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RATES SPARK

Rates Spark: Volatility is no friend of spreads

Elevated global rates volatility is keeping EGB spreads under pressure, despite European political efforts. With inflation uncertainty likely to persist, a return to the low-volatility conditions that previously supported carry trades and tighter spreads looks unlikely



With inflation uncertainty likely to persist, we don't expect a return to low-volatility conditions

Politicians alone cannot tighten EGB spreads

European government bond (EGB) spreads will need more than political willpower to tighten. Compared to the start of this year, we are facing a significantly more volatile global rates environment, which feeds directly into wider EGB spreads. Before the Middle East conflict started in March, financial conditions were very favourable for carry trades. French government bonds were a popular choice for investors, but also Italian government bonds and Spanish government bonds were often part of such trades. Borrow at low and stable short rates and invest in longer-dated government bonds. A simple strategy which, in leveraged setups, can offer attractive returns. Such strategies helped with the demand for EGBs and consequently tightened spreads.

But rate volatility has spiked over the past few weeks, and this is not just a European story. The 10yr UST yield passing the 5% mark turned US implied volatility higher and this is actually a

key driver behind the moves in euro rate volatility. In effect, this means that Europe alone will not have the tools at hand to tighten spreads to earlier lows. A common driver also explains why Italian government bonds witnessed similar sell-offs as their French counterparts.

The rates' outlook continues to face uncertainty with many forces pushing and pulling in different directions. Inflation continues to be the biggest unknown and will be an important determinant for the next move in rates. We still think second-round inflation risks are more benign than markets position for. But markets and central banks will need additional data to become more confident about inflation dynamics. As such, we expect rate volatility to remain elevated for the coming months, at least.

Thursday's events and market view

The ECB will publish the minutes of the September meeting, but since then Lagarde and Chief Economist Lane have already struck somewhat more dovish tones by referencing the tightening of financial conditions. There will also be a busy slate of central bank speakers. The ECB's Moulin, Lane and Stournaras will speak. From the Bank of England, Greene, Pill, Lombardelli and Governor Bailey are due to appear. The Fed will field Waller, Kashkari and Musalem.

Headlines could also emerge from the political front. The Eurogroup meeting in Luxembourg is also attended by ECB President Lagarde. Italy should see the final vote on Meloni's election reform.

In terms of data, the only release of note is the weekly jobless claims. The US will auction US$33bn in 30y bonds.

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