RBC BlueBay
Asset Management

Market Commentary

The bloodied French

French politics are messy, but Mbappé's nose is messier!

21 June 2024 (London): US yields were not much changed over the past week, with activity quiet, as the Juneteenth holiday provided an opportunity for a long (hot) summer weekend break for many. With respect to economic data, retail sales was another softish print and notwithstanding equity markets making new highs, a picture of moderating activity leading to one, or maybe two, cuts in the second half of this year remains in prospect.

This view remains broadly in line with market pricing, so we don't see a compelling directional view on rates at the current time. However, we continue to build conviction with respect to curve steepening. We already think long dated yields are too low relative to the likely path of future cash rates.

Meanwhile, the example of bank losses at Norinchukin serves as a reminder of how inverted curves can be problematic for banks and reduce the demand for longer dated assets as we move forwards. Though a failure to hedge against higher rates has been a theme impacting a number of challenged financial institutions, it is also understood that inverted curves take away the traditional carry from owning duration and, as this persists, it can continue to diminish demand for longer dated bonds, just at the time when we know that fiscal deficits mean that there will be a more abundant supply of these securities.

European markets continued to be relatively volatile in the run-up to French elections at the end of the month. The far right National Rally continues to top the polls, with the left wing socialist alliance also making gains in the polls as the political centre gets squeezed.

With the two groups with the most votes in each constituency entering a 2nd round run-off, there is a sense that voters in many districts will be left with a choice between hard right and hard left, with Macron's party experiencing a near annihilation as things currently stand. In this context, the French establishment has been happy to talk up fears of potential financial chaos, in the hope that scare tactics will see voters come back to the middle, but there is not much sign of this delivering tangible results.

We continue to see the National Rally as the largest parliamentary party after July 7th and given the choice between the far left and far right, this could represent the most palatable outcome for markets and the broader business community. However, we would continue to note that the dynamics of a co-habitation mean that there will be a limit to the amount of change that the RN is able to deliver this side of presidential elections in 2027.

Of course, it is possible that Macron could quit early in a fit of pique, though we think that this is unlikely to occur, and he will hope that should the RN be the party of government, then this could see Le Pen's appeal start to fade, if voters become disenchanted with the lack of progress in delivering many of their promises.

We have thought that market stress could remain elevated in the period up to the vote at the end of the month, with many overseas investors in the US or Japan still digesting recent political events. However, if spreads widen much beyond 80bps relative to bunds, then markets may be in over-shooting territory, and we may look to add risk (either closing France OAT shorts or adding EU risk elsewhere).

Once the elections pass, we think that markets should then start to calm over the rest of the summer. However, spreads are unlikely to return to their recent highs, given that increased French risk premia infers an elevated risk premia for all European assets.

Meanwhile, we would also infer that regardless of the outcome of the French vote, the direction of travel in the country is towards more fiscal easing. Indeed, it seems likely that the EU will declare France (along with Italy) as subject to excessive deficit procedure (EDP) in its upcoming Budget assessment.

In light of this, we have already moved to book profits on a long duration stance in German bunds, which was incepted shortly after Macron's surprise election announcement. Indeed, with bunds rallying, it is notable that French yields are not much changed in absolute terms over the past couple of weeks. As a flight-to-quality bid to bunds fades, so we are now happy to be at a neutral duration stance in the EU overall.

UK yields traded in line with other markets. Although headline CPI hit the BoE 2% target last month on base effects as expected, core services inflation close to 6% remains an ongoing concern. The BoE itself is more dovish in its assessment of UK inflation than we are, and so may look to cut at its August MPC, once the election is behind us. However, we think that as inflation rises in H2, it will be hard for the BoE to ease very much in the months ahead, and this leads us to retain a relatively bearish view on UK gilts.

JGB yields continued to move lower during the past week, in the wake of last week's BoJ meeting, which delivered no immediate change in policy. However, we would note that Ueda's plans to start reducing JGB purchases substantially after July could represent a material shift.

It is also interesting to note comments that the BoJ is planning to move straight from a stance of balance sheet growth and quantitative easing, directly into a shrinking balance sheet and quantitative tightening. In this context, it will be interesting to observe further details once they emerge.

However, we would continue to highlight the structural over-valuation of 10-year JGBs, as demonstrated with 10-year yields below 1% and 30-year securities close to 2.2%. In this context, we continue to look for 10-year JGBs to rise above 1.25%, as the BoJ winds down its purchases and stops controlling prices.

In FX, the yen has continued to remain under some pressure, though market participants will be wary of renewed intervention on a return to 160 versus the US dollar. Meanwhile, the euro has proven relatively resilient, notwithstanding turbulence in France. In part, this may be explained by signs of cooling in US growth and a moderation of US growth exceptionalism.

However, it seems that valuations are playing at least as important a part in the dollar's inability to rally much further for the time being. There is an overarching sense that the greenback is overvalued, and this means there has been little enthusiasm to chase the dollar down towards parity versus the euro, notwithstanding the uptick in euro area stress.

In emerging markets, South African assets have continued to recover in the wake of an agreement of a government of national unity, without the participation of the more radical MK or EFF parties. We look for a constructive agenda, which should see local bond yields decline further over the weeks ahead, though we are possibly concerned at the scope for social unrest in regions like KwaZulu-Natal, as the former president, Zuma, stokes discontent on the part of his MK party.

There has also been more stability in Mexican assets over the past week, and we are hopeful that following a couple of weeks, which have seen a widespread capitulation across bonds and FX, these moves have now run their course and there could be scope for a retracement rally ahead. Brazil is a similar story, and we believe that institutional support for orthodox policy should see markets turn, following a steep rise in yields in the past few weeks.

In corporate credit, European spreads have materially underperformed over the past few weeks. However, it is worth highlighting that a 14bps widening in index euro corporate OAS spreads versus government bonds since the start of June, is principally a function of a move 10bps wider in underlying swap spreads versus bunds. In this context, price action in corporates has been relatively orderly, with most assets simply failing to keep up with the rally in underlying bund yields since the start of the month.

That said, French assets have underperformed, and financials as a sector have also given back prior gains. In this context, euro financial index spreads have widened by 20p to 136bps over the month, a level last seen at the end of February this year. Across the Atlantic, US spreads have been more stable as the S&P continues to hit new record highs, and the Vix index has dropped back below 13.

Looking ahead

We continue to expect price action in Treasuries as contained, until we can reach greater clarity with regards to the FOMC and rates at the September meeting. This could suggest that US yields are more stable, absent data shocks or exogenous impacts.

Europe looks set to be more volatile in the run-up to the French elections. With events in the country casting a shadow across all assets on the Continent, there certainly is some anxiety at the bloody mess that is French politics at the moment…a metaphor somewhat mirrored in the face of Kylian Mbappé, as he was laid out on the pitch earlier this week! That said, a broken nose may be a bit easier to fix than French democracy in the months ahead….

Notes to Editors

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