Rates Spark: EU underlines fiscal concerns

Markets have calmed down a bit since the French election turmoil started last week. Bund yields remain lower, reflecting still lingering uncertainty and reduced risk appetite. The start of the EU's Excessive Debt Procedure did not stir markets, but we think political risks can materialise later this year as correction plans are handed in for evaluation.

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EU's Excessive Debt Procedures not stirring markets yet

Wednesday proved to be a quiet day, with US markets closed to celebrate Juneteenth. With little guidance from the ECB about upcoming cuts, euro rates seem to lack direction without US markets telling them where to go. The 10-year Bund yield has maintained a holding pattern the past few days at around 2.4% which still reflects a level of lower risk appetite since the French election turmoil took off. In the near term we see few catalysts for the EUR curve to shift back up, given that election uncertainty will continue to loom and the momentum for US yields is down.

Yesterday's kick-off of the European Commission's (EC) Excessive Debt Procedure (EDP) did not shake markets either, despite the inclusion of five eurozone countries including Italy and France. EGB spreads showed some widening but the daily move for the 10y BTP-Bund spread was kept to 4bp and for France just 2bp. The news did not come as a surprise, and the real event risk in our view will come as countries hand in their adjustment proposals on 20 September.

The consequences of the EDP are hard to pinpoint based on experience, but a political clash on the way towards compliance could be a basis for market volatility. In theory the EC can write out fines up to 0.1% of GDP per year if the path of correction is not complied with, but this has not been done before. The eligibility of the country's bonds in the Transmission Protection Instrument may be void, yet also here we cannot rely on past experiences. So the direct impact from the EDP may be mitigatable, but with Meloni in Italy and a potentially larger role for Le Pen in France, we do see this as a potential trigger for a clash between rising populism and the EU.

Bank of England expected to cut in August

Today's it's the Bank of England's turn to discuss rate cuts. We don't expect a cut yet and nor do markets. We do, however, see August as the most likely timing for the first cut. Inflation numbers yesterday were a tad higher than hoped, but we still think the services CPI will come down sufficiently by then. Markets seem less convinced and less than 50% of a cut is now priced in by August's meeting. Depending on today's communication, we could therefore see the short end of the GBP curve nudge lower.

Today's data and market views

In Europe the BoE meeting will be the highlight. Beside that, first PPI data from Germany already came in cooler than expected this morning, but was not a market mover. Maybe more interesting will be the eurozone consumer confidence index which is expected to continue the slow but gradual improvement. Later in the day the weekly US jobless data will be watched closely and, given EUR rates are looking for direction, this could well impact eurozone markets. Lastly we have US housing data and the Philadelphia business outlook survey.

In terms of issuance, Spain will auction €5.5bn of 5y, 8y and 10y SPGBs. France has €10.5bn of OATs in the pipeline for 3y, 5y, 6y and 8y maturities, which is in addition to a €2.25bn auction of OATei with 3y, 12y and 29y maturities. From the US we have a 5y TIPS auction valued at $21bn.

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