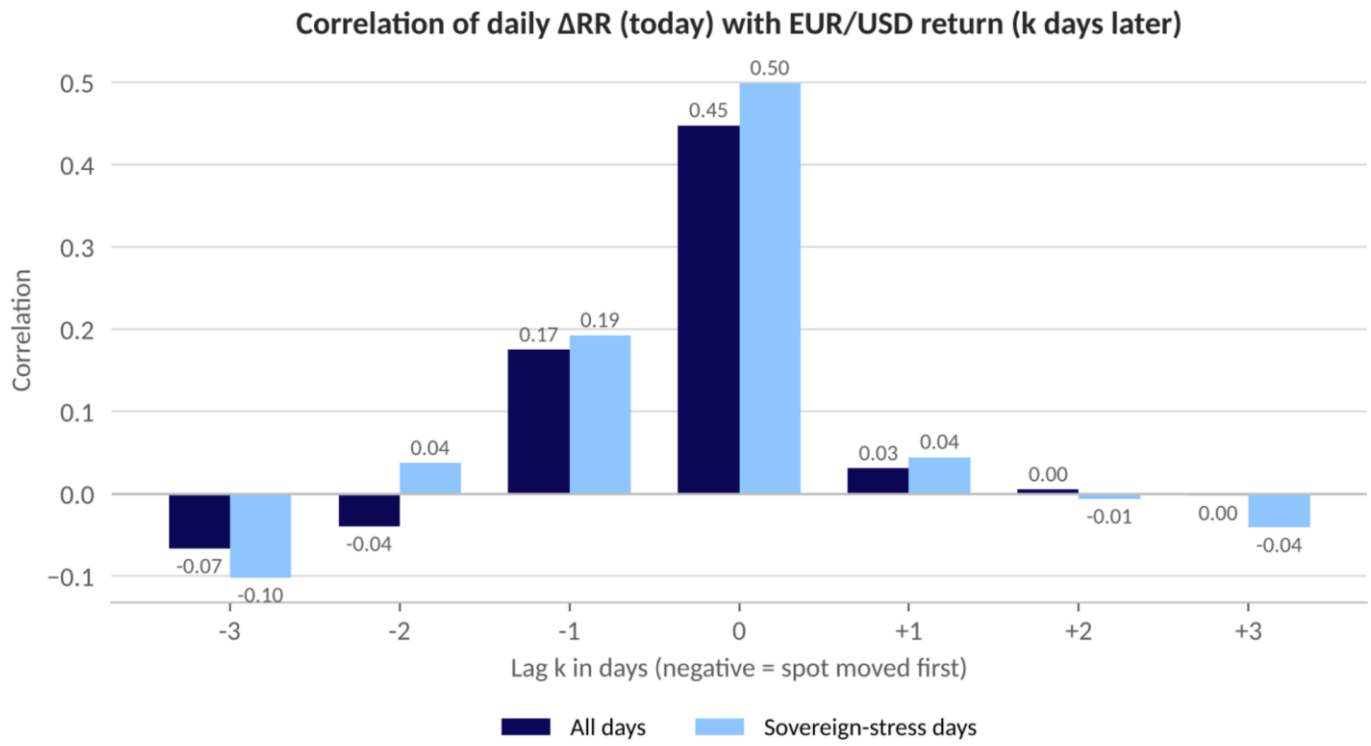
If skew actually carried information about sovereign stress, it should move before spot does. Hence, options traders would bid up euro puts ahead of the sell-off in EUR/USD. In this section, we want to test that directly. Using daily Bloomberg data from January 2010 to November 2026, we compute the correlation between the daily change in the 1M 25-delta EUR/USD risk reversal and the daily EUR/USD return. We repeat this across lags. If the lag is negative, then the spot moves before the skew and vice versa. A leading skew would therefore be confirmed by a meaningful correlation at positive lags. For that testing, we isolate periods of sovereign stress from the overall timeline to see whether there are differences or not. Such periods are defined by the 20-day change in the average of the IT-DE and FR-DE 10Y spreads being in its top decile, leaving roughly 440 days. To check whether the

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skew predicts over longer horizons, we will test whether the level of risk reversal says anything about EUR/USD returns over the following week to three months.

Skew vs spot

The correlation we want to check is the one between the skew and the spot. For this, the chart below shows the correlation of the daily change in the risk reversal (RR) with the EUR/USD return.



