Rates Spark: We’re not anticipating a crisis, but there, we’ve said the word

The unfolding saga out of France probably blows over. There have been many before. But at the same time, we need to be vigilant. The market discount certainly sniffs a growing issue. We'll observe and monitor, adding it to the list of other worries. Meanwhile, the US has rate-cut tunnel vision, with PPI and a 10yr auction the next tests

Even with France's recent difficulties, we don't expect a full-blown crisis

We've been watching France for a while. Sharpen that focus now given recent developments

For those sitting in Europe, it's been easy in recent months to “tut-tut” at the goings on the US. The Trump administration has been extremely busy taking extreme action, some good and some bad, but mostly looked at with a combination of disdain and disbelief from afar. It should in fact be a moment for Europe, and the eurozone in particular, to show itself off, to market its wares, and provide reason to perhaps shun the US and shift focus to Europe. If only. The UK has yet again shown a remarkable ability to trip itself up, politically and economically. But the heart of the eurozone is now under a degree of threat. Many believe Germany is that heart-beat. It’s not. Germany is the benchmark, the core and the economic driver of Europe. But France is more akin to the architect of it, certainly of the eurozone. And right now, there’s a huge cloud over France. See more here.

From a markets perspective, we can make a few simple remarks. First, France is now viewed as being on an equal footing to Italy from a credit perspective (no judgement on Italy per se). Second, Germany, despite its multi-year macro malaise, has further enhanced its core credentials, again from a credit perspective (look at diverging debt/GDP ratios for evidence of this). Third, if the Franco-German axis is seen as the key gel factor for the eurozone, it is now being thoroughly tested, as there is a growing strain between the two (again, from a credit perspective). Hence the widening in spreads, and the risk for more. True this could be countered by noting the ongoing (relative) political harmony between France and Germany. But here we are focussing on a cold credit divergence analysis.

We are not anticipating that this will become a full-blown crisis. But we are watching very carefully. The Great Financial Crisis was anticipated by few. The genesis of that was the implosion of a quirky part of the US mortgage market, and before we knew it the global marketplace became accustomed to terms like sub-prime and alt-A. Few crises are seen with clarity beforehand. Even the Greek debt crisis that culminated in default was a slow car crash that went on quite a bit before it blew up.

There are two central issues here. First, France has clear vulnerabilities when it comes to debt dynamics. And second, waiting in the wings is a right-leaning ideology that is bordering on being anti-eurozone / EU. Throw in some poor policy decisions and we can see how this can all turn bad. It probably won't. But watch this space all the same.

The US is watching, but more interested right now in auctions and inflation data

In terms of Treasuries, there are a couple of things going on. On the front end, the 3yr auction was solid. Dealers did not have to do too much. The indirect bid was strong (typically includes the biggest lump of the central bank component). And the pricing was tidy, technically coming a tad through the secondary curve (negative tail). This provides evidence that market participants are comfortable with the latest pricing on the front end of the curve in the wake of the big rally seen in the past week or so. Makes sense, given that the 3yr is trading with a 50bp spread above the expected terminal rate for the funds rate.

The more interesting test will be Wednesday's 10yr auction. This is the benchmark point, and deviant enough for the immediate rate-cutting process to perhaps feel more discomfort from longer term issues or concerns. That area of the curve is hovering just above 4%, and we think is intent on having a go at breaking below, even if just for a short period. See more here.

We need to get through US PPI first. The expectation is for 0.3% month-on-month, which while not catastrophic, is also not good. And leaves core PPI inflation running at 3.5%, broadly flat, in fact, to the 10yr SOFR rate. That should be uncomfortable for the 10yr. But the rate-cut fever out there has the 10yr thinking more short-term than it really should be.

Wednesday's events and market views

From Europe we will first get Spanish and Italian industrial production data, but these are usually not market moving. More important will be the PPI data from the US later in the day. The headline and core figures are expected to increase by 0.3% month-on-month, which when annualised still points to hot inflation.

In terms of supply we start with a UK 6Y gilt auction for £4bn. Portugal will auction 10Y and 17Y OTs for a total of €1.25bn and Germany 15Y and 16Y Bunds totalling €2.5bn. From the US we have $39bn of 10Y Notes for auction.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("**ING**") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.