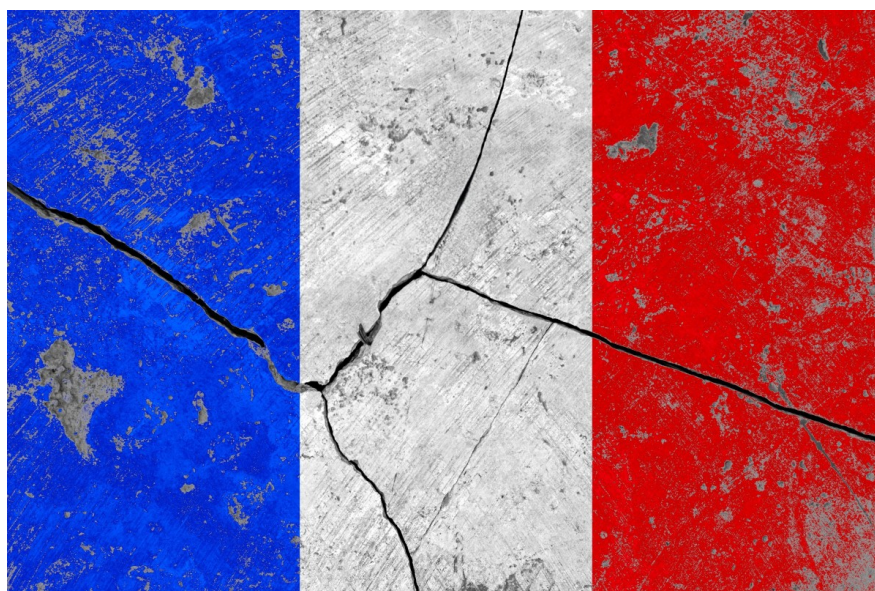


## Rates Spark: Resilient risk sentiment

Risk sentiment remains resilient and largely unaffected by factors such as French politics. While this should support EUR rates grinding higher and spreads – outside of France – still tighter, plenty of risks are looming. US rates are another directional driver, and today US data is in focus ahead of Wednesday's Fed decision



The recent political upheaval and rating downgrades in France has had little spillover to broader eurozone markets

### Implied volatility measures grind lower as risk sentiment remains resilient...

With the French turmoil contained so far, the positive risk sentiment in euro markets may help rates grind higher, with the easing of trade tensions helping to reduce the uncertainty ahead. For rates, the implied volatility priced in over the next three months is now at the lowest level since 2022, and credit and sovereign spreads are very tight. The positive risk sentiment environment should have a bearish impact on rates as the perceived need for more European Central Bank cuts is reduced.

We do warn against complacency, however, as plenty of risks are still looming. Eurozone data has improved, but the recovery in growth is fragile. Soft data points to an improvement, but the hard data will have to confirm this. In the US, a further deterioration of economic data could trigger a global shock to risk sentiment, which would then cap the bearish momentum in euro rates. And

although trade tensions have eased, working out the details of trade deals still risks escalation.

## ... and largely unaffected by factors such as French politics

On the first day after [Fitch stripped France of its AA](#) rating, French government bond spread over Bunds actually tightened somewhat. To a degree, we think this muted reaction is just reflective of the notion that spreads were wide to begin with and already incorporating the rating migration lower of the French credit; after all, the spreads of France and Italy are now basically on par.

More importantly, the entire episode of French political upheaval and now downgrades has had very few implications for the broader sentiment in the European bond space. Of course, we had the contemporaneous upgrades of Spain and Portugal to underscore that French bonds are their own special case. With the overall risk backdrop resilient, as highlighted by the above-mentioned low volatility measures, the carry environment remains constructive. Italy's 10y spread over Bunds has managed to dip back below 80bp, on track to levels last seen more persistently ahead of the European sovereign debt crisis. And given that French bonds are likely to see a more persistent political risk premium, we would not be surprised to see them trade cheaper than Italy.

### Tuesday's events and market view

Following the early morning release of UK jobs data, the focus shifts to the German ZEW, which is anticipated to show worsening current conditions and also softer expectations. The eurozone will release industrial production data, while ECB speakers for the day are Simkus and Escriva.

The main market mover ahead of Wednesday's Fed decision is likely to be US data. Retail sales will likely be held back by subdued consumer sentiment and a fall in auto sales. Industrial production may contract yet again based on manufacturing survey evidence. We will also get import price readings for August.

In terms of issuance, Germany auctions €4.5bn in 5y bonds, Finland €1.5bn across 6y and 10y lines. The UK auctions £3bn in 14y gilts and in the US the Treasury will sell US\$13bn in 20y bonds.

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