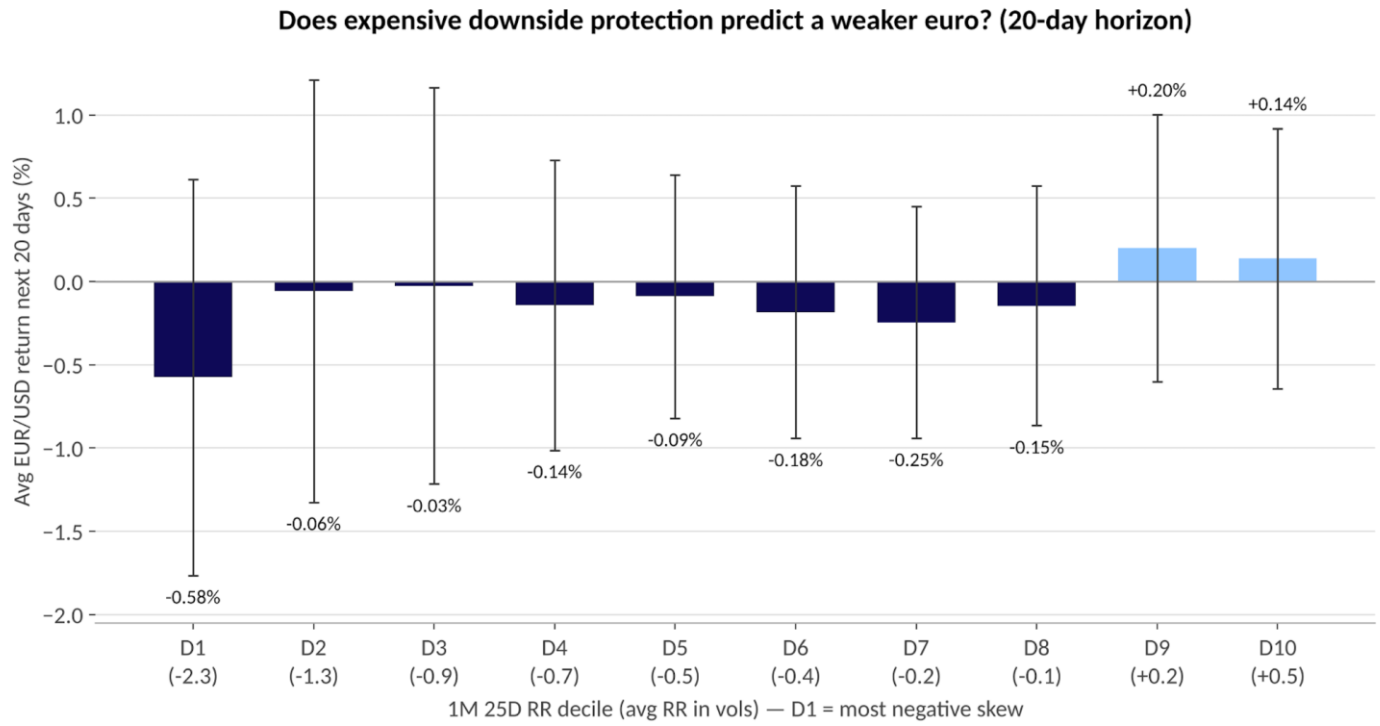
Source: Bloomberg, BSIC. Daily data Jan 2010 – Nov 2026; stress days = 20-day change in avg IT/FR–DE spread in top decile.

Over all days, the same-day correlation is 0.45. For stress days that number is even higher, 0.50, meaning the skew moves with the euro. So, when EUR/USD falls, puts get bid. The next tallest bars are on the left of the previous ones, at lag -1. With 0.17 on all and 0.19 on stress days, yesterday's spot move still shows up in today's skew. That means the skew followed the spot with a delay. After today, we see overall 0.03 for lag +1 and 0.00 for lags +2 and +3, respectively. For stress days those numbers change to 0.04, -0.01 and -0.04, respectively. Those numbers are too small to be economically meaningful, meaning today's skew change does not tell you anything about where EUR/USD goes next. With only about 440 stress days, correlations smaller than roughly ±0.09 cannot be told apart from zero. The stress-day bar at -3 (-0.10) is borderline, but with several lags tested it is most likely noise, as are the small bars at -2 and +1 to +3.

Longer horizons

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Now, we want to look at the return of the spot based on how big the skew was. For this, we have the following chart with the average return of the spot over the next 20 days on the y-axis, and groups of how negative the skew was on the x-axis. D1 has the most negative skew, D10 has the least negative skew.



Source: Bloomberg, BSIC. Daily data Jan 2010 – Nov 2026; whiskers = 95% CI adjusted for 20-day overlap.

As described before, the days were ranked into ten buckets by skew level (D1 to D10). The most negative bucket (D1), with an average risk reversal of -2.3 vol, is followed by an average EUR/USD return of -0.58% over 20 days. That alone would suggest that very expensive puts signal a future depreciation of the euro. However, its 95% confidence interval stretches from -1.8% to +0.6%. None of the other buckets is significantly different from zero either. It can be concluded that those results are not really significant and do not show a skew indicating the future movement of the spot.

Another method to research the significance of the skew is regressing the forward EUR/USD return on the skew level. The t-statistic (t = estimated coefficient / standard error) tells you then whether the effect can be told apart from zero. For reference, an absolute t of above two means significant at the 5% level. Regressing on our data, we get t-statistics of 0.8 for one week, and 1.0 for two weeks and one month, respectively. Using the skew's distance from its 60-day high as a second test, we get no significance at any horizon either (overall largest $|t| = 1.3$ at 3 months).

Episodes

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If the skew was indicative of the spot movement, we would expect that the skew's lows mark the spot's turning points, so it would bottom around the same time. To check those expectations, we can look at some of the past episodes of eurozone sovereign stress and how the timing of the skew and spot lows compares.

Table 1: Timing of skew and spot lows

Episode	Skew low (1M 25D RR)	EUR/USD low	EUR/USD from skew low to spot low
2011 Italy	9 Nov 2011 (−4.19)	16 Jan 2012 (1.2667)	−6.5%
2018 Italy	30 May 2018 (−0.88)	29 May 2018 (1.1540)	Turned together
2022 Italy	14 Jul 2022 (−2.12)	22 Aug 2022 (0.9943)	−0.7%
2024 France	17 Jun 2024 (−1.53)	26 Jun 2024 (1.0681)	−0.5%
2026 France	1 Oct 2026 (−1.47)	16 Nov 2026 (1.0997)	−2.2%

Source: Bloomberg, BSIC. Lows within each episode window; 1M 25D RR in vols.

