



Has the sell-off in France gone too far?

Bond markets demand change from France

Key points:

- **French yields:** 10-year yields exceeded 5% with the spread to bunds surpassing 175bp for first time since 2011, in the wake of French riots exacerbating credit concerns.
- **Bond market signal:** the bond market is effectively demanding that French policymakers change course and get on top of the burgeoning deficit and public debt burden.
- **Eurozone sovereign credit:** we push back against the notion that EMU stability is being questioned, and see value in Eurozone sovereign credit, with index-level spreads at their widest in years.
- **US markets:** with markets having largely discounted a Fed rate hike next week, Treasury yields edged lower on a flight to quality with equities and credit coming under some pressure
- **US rates outlook:** wobbles in tech suggest economic momentum could wane through 2027, pointing to fewer FOMC hikes than discounted, though higher energy prices remain a risk of a protracted inflation overshoot.

London, 23 October 2026: With markets having largely discounted the possibility of the Federal Reserve raising interest rates next week, Treasury yields have edged lower on a flight to quality over the past week, with equities and credit coming under some pressure.

Meanwhile, across the Atlantic, European markets have been a focus of attention in the wake of French riots exacerbating credit concerns in the OAT market. 10-year French yields have traded above 5%, with the spread to bunds exceeding 175bp for the first time since 2011, at a time when the prospective break-up of the Eurozone had felt like a very tangible prospect.

Essentially speaking, the bond market is demanding that policymakers change course, and act to get on top of the burgeoning deficit and public debt burden. However, it is difficult for policymakers to embrace the necessary reforms ahead of next year's pivotal presidential elections, at a time when this is so politically unpopular with the French public.

Plans to increase the retirement age or to tackle unsustainable public spending are routinely met with widespread protest and condemnation. Until attitudes begin to change, it is not clear how policymakers can show clear leadership.

In this respect, the path to reform may need to travel through a painful realisation. Consequently, EU policymakers won't be in any rush to help support France, until such a time that this is more fully appreciated. Yet as pressure builds, it will be interesting to note whether French voters will be more inclined to run back towards the safety of the political centre.

In this respect, the actions of the hard-left elements, who shoulder much of the responsibility for the destruction last weekend, could well end up weakening support for Mélenchon. This could thus increase the odds that a centrist candidate makes it into a second round run-off against Marine Le Pen, in next May's deciding vote.

From this standpoint, we would reflect that the recent widening of French OAT spreads has closely tracked the implied probability that Le Pen and National Rally would prevail with the voters. Should we witness evidence of building support for a centrist candidate, polling above Mélenchon, this could be a factor which helps to stabilise the spread.

If the hard-left is excluded from the second round of voting, then a path remains for a candidate such as Édouard Philippe, Gabriel Attal or Raphael Glucksmann to emerge victorious in the race for the Elysee Palace. In this respect, cynics might conclude that the European establishment won't be too unhappy at bond markets driving change in the French political narrative.

If the market implied probability of a Le Pen victory peaks in the next few weeks, this may help to stabilise the OAT spread. Consequently, with the 2026 Budget also likely to be approved and protests set to die back, once the weather becomes more seasonally inclement, this could also cap stress in the near term.

In the medium term, France will need to reform in order to prevent a continued slide in the country's creditworthiness, but we have reached a point in valuations where there is now a lot of bad news already embedded in the price.

Additionally, we would push back on the notion that we are witnessing a moment when the stability of European Monetary Union will be called into question. From this perspective, we see value in sovereign credit in the Eurozone, with index level spreads at their widest levels for a number of years.

Although we have seen copycat protests in other European cities, the problems in France are more unique to the country itself (with Belgium the possible exception). In Italy, Milan is a city which has been booming and more generally speaking, the Meloni government continues to follow a responsible and bond market friendly path.

Spain, Portugal and Greece are all growing robustly and represent improving credit stories. Although challenges with respect to affordability and youth disillusionment are continent wide, there are very few who would advocate that individual countries would be better off alone at this point in time.

Indeed, we continue to look at a queue of countries lining up to join the EU. Moreover, the travails of the UK, ten years on from Brexit, have served as a clear disincentive to others who might otherwise want to make a case for leaving.

In defence of the European Monetary Union, policymakers have a number of tools to combat systemic threats. Verbal support for the integrity of the Eurozone is highly likely to be reiterated in the coming days. Beyond this, the next focus for policymakers will likely be with respect to European banks, should liquidity start to dry up. This could trigger further TLTRO operations, if required.

We also see the ECB ending its planned balance sheet reduction. With respect to interest rate policy, the ECB needs to remain vigilant on inflation, though it may conclude that higher bond yields are already tightening financial conditions and this may speak to the need for fewer rate hikes than otherwise would have been the case.

