Rates Spark: French politics and the Trump vacuum

Spreads on French government bonds are touching new highs again as Le Pen and the opposition are threatening to topple the government (again). Spillovers to other markets remain limited, but the uncertainty ahead does help support the prevalent dovish sentiment. Meanwhile, US Treasury yields are finding their own valid excuses to test lower

French government bonds continue their rollercoaster ride - this time on the budget

No-one can predict where French politics will be headed next

French government bonds keep their seat in the rollercoaster as the intensity of the political stand-off between the government and Le Pen is reaching new highs. The 10Y Bund-OAT spread closed at 88bp, at the record high from last week (and 2012). The coalition seems dedicated to pass the budget while also showing a willingness to make concessions to Le Pen's demands. But a no-confidence vote can be initiated at any time by the opposition. Markets know this, and thus even if the situation de-escalates in the near term, spreads can remain at current levels.

We deem the chance of the coalition falling at some point during the negotiations as a likely scenario which means markets would face even more uncertainty. For this reason the scope for spreads to tighten is limited and we could very well see a further widening if a no-confidence vote returns the political situation back to limbo. If no agreement on the budget can be reached, then the budget from 2024 will become the fallback option, meaning that the ambition to address the country's budget deficits faces yet another hurdle.

The fallout remains modest, although other EGB spreads, such as the 10Y BTP-Bund spread, found themselves wider on the day. Bund swap spreads saw some movement around the headlines, but the 10Y remained close to 7bp, in line with the average from last week. One could argue that the turmoil feeds the dovish sentiment in euro rates, together with the weaker-than-expected PMI data. The US payrolls numbers on Friday, however, are likely the more important event to watch for the next step for EUR rates.

US market rates have a downside tilt for their own reasons

We continue to assess the path of least resistance as lower for US bond yields. A decent retracement is fitting following the near 100bp move to the upside for the 10yr yield, a move that was in fact sparked by the first Federal Reserve rate cut back in mid-September. That move culminated in the Trump clean sweep post the November elections. But as we push beyond that and through December, we're back to basic data watching, against a backdrop where Trump has no impact on immediate data releases. The payrolls report we get on Friday did not know that Trump was about to win, and even the next couple will not have a "Trump impact". That provides an excuse to test the downside for yields.

Another factor is the end-of-year effect. It's not uncommon for bonds to do well into the turn of the year. Cash is often parked as risk trades are wound down to some extent. And January is often a month in which liquidity comes back into the market, acting to help all types of bond products. But for the coming few weeks we continue to tactically play this from the long side. That said, we've identified a floor at 4% for both the 2yr and the 10yr yield, and we're only some 20bp above that. The rationale for the 4% floor centres on the market discount for the funds rate, which is only just under 4% by late 2025. If that holds, any break below 4% should only be temporary, if we get there at all. We remain structurally bearish beyond that, but that's for later.

Tuesday's events and market view

French headlines will likely dominate euro markets, while JOLTS job openings data could be the driver for US rates. The widely anticipated US payrolls data is slated for Friday, and because the JOLTS data does not offer much predictive value for those numbers, the market reaction may be limited.

Germany will auction 2Y Schatz for a total of €4.5bn and the UK has scheduled a total of £2.25bn of 30Y gilts.

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