When looking at the data above, we can see that only in 2018 did the skew and the spot turn together. During all other episodes, the spot kept falling for between one week and two months after the skew reached its low. Therefore, the skew did not anticipate the spot's direction; it recovered while the euro went lower. The two simply came apart.

Takeaway

The skew does not predict the next move of EUR/USD; it reflects stress already happening: it moves with the euro on the same day and catches up a day later. Therefore, a large skew sell-off means the market extrapolates recent moves; it is not information about future moves. That conclusion brings us to the next chapter: the skew overshoots.

Skew Overshoots: Paying Too Much for Euro Crash Insurance

The pattern

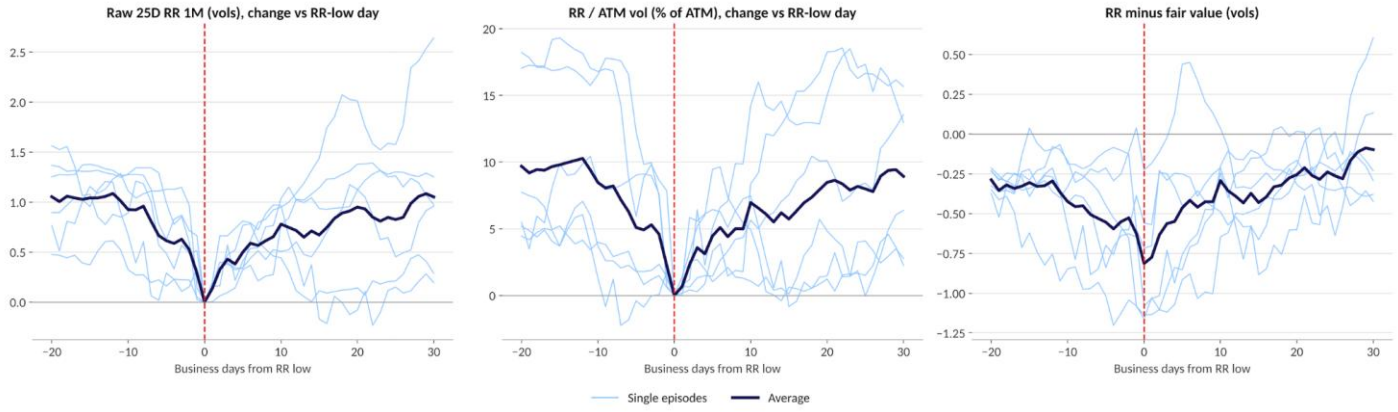
When analysing the previously described episodes, we can find a pattern of the skew's and the spot's movements. The five episodes give us six skew lows, since the episode of 2022 came with two waves that we treat separately for this analysis. Because the low is only known afterwards, part of the drop-and-rebound shape is built into the method. The next section of this article therefore tests a signal that uses only information available at the time. Starting before the low, in the 20 days leading up to it, the risk reversal falls between 0.5 and 1.6 vol (1.05 vol on average), EUR/USD falls between 1.1 and 5% (about 2.5% on average), and the spread widens by about 75bp on average (between 4 and 179bp). After the low, the skew recovers at least 56% of that drop within 10 days, on average about three quarters by day 10 and roughly all of it by day 30. Furthermore, EUR/USD was lower by day

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30 in four of six episodes, and 1.3% lower on average across all six. The spreads, however, retrace only partly, on average only 12bp below their level on the day of the skew low by day 30. For the second wave in 2022 and for 2026, they were still wider. Based on that data, we can argue that after a while the price of the insurance normalised, while the risk it insured against did not.

This is not just vol rising

In stress, all implied vols rise. A higher ATM vol can therefore mechanically make the risk reversal more negative even if the relative pricing of euro downside has not changed. To check whether that is the case here, we divide the 1M RR by 1M ATM vol and repeat that study around the six skew lows. Our results are presented in the following line graph.



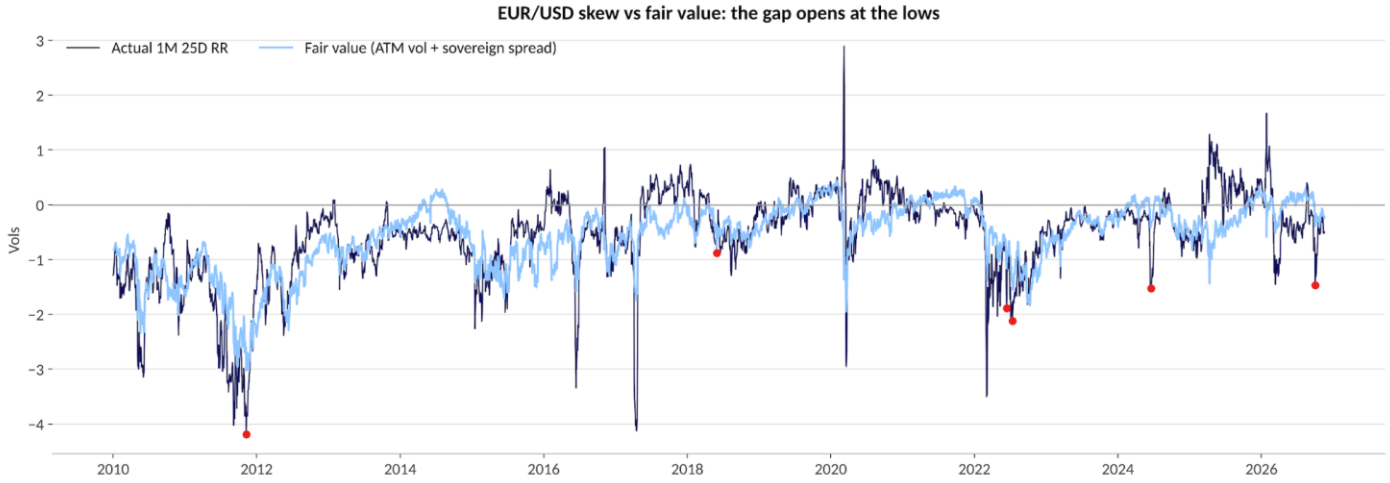
Source: Bloomberg, BSIC. Episodes: 2011 IT, 2018 IT, 2022 IT (two waves), 2024 FR, 2026 FR. Fair value: full-sample OLS of 1M 25D RR on 1M ATM vol and avg IT/FR-DE 10Y spread.

From the graphs we can see that in the 20 days before the low, the ratio becomes on average about 9.7 percentage points more negative. After the low, by day 30, it is back to within about 0.8 points of its starting level. That means euro puts became more expensive relative to overall volatility, and that excess then disappeared after the low. The overshoot is therefore a shift in the price of downside protection, not the result of a higher vol in general.

Fair-value benchmark

The idea is that stress should make the skew more negative. However, higher volatility and wider sovereign spreads would justify paying more for downside protection. That is why we want to research whether the skew falls more than these two drivers can explain. We build the fair value by estimating the historical relationship between the 1M risk reversal and two variables: the 1M ATM vol and the average IT/FR-DE 10Y spread. We therefore use daily data from 2010 to 2026. Our fair value on any day is the risk reversal this relationship predicts. Hence, the gap is the part of the skew that vol and spreads do not explain.

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Source: Bloomberg, BSIC. Red dots = episode RR lows. Fair value: OLS of RR on ATM vol and avg IT/FR-DE spread, Jan 2010 – Nov 2026.

As a result, our model explains 58% of the RR variation. For the ATM vol, each extra vol of ATM vol makes the RR 0.20 vol more negative. For the spread, each extra 100bp of spread makes it 0.36 vol more negative. Both are significant at the 1% level. To explain that concept a bit better, here is a quick example from 9 November 2011: given the vol and spread that day, the model expected a RR of -3.03. The actual was -4.19, so the gap was -1.16. That means even after accounting for the crisis, puts were priced about 1.2 vol too expensive. To summarise that research, the following table shows the gaps to the fair values of these episodes at the lows of the skews.

Table 1b: Gap to fair value at the skew lows

Episode	Skew low	Actual 1M 25D RR	Fair value	Gap
2011 Italy	9 Nov 2011	−4.19	−3.03	−1.16
2018 Italy	30 May 2018	−0.88	−0.65	−0.23
2022 Italy (wave 1)	14 Jun 2022	−1.89	−1.17	−0.72
2022 Italy (wave 2)	14 Jul 2022	−2.12	−1.56	−0.56
2024 France	17 Jun 2024	−1.53	−0.39	−1.14
2026 France	1 Oct 2026	−1.47	−0.39	−1.08

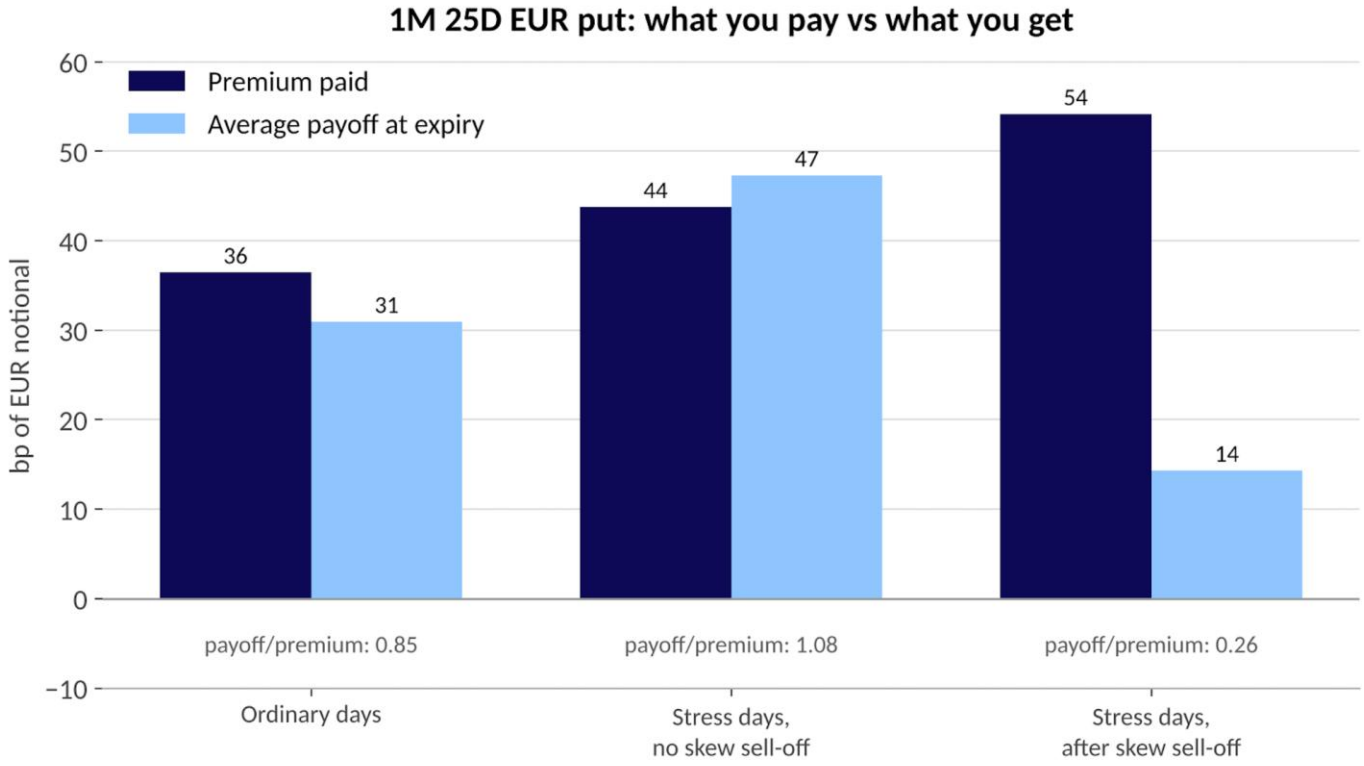
Source: Bloomberg, BSIC. Fair value: regression of 1M 25D RR on 1M ATM vol and avg IT/FR–DE 10Y spread, 2010–2026. All values in vols.

