Rates Spark: French bonds not benefitting from return of risk appetite

After Friday's risk-off sentiment, risk appetite seemed to have returned a bit this week. French bond spreads, however, remain high and won't see an abatement of uncertainty until after the elections at the beginning of July. We believe spillovers to other rates markets will remain limited. US Treasuries will in the end build to a 0.0% MoM core PCE ahead

Wider French spreads possible but spillovers contained

Monday saw a bit of a relief after risk-off sentiment dominated on Friday, which suggested that investors weren't keen to go into the weekend with too much risk on their books. French government spreads didn't reverse much however and ended near last week's close. The 10y OAT-Bund spread now stands at 77bp, the highest level since the eurozone debt crisis, and just between the spreads for Portuguese and Spanish bonds. Some of the risk reversal may be attributed to Le Pen assuring markets that she was not calling for institutional chaos.

European Central Bank chief economist Lane didn't seem too concerned about the ongoing market dynamics, but Lagarde later in the day acknowledged that recent market developments are being closely watched. In theory the ECB can resort to the Transmission Protection Instrument (TPI) to address market volatility if it poses a risk to the transmission of monetary policy. But given French spreads are still well below that of e.g. Italy, we see little reason for the ECB to react through such tooling in the near term.

So far the contagion to other rates markets seems limited, with EGB spreads wider across the board but still well contained compared to previous episodes of eurozone risk. The 150bp of 10y BTP-Bund spread, for instance, is far below the previous peak of 250bp in 2022. Also, the widening of swap spreads is manageable considering the 10y swap spread is still below this year's high. We believe the high degree of uncertainty is here to stay until the final election round in early July and thus French spreads can still drift higher. But with Le Pen's strategy seeming one of moderation the contagion to other rates markets may remain limited.

US Treasuries on a pause phase, and testing a tad higher in yield, just for now

We remain in a rate-cut building phase in the US. It's not easy though, as we've been here before. In fact all the way back in March there was an effective market discount for a rate cut. So while there is a degree of market conviction behind a September cut, it's laced with vulnerability. Typically the 3-month leg into a first cut is when the market really winds up for the event, often with big moves in 2's. This time the big move might not start till we are 1-month out from the first cut event.

The other issue impacting Treasuries is the lack of a term premium in the 10yr. With the 10yr at 4.3%, the term premium is registering at -20bp. This is why we can't get too carried away with rally potential in the 10yr area. We've identified 4% as a target if the stars align and a rate cut discount continues to build for September. From an historical context that's not a big move. But it's also hard to justify a big move below 4%. Hence the conservatism.

We also note the liquidity in Treasuries is not great right now. This does not point to a particular direction. But it does point to the vulnerability to increased volatility. There is a period of potential volatility in the next week or so. But 10 days from now is when we get the core PCE deflator number. If that comes in at the 0.0% currently projected by the market, then the path to lower market rates remains the truest one.

Tuesday's events and market views

We start the day with the ZEW survey outcomes. The current expectations component for Germany is still heavily in negative territory but seems to have bottomed out, suggesting the recovering growth narrative may start showing.

From the US we have retail sales, which markets will eye for signs of weakness as pandemic-era savings have been spent and consumer borrowing costs have increased. Industrial production numbers from the US may show an uptick, but business surveys suggest the underlying trend is still to go lower.

Germany will auction a 5y Bobl for €4bn and the UK similarly a 5y Gilt for £4bn. The US is set to auction a $13bn 20y Bond.

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