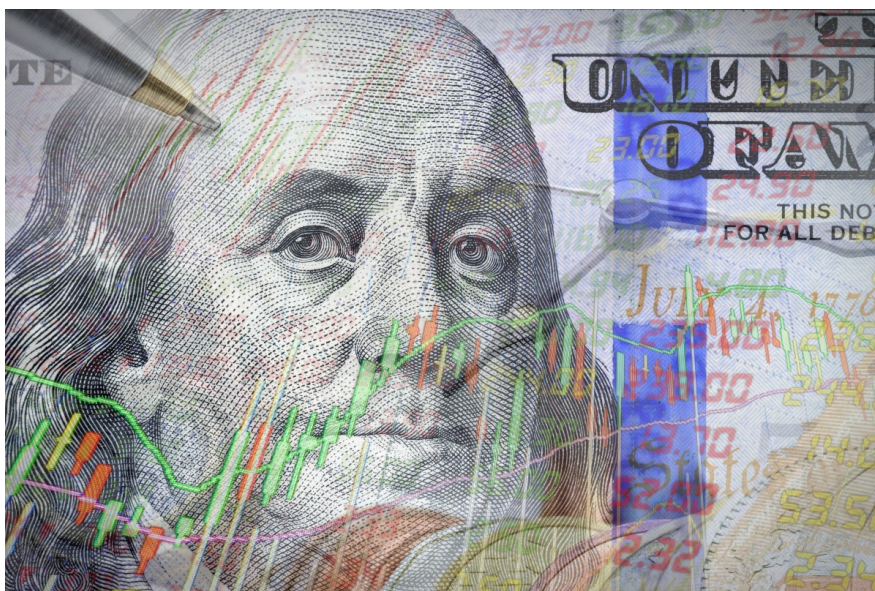


## Rates Spark: First round but then one more to go

Facing the uncertainty of the French elections, eurozone markets may not be able to fully appreciate the impact of the US PCE reading for the broader rates outlook – we think it should bring us an important step closer to Fed cuts in September



### OAT volatility not over after the first round

As we head into the last trading day before Sunday's French elections, markets can look back at still elevated levels but otherwise a relatively calm week. We expected more volatility, but the moderating tones from France's populist party leaders helped stabilise sentiment. Having said that, the game is not over. Marine Le Pen is leading with 34-36% in the polls, yet it's the second round a week later that really counts. EGB spreads will therefore remain elevated and volatility could even pick up. Since no outcome has the prospect of solving France's fiscal challenges, we do not see scope for much OAT spread tightening going forward.

If the coming weeks were to trigger a significant spread widening of French government bonds, we do not expect the European Central Bank to be quick to interfere. Over the past few years, market discipline has bound politicians to budgetary reason, with former UK Prime Minister Liz Truss a peak example. The European Central Bank has little incentive to dampen this effect. And just

yesterday the German finance minister highlighted that any strong intervention may not be in line with legal treaties, so the political appetite may also be lacking.

## US PCE reading likely to help build rate-cutting narrative

US rates inched lower yesterday, with the 10y US Treasury yield below 4.3% again. The core durable goods report showed a contraction in May, whilst expectations were still for month-on-month growth. Also, continuing claims data was weaker than consensus, which could be a leading indicator for a rising unemployment rate, an important data point that will be released next week. The Federal Reserve still has been more hawkish in tone recently, but if unemployment numbers show a notable deterioration this will help support a September rate cut.

Having said that, the US PCE reading today will be more important to yields than underlying growth dynamics. Because the PCE is composed of many price measures that have already been published earlier, there is a high confidence that the core month-on-month number will land between 0.1% and 0.2%. In our view, both readings would be acceptable for the Fed's cutting narrative to build further and thus we remain bullish on USTs.

### Today's events and market views

US PCE data will likely take centre stage in global bond markets and indeed the consensus is firmly on a 0.1% month-on-month core reading with no individual forecasts above 0.2%. From the eurozone, we also have preliminary inflation numbers from France and Spain ahead of next Tuesday's flash CPI for the eurozone – here the core inflation rate is expected to nudge only slightly lower to 2.8% from 2.9% year-on-year, a level that by itself clearly is too high for comfort. The ECB's release of consumer inflation expectations on the 1Y and 3Y horizon will round off today's releases.

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