From the data of the table, we can see that there was an average gap of -0.81 vol at the low. Furthermore, the average gaps were -0.29 vol 20 days before, -0.29 vol by day 10 after and -0.10 vol by day 30 after the skew low. Overall we can say the excess fear opens up exactly at the skew low and is on average back to its pre-episode level within about two weeks. Note that it is a statistical benchmark, not a true price. It only reflects vol and spreads, not other drivers, such as for instance the EUR/USD interest-rate differential. Moreover, it is fitted on the full past sample, so it describes the past rather than being a real-time signal.

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Insurance cost vs payout

Another way to look at the pricing is whether the puts paid out what they cost. For that research, we price, every day, from 2010 to 2026 a 1M 25-delta EUR put from the quoted ATM vol, risk reversal and butterfly. We use *Garman–Kohlhagen* with zero interest rates and express the premium in bp of EUR notional. Zero rates ignore the USD–EUR rate differential. At a 2–3 percentage point gap this influences a 1M 25-delta put's value by roughly 5bp, small relative to the gap between premium and payoff. After pricing the put option and "buying it", one month later (21 trading days), we check EUR/USD. The put pays strike minus spot if spot is below the strike, otherwise it pays nothing. As an example we can again take 9 November 2011: the put cost 83.5bp with an implied vol of 18.9% and a strike of 1.3073 against spot at 1.3542. One month later, EUR/USD was at 1.3341. It therefore was above the strike, meaning the option did not pay anything. For our research, we compare the average premium with the average payout of three groups of days: ordinary days (no sovereign stress), stress days without a skew sell-off, stress days after the skew has sold off (RR at least 0.75 vol below its 60-day high).



Source: Bloomberg, BSIC. Daily data Jan 2010 – Nov 2026. 1M options rebuilt from BGN ATM, 25D RR and BF with Garman–Kohlhagen (zero rates), held 21 business days, no costs. Stress days = 20-day change in avg IT/FR–DE spread in top decile; skew sell-off = 1M 25D RR ≥0.75 vol below its 60-day high.

In the graph above, we can see that on ordinary days, the put cost 36bp and paid out 31bp. The ratio is 0.85, a normal insurance margin. On stress days without a skew sell-off, the puts cost on average 44bp and paid out 47bp. Its ratio of 1.08 shows protection bought before the panic was fairly priced. When looking at stress days after the skew has sold off, that image changes. Buyers paid an average of 54bp and were paid out only 14bp on average. Buyers got back about one quarter of what they paid, a ratio of 0.26. That shows at the peak of the panic, euro crash insurance costs about 50% more than on ordinary days but pays out less than half as much. That overpricing sits in the put premium itself: the seller collects that excess which is also the starting point for the trade in the next

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section. Note that for this section we only have a small sample for the stress-after-sell-off days: 245 days that amount to only about 12 independent one-month periods. Furthermore, we use mid quotes for the prices and we do not account for any transaction costs or hedges. We just measure the value of the insurance, not a tradable strategy. The next section adds hedging, costs and an entry rule.

Episodes

We now want to briefly take a closer look at two events from the past. The first one is Italy 2011. The skew there bottomed at -4.19 on 9 November 2011, the day the IT-DE spread peaked at 543bp in our Bloomberg data. By 16 January 2012 EUR/USD had fallen another 6.5%, yet the skew had recovered to -0.88. The second episode we want to look at is France 2026. The skew bottomed at -1.47 on 1 October. The FR-DE spread then kept widening to 174bp on 22 October, and EUR/USD fell to 1.0997 by 16 November. Meanwhile, the skew recovered to about -0.5. In both cases, fear in the option market faded, while the euro kept falling.

Takeaway

In the last two sections we found that the skew does not warn of sovereign stress, but once the panic hits, euro crash insurance becomes excessively expensive: it costs far more than it pays out and that excess fades within weeks, while the euro stays weak. The next section therefore wants to look deeper into the opportunity of selling protection after the panic peaks. It transforms that idea into a rule-based trade and tests whether the excess can be captured after hedging and costs.