However, activation of the TPI bond support programme is much less likely, any time soon. In this respect, there is an argument that this tool is best left unused, as a potential deterrent against speculation. That said, if it were deployed, then French OATs are unlikely to benefit in the absence of a material fiscal adjustment being announced.

Certainly, EU policymakers would like to isolate France and avoid contamination elsewhere. Yet policymakers may need to tread carefully, inasmuch as getting bond markets to do their work for them, as we have often seen how events can quickly spiral out of control and it is important to be on guard against potential negative consequences.

Elsewhere, building pressure on energy prices suggests a less favourable inflation backdrop. In this respect, chatter with respect to a possible U.S. escalation of the conflict with Iran, in the wake of the midterm elections at the start of next month, has unnerved markets. Although there remains no credible U.S. plan for victory in the Middle East, an escalation appears to be viewed more widely as becoming inevitable at this point.

This creates the risk of an additional inflation shock coming on top of what we have already witnessed. Although talks keep trying to plot a pathway to peace and compromise, this is not looking very viable at the current point in time. Meanwhile, the outlook in Russia/Ukraine remains very challenging and ongoing attacks on energy infrastructure are only helping to add to global energy costs and elevated rates for shipping.

Meanwhile, wobbles in tech have suggested that economic momentum could start to wane as we move through 2027. This has contributed to our view that the FOMC will deliver fewer hikes than are being discounted. However, we would reflect that energy price inflation remains a risk to a more material and protracted inflation overshoot, should prices take another leg higher from here.

In this respect, our conviction has been moderating somewhat over the past few days. As such, we favour holding a long position in short dated U.S. rates, in conjunction with a position in inflation-linked swaps, in the context of this offering attractive value in real yields.

We have also been tempering our enthusiasm for Eurozone duration, on building energy risks. However, the case for owning duration has been supported on recent evidence that government bonds have been working as a better hedge to risk assets.

Meanwhile, we retain a constructive stance at the long end of the Japanese yield curve, on building evidence of domestic demand. This was something evidenced in this week's 20-year JGB auction, which saw a record 5.4 times bid to cover ratio.

Often in the past, we have witnessed some herding of behaviour in Japanese domestic investment flows and so it is interesting whether the recent trickle, which has been helping to stop yields rising, will turn into more of a flood, over the coming weeks and months ahead.

Corporate credit spreads have been under some pressure in recent days, in the wake of supply indigestion, tech worries, and in Europe, the pressure on sovereign government bonds. As valuations become cheaper it is tempting to lift hedges and extend directional credit beta. However, spreads have been compressed during 2026, notwithstanding a number of building concerns, which would typically have weighed much more heavily on markets.

A darkening of investor sentiment could easily cause this retracement in credit to run further over the next couple of weeks, especially if equity markets also come under more pressure. Yet, with recession risk in 2027 remaining low and many corporate balance sheets looking robust at a time when a number of government balance sheets are deteriorating, so it seems reasonable to expect any widening of spreads from this point to represent more of a buying than a selling opportunity.

Looking ahead

The coming weekend sees the presidential runoff elections in Brazil, where we expect Flávio Bolsonaro to emerge victorious. This should benefit Brazilian assets in the coming week, and we continue to see value in local rates and FX. Political trends across Latin America have tended to be more market friendly in the context of a rightward shift under something of a 'red wave'.

Returning to France, it is quite sobering seeing sovereign credit spreads matching and exceeding levels in BB-rated sub-investment grade sovereigns such as South Africa, Georgia, Albania and the Dominican Republic and one wonders whether OATs may start to offer relative value to emerging market investors at some point soon!

In many respects, spread levels are approaching an unstable equilibrium. As pressure builds, there is a risk that we move towards full blown crisis, ahead of the elections, should the integrity of the French state begin

to be called into question. Yet, what we are witnessing is creating long-term value, as long as we are not witnessing the end of the 5th Republic and a slide into anarchy, default and a breakup of the Eurozone.

Memories of investing through the euro sovereign crisis remain firmly etched into our memories. In this respect, it can be interesting to reflect how many investors who would have been regular buyers of French debt when it traded 50bp over bunds, now won't even think about adding OATs. This behaviour can lead to market dislocations and overshooting, particularly when systematic hedge funds and CTAs are selling in response to trend following signals.

But there won't be a sustainable future for France if debt spreads continue to rise from here and without France, there won't be much of a future for the EU. Knowing this, policymakers will want to circle the wagons, as they have done successfully before.

In this case we look toward what Madame Lagarde has to say at the ECB meeting next week and so are inclined to look for some stabilisation in the days ahead. