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RATES SPARK

Rates Spark: Don’t get too comfortable

US Treasuries have calmed. But plenty of opportunity and time for markets to (re-)change their tune. Italian bond investors signalled their liking of an electoral reform that would potentially improve governability. We draw the parallel with France, where improved governability is a prerequisite for a material tightening of spreads



With the UST 10yr yield dipping below 5.25%, it does not mean the bond market sell-off is over, but rather on pause

Treasuries sail calmer waters, but we'd not get too comfortable

It's been a good week for US bond auctions. Solid 10yr and 30yr auctions over consecutive days show there is a level where buyers step in. The 30yr auction saw a strong international and domestic bid that took down the paper at secondary market levels, and the previous day's 10yr auction came a tad rich to secondary. The 10yr yield is back below 5.25%, partly a reflection of this, but also reflective of some value hunters generally. It does not mean the bond market sell-off is over, but it does at least put it on pause, at least just for now.

We also note that Treasuries are holding on to the moderate richness built since the increased long-end-buyback announcement, in the guise of tighter swap spreads; the antithesis of what we saw in France over the past weeks, where swap spreads gapped wider by a factor of at least two. Nothing like that has occurred in the US, as the 10yr yield holds at just under a 40bp spread to 10yr SOFR.

That said, the 10yr swap spread is off its recent lows, and we continue to anticipate a likely widening in US swap spreads ahead as we head into the mid-terms with not nearly enough chat on fiscal deficit-reduction actions plans. Plenty of opportunity for markets to wake up and decide to start to price that through a widening in the implied Treasury credit spread to the SOFR risk-free rate.

Italy highlights the importance of governability

Thursday saw a recovery in European government bond spreads that was led by Italian bonds. Their 10y spread over Bunds tightened around 5bp towards 110bp. This is still above the levels seen before French repricing started to spill over, but it came with a backdrop of rising energy prices. Since February, higher oil prices have tended to generally widen spreads and in particular hurt Italian bonds relatively more.

The outperformance was attributed to the Italian PM Meloni securing the final vote for her electoral reform that would grant any leading coalition with more than 42% of the votes bonus seats to secure stable majorities. It is actually unclear whether she will benefit from this, but the prospect of clearer majorities and better governability is in general a positive for anyone looking for exposure to sovereign risk.

It also highlights what we see as a precondition for any lasting recovery in French bond spreads – political predictability and stability. With the two rounds of the presidential elections only in April and May next year, French bond spreads are still looking at more than half a year of higher volatility and continued spread elevation.

Friday's events and market view

It will be another relatively quiet day in terms of macro releases. The only notable data release is the University of Michigan US consumer confidence index. More attention may fall on central bank communication. The ECB's Lagarde will join the Ecofin meeting, and public appearances are scheduled for Wunsch, Cipollone and Schnabel.

After markets close, eyes will be out for possible rating updates. Among the scheduled reviews are of Belgium (Moody's A1/Stable) and the UK (S&P AA/Stable).

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