From Overpriced Fear to a Trade: Selling EUR/USD Skew After the Panic

Step 1 – When to sell the skew

The evidence shown so far underlines that skew does not warn us that sovereign stress is coming, but it suggests that euro crash insurance is overpriced once the panic peaks, and more importantly that the premium fades within weeks. We therefore build a signal that waits for the stress and then sells the excess premium.

The signal requires two conditions to hold on the same day. The first captures sovereign stress: the 10-year spread of Italy or France over Germany must have widened by at least 20bp over the previous 20 business days. This threshold sits close to the most stressed decile of 20-day spread changes in our sample, which begins at about 18bp. The second condition captures panic in the options market: the 1M 25-delta RR must sit at least 0.75 vol below its highest level of the previous 60 business days.

Since skew falls together with the spot rather than ahead of it, we do not sell it on the first day of the signal. Instead, we wait for EUR/USD to go five consecutive business days without making a new low, and enter at that day's close. If this does not happen within 60 business days of the trigger, we discard the signal, so that we only sell skew while the panic is still recent. After an entry, we take no new signal for 21 business days so that each stress episode produces at most one position at a time.

We set the above-mentioned thresholds ex ante at round values rather than optimising them. As we will show below, the size of the profit varies with this choice, but its sign does not.

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Step 2 – Constructing the trade

On the entry day we sell a 1M 25-delta EUR put and buy a 1M 25-delta EUR call on the same notional. We are therefore selling the expensive side of the volatility smile and buying the cheap one: at the peak of the 2024 French election stress, the 25-delta put traded at 8.2% implied vol against 6.6% for the call. Because both legs gain when the euro rises, the combination carries a long EUR/USD exposure of roughly half the notional. We neutralise it by selling EUR/USD spot and rebalancing the hedge daily at the close, so that the direction of the euro is not relevant for our trade (delta hedge).

To give a sense of scale, at €10M per leg the initial hedge is a short of a little less than €5M EUR/USD. A one-vol rise in the RR, at an unchanged spot, is worth about €9,000, or roughly 9bp of notional. The position is held for 20 business days, close to the option's expiry. As a risk control, we exit early if the RR falls more than 0.25 vol below its post-signal low, which would be an indicator for a second wave of stress.

It is worth being precise about where the money comes from. Held close to expiry, the options' value no longer depends on the skew itself. What the trade earns is the excess premium on the put we sold, collected as it decays over the following four weeks. The recovery of the RR is the sign that the panic is fading, not the source of the P&L. Consistent with this, closing the position as soon as the risk reversal recovered by 0.3–0.5 vol earned only about +1 to +5bp of notional per trade, against +9bp when holding for 20 days.

Step 3 – Backtest across sixteen years

Between January 2010 and November 2026, the signal fires 31 times. The delta-hedged short skew earns on average +12.3bp of notional per trade before costs and +9.3bp after them, with 20 winning trades out of 31. The median trade makes +8.1bp, the best +72.6bp (October 2011) and the worst -43.4bp (April 2017). Summed over the whole sample, the strategy makes about +290bp of notional, with a maximum drawdown of 47bp, measured on closed trades.

The most interesting result is how the trade compares with the obvious alternatives on exactly the same signals. Buying EUR/USD, the intuitive bet that the panic is over, earns +7.5bp per trade after costs, with only 48% of trades positive and a return per unit of risk close to zero. A long BTP or OAT position against Bunds, betting on spreads tightening, loses -21.6bp per trade. The short skew without the delta hedge earns more on average, +22.2bp, but swings so widely that its return per unit of risk is half that of the hedged version (0.17 against 0.33). As the chart below shows, the hedged short skew offers by far the best return per unit of risk, measured as the average P&L per trade divided by its standard deviation. This is what our earlier results predict: after the panic peaks, skew normalises, while spot and spreads are no better than a coin flip, with EUR/USD lower in 16 of the 31 trades and spreads wider in 16.

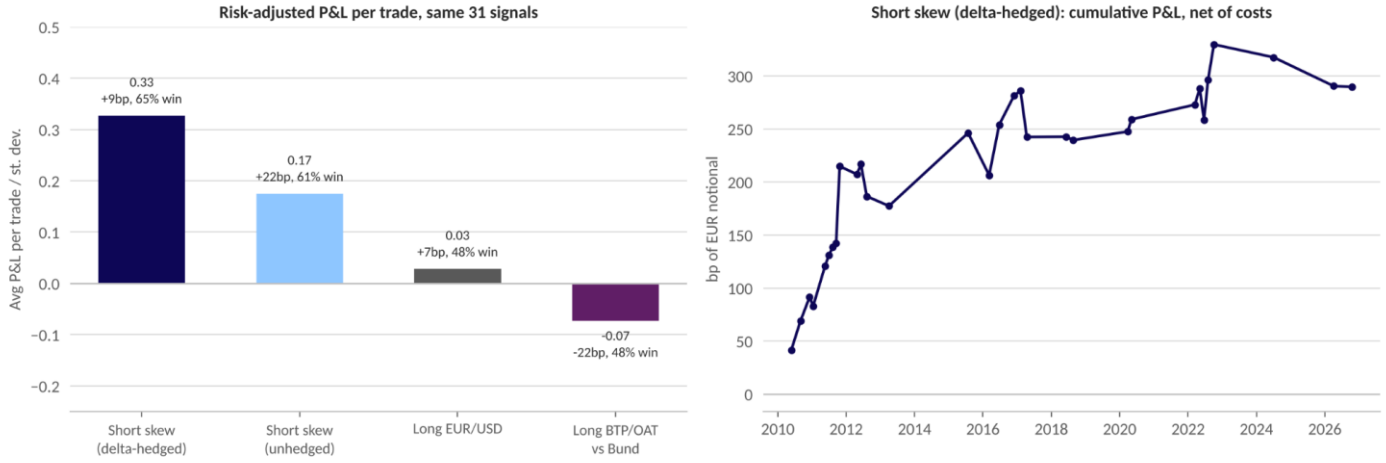
Two caveats keep these numbers in proportion. First, selling EUR/USD skew pays a premium even without our signal: selling it every month earns +3.8bp per trade after costs, with 54% winners. The signal more than doubles the profit per trade and cuts the maximum drawdown from 169bp to 47bp, because it only takes the risk when skew is genuinely overpriced. With about 30 events, however, the difference is not statistically significant. We

