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RATES SPARK

Rates Spark: Bifurcated risk sentiment

Risk sentiment is improving as equities rise, oil trends lower and volatility eases, but financial conditions remain uneven. Marine Le Pen's fiscal plan may briefly support OATs, but a lack of credibility and the election uncertainty ahead still point to spread widening risks



Risk sentiment is improving but there are still some opposing forces

Big contrasts in financial condition measures

Risk sentiment is turning more optimistic again, at least for now, with French government spreads tightening and the S&P 500 at new highs. Meanwhile, Brent oil temporarily nudged below $100, helping to ease market concerns about inflation. Implied rate volatility has also ticked slightly lower, suggesting markets are hoping the worst is behind us. But the overall macro landscape continues to be strained by many, often opposing, forces, and therefore we doubt rates will calmly settle at current levels.

One could argue that financial conditions are looking good at a macro level, but not everyone will agree. Financial conditions based on record equities and still relatively tight credit spreads suggest a very positive market outlook. But consumers needing to refinance a mortgage are unlikely to agree. The same parallel can be drawn with European governments. Unless growth expectations for the eurozone continue to improve, AI-related or otherwise, concerns about European government debt can continue to be a disrupting force in markets.

Le Pen's fiscal plan likely offers OAT spreads only temporary relief

Presidential race front-runner Marine Le Pen outlined her fiscal consolidation plans, which have been well received by markets. French bond spreads liked what they heard and the 10y OAT/Bund spread tightened almost 10bp towards 125bp. While acknowledging the scale of France's fiscal challenges, on closer inspection we think the plan relies on overly optimistic assumptions and difficult-to-deliver measures, limiting the scope for lasting spread compression.

On the positive side in the near term, it could also signal less resistance to the government's current proposal for 2027, which targets a deficit of 5% rather than the 3.7% that Le Pen's plan envisages. Looking ahead to the elections, we still face a prolonged period of uncertainty and headline risks that is likely to deter investors from exposure to French debt, and the plans might even expose her presidential campaign to more attacks from her opponents.

More importantly, we think that she will also face the same public resistance to her plans as have most other efforts to rein in spending. Currently, student unrest across the country is filling the headlines and, on Tuesday, unions called for nationwide strikes in early November.

While hitting the right tone, we don't see lasting relief for spreads from plans that are difficult to deliver on. On balance, we still see risks tilted towards a re-widening of spreads as we head closer to the elections and expect the spread to remain in the 125-150bp range for now rather than move lastingly lower.

Wednesday's events and market view

The day will be light on data with the highlights being German industrial production and the US consumer credit data. However, we will see a few European Central Bank officials speaking, such as Piero Cipollone and Boris Vujcic, and in the US, the Federal Reserve will release the minutes of the September FOMC meeting.

In primary markets, Germany will auction a new 7y Bund (€4bn) while the UK tenders 2y and 5y gilts (£2.5bn). The US then auctions 10y notes (US$39bn).

Author

Michiel Tukker
Senior UK & Eurozone Rates Strategist
michiel.tukker@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

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