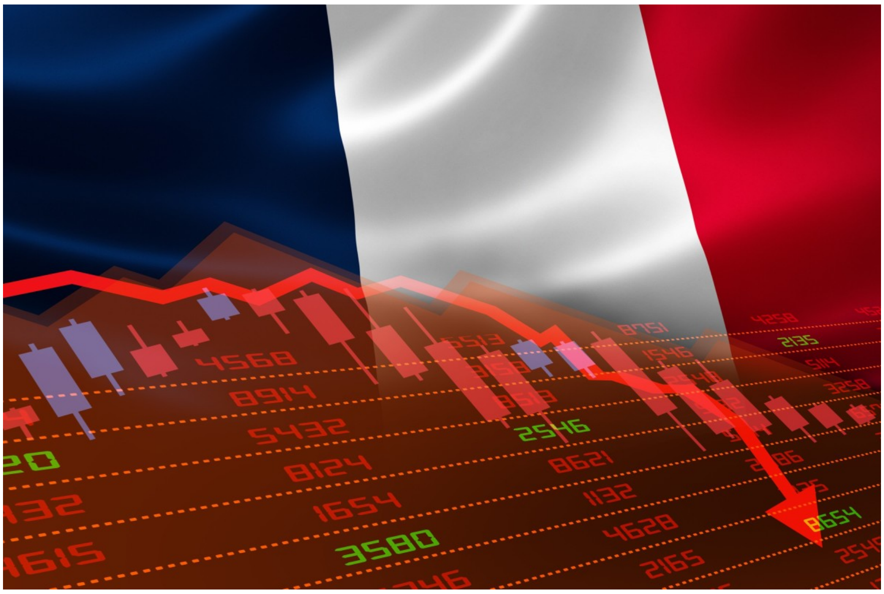
Rates Spark: French problems; politics and PMIs

Markets are reducing the likelihood of a 50bp cut by the European Central Bank in December, as central bank officials do not appear overly concerned about recent weak PMI readings. Ongoing issues in French politics and a weakening economy, as indicated by last week's PMIs, are not benefiting French government bonds (OATs)



The ECB is reluctant to give forward guidance about a 50bp cut

Despite both German and French consumer confidence undershooting expectations, markets pushed back against the frontloading of ECB rate cuts again. The impact of the disappointing PMI readings last week has now fully faded with the probability for a 50bp cut in December back to just 15%.

Markets were hoping the poor numbers would bolster the dovish attitude of the ECB, but the speakers so far have been reluctant to give in to this wish. In an interview, board member Schnabel acknowledged the weak PMIs but at the same time preferred waiting for hard data before drawing any conclusions.

Even if a 50bp does not materialise in December, we still believe the bull steepening in the eurozone has more room to go. With the economy clearly weakening, the ECB is willing to return to neutral at a reasonable pace, and even towards expansion territory as additional insurance. The landing point is currently priced at around 1.75%, and thus the ESTR 2Y swap rate of 2.0% still has room to go lower. Not only will cuts start rolling in, mechanically reducing the 2Y, but also the fragile risk sentiment could trigger dips lower.

French politics and PMIs are not helping OATs

Meanwhile, the 10-year OAT-Bund spread experienced slight tightening on Wednesday, but overall, the spread remains at its highest levels since 2012.

We don't think Le Pen will follow up on her threats to topple the government in the near term, but it does remind markets of the precarious situation the country is in. A no-confidence vote would reset the progress made with the current budget proposal and trigger a new period of political limbo. But given new parliamentary elections cannot be held until mid-2025, the timing for such a move seems presumptuous.

That said, the economic outlook for France in the longer term is bleak and has deteriorated over the past few months. The Services PMI stands at 45.7, indicating a significant contraction, while the Manufacturing PMI is even lower at 43.2, matching the figure for struggling Germany.

But in contrast to France, Germany still has plenty of fiscal headroom if needed. A weakening French economy will make the already seemingly impossible task of fiscal consolidation even more challenging. Therefore, even the survival of the coalition for now does not argue for a significant retightening of spreads in our view.

Thursday's events and market views

From the eurozone, we have Spanish and German CPI numbers, which should shape the market's view on the eurozone aggregate CPI readings on Friday. We also have eurozone M3 money supply and consumer confidence numbers. Later in the day, we have several ECB speakers, including Villeroy, Knot and Lane. Overall, markets will be relatively quiet given the US Thanksgiving holiday.

Italy has scheduled a 5Y, 9Y and 10Y BTP, together with a 7Y CCTeu, for a total of €8.25bn.

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