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therefore read the signal as a way of timing a known risk premium, not as a new anomaly. Second, the headline results do not include the stop. In our sample the stop does not help: it lowers the average to about +6bp after costs and leaves the worst trade unchanged. We keep it as discipline against a scenario the sample does not contain, a genuine break-up scare.

A note on method. We do not use traded option prices directly; we rebuild them from the ATM volatility, the 25-delta RR and the 25-delta butterfly quoted each day, pricing with *Garman–Kohlhagen* and zero interest rates. Options are repriced daily on the one-month surface as they age. Costs of 3bp per trade reflect a bid–ask spread of about 0.25 vol on each 25-delta leg, worth roughly 2bp of notional in calm markets and up to 5bp in stress.



Source: Bloomberg, BSIC. Signal: IT or FR–DE spread +20bp in 20d and 1M 25D RR ≥0.75 vol below 60d high; entry after 5 days without a new EUR/USD low; 20-day hold. Net of costs (options 3bp, spot 1bp, bonds 2bp per trade). Options rebuilt from BGN ATM, 25D RR and BF with Garman–Kohlhagen (zero rates).

Step 4 – How sensitive is the signal

Since we chose the thresholds after studying the episodes, a fair question is whether the result depends on them. We rerun the backtest varying each parameter around our choice, without picking the best combination.

Table 2a varies the trigger. All nine combinations of skew spike (0.5, 0.75, and 1 vol below the 60-day high) and spread widening (15, 20, and 30bp in 20 days) are profitable after costs, earning between +5.6bp and +13.8bp per trade. The rule we chose sits in the middle of those ranges. One pattern stands out and makes economic sense: the larger the skew spike required, the higher the average profit, rising from about +6bp at 0.5 vol to +11–14bp at 1 vol. In short, the deeper the panic, the more overpriced the insurance.

Table 2b varies the entry window and the holding period. Waiting three, five or ten days without a new EUR/USD low makes little difference: all variants earn between +7bp and +12bp when held for 20 days. Shortening the holding period to 10 days, however, cuts the profit to between +1bp and +3bp. This is consistent with the trade earning its money from the put premium decaying towards expiry, rather than from a quick repricing of the skew. It is worth noting that part of the gap may reflect how we value the options before expiry, using the one-month smile.

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These checks show that the result is stable, not that it is proven. With around 30 events per variant, every row of the tables carries the same small-sample caveat as our main result.

Table 2a: Sensitivity to the trigger thresholds

Skew spike (vols below 60d high)	Spread widening (20d)	Trades	Avg P&L (bp of notional, net)	Winners
0.50	15bp	52	+5.6	54%
0.50	20bp	40	+6.2	55%
0.50	30bp	32	+11.6	66%
0.75	15bp	33	+9.7	64%
0.75	**20bp**	**31**	**+9.3**	**65%**
0.75	30bp	28	+7.9	61%
1.00	15bp	28	+13.8	71%
1.00	20bp	27	+12.4	70%
1.00	30bp	24	+11.1	67%

Source: Bloomberg, BSIC. Delta-hedged short 25D risk reversal; entry after 5 days without a new EUR/USD low; 20-day hold; net of 3bp costs. Highlighted: rule used in the article.

Table 2b: Sensitivity to the entry window and holding period

Days without new EUR/USD low	Holding period	Trades	Avg P&L (bp of notional, net)	Winners
3 days	10 days	34	+1.6	56%
3 days	20 days	34	+7.0	56%
5 days	10 days	31	+0.7	55%
5 days	**20 days**	**31**	**+9.3**	**65%**
10 days	10 days	28	+2.8	54%
10 days	20 days	28	+11.8	71%

Source: Bloomberg, BSIC. Trigger: spread +20bp in 20 days and RR ≥0.75 vols below 60-day high; net of 3bp costs. Highlighted: rule used in the article.

Step 5 – When the trade loses

It is worth underlining that the trade is not a "free lunch", in fact 11 out of 31 trades lost money. Table 3 shows the trades opened during the five episodes studied above. The four 2011 trades were all profitable, while 2022, 2024 and 2026 include losses or flat results. The losing trades fall into the following three groups.

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The first and most important is a second wave. When stress returns after entry, the put we sold becomes even more expensive than when we sold it. In June 2022 we entered after the ECB emergency meeting; the July wave then pushed EUR/USD down 3.5% to parity, and the RR fell from -1.15 to -1.77. In that specific occasion, the trade lost 29.5bp of notional.

