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RATES SPARK

Rates Spark: Repricing the ECB path

Turmoil in European government bond markets could trigger a further dovish repricing for the European Central Bank, especially as second-round inflation risks seem limited. Fiscal plans from Le Pen could ease French government bond spreads if they contain credible measures to tackle the issue



Marine Le Pen, the leading candidate to be the next French president, will present a counter budget for 2027 on 6 October

Plenty of room for more dovish ECB pricing

Upward pressure on longer-dated rates remains, which means a dovish turn by the ECB can trigger more curve steepening. Already we see that the volatility in European government bond markets is pulling down the short end of the curve. And for good reason. So far, the risk of a second-round inflation impact has not materialised, and as we've argued before, is likely overestimated by the market. Labour markets are not as tight as in 2022, which should limit the risk of wage growth pushing inflation higher.

Meanwhile, weaker market sentiment also provides a reason for markets to turn more dovish on the ECB. Credit spreads are widening, tightening financial conditions, and a weaker growth outlook should allow a more balance reaction function. Contagion from French government bonds to other markets also increases financial stability risks, something which the ECB is likely to wish to mitigate.

In contrast, longer-dated rates should continue to feel a push higher, but this should be seen in a global context and not specific to euro rates. A global repricing of 10yr real rates combined with lingering supply pressures can keep the long-end elevated. This also adds to the financial tightening of conditions. So, unless the 10yr UST yield comes down, we shouldn't expect much downside for 10yr euro swap rates either.

Presidential frontrunner Le Pen is expected to detail her fiscal plans

French bonds have started the week with tentative signs of relief as the 10y OAT/Bund spread tightened more than 4bp to 134bp. Coming from below 90bp at the start of September, that is still a stretched level reflecting a considerable political risk premium. Marine Le Pen, who most observers at this point believe will emerge as the winner of next year's presidential elections, is due to present a counter budget for 2027 on Tuesday. Last week, she had also touted a "golden rule" for deficits akin to the German debt brake. Providing details of her fiscal plans could help stabilise spreads – that is, if they contain plausible measures to tackle the issue. Without credible numbers, we think the spread could remain in the upper half of the 100–150bp range, as we are also heading into a potential ratings review from Moody's later this month. France could then well lose its last double-A rating from one of the three major rating agencies.

Tuesday's events and market view

After French industrial production data and German factory orders in the morning, we move to eurozone retail sales for August. Consensus sees a slight uptick from 0.6% year-on-year to 1.0% YoY. From the US we have the trade balance numbers for August. More interesting could be the various central bank speakers from the Federal Reserve, ECB and Bank of England. With global 10Y rates testing new highs, markets will listen for a potential reaction from monetary policy.

In primary markets, Austria will auction 6yr RAGB and 35yr RAGB bonds for a total of €1.7bn. The UK will sell £1.25bn of 9yr Gilt Linkers. Germany will auction a new 2yr Schatz for €6bn. From the US, there is a new 3yr Note auction for $58bn.

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