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RATES SPARK

Rates Spark: Widening fiscal woes

The higher rates environment is testing risk sentiment as fiscal concerns move to the forefront. Debt dynamics are no longer deemed only a French problem; other European countries are coming into focus. The ECB could soften its tone given tightening financial conditions, but eurozone CPI and US jobs data are unlikely to give central banks much room



European bond markets are seeing broader spread widening after the presentation of the French budget

Sentiment turning sour on European debt problems

European bond markets are showing the first signs of broader contagion after the French budget presentation. We had speculated it could provide temporary relief, as it marked an effort toward consolidation, but looking further ahead, spreads were more likely to test around 150bp. Relief was even more short-lived than we thought, and a renewed widening has taken the 10y OAT/Bund spread to almost 140bp already.

More worryingly, spreads of other highly indebted countries – foremost Italy and Greece – have widened even more than French spreads, with an almost 15bp widening over German Bunds in the 10y and even more pronounced widening at the short end. This broader risk-off and flight to safety and liquidity has accelerated the Bund outperformance versus swaps, in the end showing that Bunds have not lost their safe-haven status as some had feared, given the muted reaction to geopolitical turmoil over the past month.

The broader risk-off is also helping to curb the aggressive European Central Bank rate hike

discount. Market expectations have eased from as many as four hikes over the next 12 months to at most three hikes with around 70bp of tightening discounted through next September. A tightening of financial conditions through wider spreads also reduces the need for policy rate hikes. This would be in line with ECB President Christine Lagarde's argument that elevated longer-dated yields already do some of the monetary tightening, which she acknowledged at the recent EU parliamentary hearing. One thing to keep in mind: a broader risk-off makes an intervention by the ECB in bond markets more likely at the margin, as it is no longer a French problem.

Friday's events and market view

An important day for data, which includes both eurozone inflation numbers and the all-important (yet noisy) US payrolls figures. The consensus sees eurozone core inflation rising from 2.4% to 2.5%, which can still be considered benign given elevated energy prices. The expectation for non-farm payrolls is a decline from a high 162k in August to a more moderate 85k for September. Such a number would point to a still resilient jobs market.

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