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RATES SPARK

Rates Spark: Temporary relief for structural problems

Markets reacted with relief after France avoided a rating downgrade, but the story remains unchanged. With plenty of political risks ahead, we remain wary of wider spreads



French bonds staged a rally after Moody's maintained France's ratings

France dodged a downgrade, but it doesn't change the challenges ahead

French bond spreads extended Friday's relief rally. The 10y OAT/Bund spread narrowed by more than 10bp to below 155bp. Not long ago, it was trading at its widest level since 2011. The trigger was Moody's refraining from downgrading France, which still holds its double-A rating. It still comes with a negative outlook, though. And eventually, France still needs to make a "significant and sustained fiscal effort" to avoid a downgrade.

Fragmented politics and public unrest over the past weeks highlight the challenge. We do not believe that we have seen the end of the French market turmoil with uncertainty ahead of the elections next April. A tail risk remains that public discontent is channelled into more support in the presidential election for far-left firebrand candidate Melénchon.

For the ECB meeting this week, the latest retightening is still welcome news as it removes

some pressure for an interest rate hike. Officials will almost surely be asked how they would treat the issue if it were to escalate. This gives them more room for constructive ambiguity, and would support our view that markets are unlikely to find a reason for turning bullish at the meeting. Elevated energy prices and resilient data outside of France argue for continued hawkish pressure on front-end rates.

Tuesday's events and market views

After the French consumer confidence data, we will be watching the ECB bank lending survey. Higher rates should start weighing on lending, but the extent is still up for debate. From the US, we have durable goods orders, consumer confidence, new home sales and the Richmond Fed business indices.

The UK will auction £4.50bn of 5y gilts, while Italy will auction 2y BTPs, 6y BTPei and 9y BTPei for a total €3.50bn. Germany will auction €5bn of 2y Schatz, while the US will auction $70bn of new 5y notes.

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