

Rates Spark: Bond spreads return to the spotlight

French government bonds led a rewidening of eurozone government bond spreads versus Bunds as political uncertainty looms large again. But the wider fallout looks more contained, with Bund ASWs only moderately wider and ECB pricing little changed. We think US data will remain relevant for direction, biased to the upside this side of the Fed and CPI data



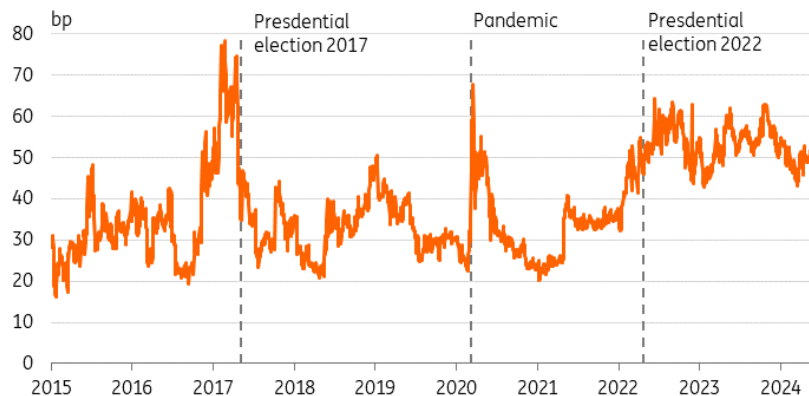
National repercussions of EU vote rewidened European bond spreads

Monday was all about digesting this weekend's news, starting with a shift towards Eurosceptic parties in the EU parliament and then French President Emmanuel Macron calling for an election. At face value, the changes in the EU parliament will not have a material impact in the near term. But we do think that the shift to the (radical) right at the national level could have repercussions on the eurozone economy and financial markets. The French elections are therefore the next event to look out for.

Notably, the market impact was felt mostly in sovereign spreads, where 10Y French bonds

widened by more than 7bp versus German Bunds. The widening was not confined to France however, but observed across the entire EGB space to varying degrees. 10Y Italian spreads widened by close to 7bp, Spain's still by over 4bp. These moves are a reflection of the heightened uncertainty in the weeks leading up to the French elections on 30 June and 7 July, and additional compensation investors now demand to hold spreads risk. However, the overall flight to safety usually observed amid spread turmoil was very muted. Bund spreads versus swaps did widen, but not materially so - while at their widest since late May at 25bp, we are still eyeing levels closer to long term lows.

French yields spreads over Bunds widen amid political turmoil



In outright terms, Bund yields continued to rise, with the 10Y extending its ascent from last week and climbing toward 2.68%. But the short-end of the curve remained anchored as markets also did not get anything from yesterday's European Central Bank speakers that would give them any feel for further ECB cuts.

While underperforming versus US rates yesterday, we see reason for euro markets to also rely on the US for direction. Leading up to the Federal Reserve meeting, the US CPI number on Wednesday will be the number to watch. In our view, a consensus reading of 0.3% month-on-month for core CPI is not a number that market should be happy about and we therefore have a continued bias for yields to nudge higher in the short term.

Tuesday has a fair bit of bond issuance lined up, so this pressure may continue a bit longer. Certainly in the US where a soft 3Y Treasury auction already added upside pressure on yields last night and now a 10Y tap looms large today. The eurozone and the UK also see their fair share of supply via government auction, supra and Gilt syndications.

Today's events and market view

No notable data from the eurozone, but we do have plenty of ECB speakers. Monday's speakers were unable to move markets, but perhaps Francois Villeroy from the Banque de France or Robert Holzmann from the Austrian central bank will have more to tell us. From the US, we have the NFIB Small Business Optimism indicator, which is not considered tier one data and markets will likely remain in a holding pattern for the CPI numbers on Wednesday.

Plenty of issuance expected. The EU has a syndication lined up for a new 15y issuance

estimated for €7bn. Eurozone auctions include a Dutch €2bn 10y DSL and Finnish 10y and 31y RFGBs for €1.5bn. From the UK we also have a syndication, with new 10y Gilts estimated for £10bn. The US will auction a 10y Note for a total of \$39bn.

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