Rates Spark: Payrolls Friday to settle things

Eurozone government bond spreads tightened significantly on improving risk sentiment as Le Pen suggested a new budget could be put together in weeks. Front and centre though is the US payrolls report. Crucial as always, but this time interpretation is made tougher by returning strikers and the hurricane impact. Watch the unemployment rate this time

It's payrolls Friday ahead, and as always the number(s) are crucial

On the number itself, we're repeating the below from our US chief economist, James Knightley: "Last month's 12k outcome for non-farm payrolls was considerably weaker than expected. State data shows that Hurricane Milton had a negative influence. We approximate it depressed Florida payrolls by around 51k. Add the Carolinas and Virginia, and we can round that to a 60-65k impact. We also know that strike activity, predominantly at Boeing, subtracted 44k. All of these factors will reverse. This means we have 109k as a base for November before we consider any actual payrolls growth. We forecast headline payrolls growth of 225k, but given that 109k of this is the technical rebound, it implies "true" payrolls growth of just 116k."

As a strategist, the crucial aspect is how the market will feel about a 200k+ payrolls outcome. The optics would suggest that's still a good looking number. It's likely this time the key number will be the unemployment rate. It fell to 4.1% last time. If that sticks at 4.1% (which is what the market expects) then we are left with a glass half full labour market. If it rises, then signs of underlying weakness would be more clearcut. The high this year was 4.3% in July, and in many ways the slip back down to 4.1% was a surprise, but tells its own story of relative robustness.

The market has been trading as if we're about to see a weakish number. Which is why a 4.1% unemployment rate would be liable to pressure market rates back up. But we've got a 4.2% unemployment rate as an expectation. Get that and we can maintain our tactical bullish stance on US Treasuries, all the time with 4% presented as the fair value floor (for the 2yr and 10yr, but especially the 10yr).

Le Pen's comments helped broader risk sentiment in the eurozone

Eurozone markets expressed relief when Le Pen seemed dedicated to pass a new budget in a matter of weeks. Her comments suggest the political deadlock may not be as stuck as suggested over the past few days. Of course these are just words, and actually reaching a credible government budget that also satisfies Le Pen’s party will prove a challenging task.

Nevertheless, the 10Y OAT-Bund spread tightened by some 6bp on the day, bringing the level to 78bp, the lowest in two weeks. Interestingly the spread tightening was felt more broadly throughout rates markets, with also Italian BTPs and Spanish SPGBs benefitting from the improved risk sentiment. The euro swap curve retraced a small part of the move lower from the past days. So while the spillovers from French politics have so far appeared limited in terms of volatility, rates markets are not entirely immune either. Given the pessimism on the French economy in the near term, we do think spreads will struggle to make a meaningful push lower until big strides are made on the new budget.

The relief did little for the Bund swap spread, however, which traditionally is a good measure of risk sentiment. In other words, Bund yields did not rise versus swaps, suggesting no significant repricing here on the back of safe asset flows. Such muted behaviour falls in line with our broader observation that investors are reassessing the relative spreads of EGBs. The economic outlook for Spain and Italy, for example, seems to be much more positive than say Germany and France.

Friday's events and market views

Everything will be about US nonfarm payroll numbers, of which consensus expects a 215k reading. Whilst EUR rates have diverged significantly from the US over the past month, especially the back end of the curve remains sensitive to US macro data. The US unemployment rate is expected to remain constant at 4.1%. Lastly, the final eurozone GDP figure for the third quarter is likely to remain at 0.4% quarter-on-quarter.

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