

Rates Spark: Politics and fiscal issues muddy waters

Passing the new budget through the French parliament may prove difficult and generate more rates volatility. EGB spreads look tight given defence spending ambitions. US Treasuries yields decide to test the upside, and for good reason we think



Negotiations on the next budget in France could prove difficult

Treasuries decide to take matters into their own hands for a bit

US Treasuries went into sell-off mode about an hour after Tuesday's CPI numbers. It was not driven by the CPI data itself (as the data was okay versus what was expected). But the CPI data did present an opportunity for the bulls to have a go at pushing yields lower. The fact that the market went the other way is indicative of one of two things. Either a large seller or two decided to counter the potential buy mood with a large contrarian order. Or, we're breaking out here to the upside premised off the mood music of the past few weeks, which has been interlaced with unsolved fiscal concerns and future upside risks to inflation (tariffs), which in turn makes Fed cuts tougher to deliver. There is also the extra issuance to be done. The fuss over Chair Powell's position is a factor too. And there is background fiscal concerns doing the rounds too (Japan, UK). It's all a bit messy. But we can't say this latest move does not make sense. Quite the contrary – it makes full sense.

Expect more volatility as French budget talks take off again

French politics may trigger more headlines the coming months as the government tries to negotiate parliamentary approval for a new budget. The budget, which was presented on Tuesday, contains unpopular measures to cut spending, including for instance the reduction of public holidays. It's a move in the right direction to address the fiscal deterioration, but markets did not show much reaction to the budget presentation and the spread between the 10Y French government bond (OAT) and Bund remains around 70bp. The real test will be whether a majority in parliament can be found or whether France will again have to rethink its attempts to address the worrisome 6% government deficit as a share of GDP.

With global markets laser focussed on fiscal dynamics, we may see more rates volatility going forward. Having said that, since the turmoil started last year, French fiscal concerns have shown little spillovers to other European government bond markets. On the contrary, Italian BTPs have tightened significantly ever since. We do think the tightening of EGB spreads may have reached its limits. Increased European Union defence spending plans whilst the European Central Bank continues to unwind its balance sheet are both factors that should widen spreads going forward. With this in mind, we find it difficult to find a bullish case for French government bonds.

Wednesday's events and market views

We'll start the day with UK CPI numbers, which will be closely watched given the Bank of England's easing path is far from set in stone. Consensus sees the important services component ease from 4.7% to 4.5% year-on-year. Later from the eurozone we'll have trade balance numbers from May. These numbers could provide some initial insights on the impact from the tariff tensions. From the US we have PPI data, the next price numbers that could tell us more about the tariff pass-through. Consensus sees a slight pick-up in the month-on-month figures. Other US data includes industrial production and capacity utilisation, both for June.

Later in the day we also have the Beige Book from the Fed, which contains qualitative data on the state of the economy. Not a big market mover of itself, but it does add colour to the quantitative data.

For supply we first have the UK with a 9Y Gilt tender totalling £1.5bn. In addition, Germany will auction 23Y and 31Y Bunds for a total of €2.5bn.

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