The second is a large jump around a scheduled event shortly after entry. The two largest losses in the sample come from April 2017, when the euro rallied about 3% on the French presidential election, and March 2016, two days before a large ECB easing package. They cost 43.4bp and 39.9bp respectively. A smaller loss of 12.1bp in July 2024 came just before the second round of the French election. In all of these cases the euro moved too fast for the daily hedge to keep up. However, the pattern is not a rule. For instance, the trade opened on the day of the Brexit vote in June 2016 earned 47.6bp, and the one held through the October 2011 EU summit earned 72.6bp.

The third is a late entry. In October 2026 the signal only triggered on 19 October, when the RR had already recovered from -1.47 to -0.45; with most of the excess premium gone, the trade finished flat at -0.7bp. An entry rule based on a 0.3-vol bounce in the RR would have entered on 6 October and earned 19.3bp.

Finally, there is a risk the sample does not contain. Selling a put option means paying out if the euro collapses, and a daily hedge cannot follow a sudden gap. As an illustration, at €10M per leg, an 8% weekend gap lower in EUR/USD would cost roughly €250,000 net of the hedge, compared with an average gain of about €9,000 per trade. Such gaps are rare but not hypothetical in the FX market. In January 2015 the Swiss franc jumped by roughly 30% within minutes after the SNB abandoned its EUR/CHF floor. A genuine euro break-up scare would be the equivalent here, which is why the position should be sized small.

Table 3: Trade results in the five sovereign-stress episodes

Episode	Entry	1M 25D RR (entry → exit)	EUR/USD over trade	P&L (bp of notional, net)
2011 Italy	01 Jul 2011	−2.18 → −2.00	−0.9%	+10.4
2011 Italy	11 Aug 2011	−3.42 → −3.60	−2.5%	+7.9
2011 Italy	16 Sep 2011	−2.62 → −2.64	+0.6%	+3.4
2011 Italy	24 Oct 2011	−3.31 → −3.36	−3.2%	+72.6
2018 Italy	05 Jun 2018	−0.36 → −0.67	−0.5%	+0.2
2022 Italy	20 Jun 2022	−1.15 → −1.77	−3.5%	−29.5
2022 Italy	02 Aug 2022	−1.64 → −1.22	−1.5%	+37.4
2024 France	03 Jul 2024	−0.50 → −0.29	+0.4%	−12.1
2026 France	19 Oct 2026	−0.45 → −0.52	−1.9%	−0.7

Source: Bloomberg, BSIC. Delta-hedged short 25D risk reversal, 20-day hold, net of 3bp costs. Full sample: 31 trades, 20 winners, average +9.3bp.

Disclaimer: the trade described in this section is presented for educational and illustrative purposes only and does not constitute investment advice or a recommendation to buy or sell any instrument. The backtest is hypothetical: option prices are reconstructed from end-of-day

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Bloomberg quotes under simplifying assumptions (zero interest rates, mid prices, a stylised cost of 3bp per trade), and actual execution, liquidity and costs could differ materially, especially in periods of stress. Past performance is not indicative of future results. Selling options exposes the holder to potentially large losses, and readers should conduct their own analysis before taking any position.

What Would Change This View?

As of today, 29 November, the signal is not active. The sovereign side of the trigger is clearly not met: the France–Germany 10-year spread has not widened significantly, while the Italy-Germany spread has narrowed to around 105bp. The option side, by contrast, was already met in our latest data (17 November), and EUR/USD has just rebounded towards 1.10 after hitting its lowest level of the year recently.

Three developments would make us reconsider the thesis rather than the timing. The first is a skew that stops mean-reverting after the panic, which would suggest that the market is pricing a lasting change in euro risk rather than a temporary fear premium. The second is a genuine break-up scenario, with markets pricing a country leaving the euro, where selling crash insurance could lead to heavy losses.

The third concerns the benchmark itself. Our signal measures sovereign stress as spreads over Bunds, which assumes that Germany remains the euro area's risk-free asset. That assumption is weaker than it used to be. With Germany borrowing heavily to fund defence and infrastructure, the 10-year Bund began trading above euro swap rates in late 2024, a sign that markets no longer treat it as entirely risk-free. If Bunds themselves came under pressure, euro-wide stress could push yields higher everywhere while spreads over Germany stayed flat, and our trigger would not fire. In that case, spreads over euro swap rates would be a better gauge of sovereign stress than spreads over Bunds.

Two refinements of this trade are worth testing in future work: avoiding new positions just before scheduled binary events such as elections and ECB meetings, and entering on a bounce in the RR rather than on spot stabilising, which would have captured more of the 2026 recovery.

Conclusion

The question that started our research is whether the EUR/USD options market sees eurozone sovereign stress coming. As we have shown, it does not, and sometimes it moves even a day after it. What the options market does is overprice the panic once it arrives. In every stress wave since 2011, euro crash insurance became far more expensive than the move in spot justified, and the premium faded within weeks while EUR/USD stayed weak and sovereign spreads stayed well above their pre-stress levels.

Selling the excess premium on euro puts after the panic peaks, delta-hedged, earned about +9bp of notional per trade after costs between 2010 and 2026, with roughly two winning trades out of three, while buying the euro or betting on tighter spreads on the same signals did not pay consistently. The result holds across reasonable choices of thresholds but rests on around 30 events, and the trade carries the classic risk of selling insurance: small, frequent gains against rare, large losses if the stress returns or the euro gaps lower.

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TAGS: EUR/USD, FX options, risk reversal, volatility skew, implied volatility, sovereign spreads, OAT-Bund, BTP-Bund, ECB, sovereign stress, options trading, backtest

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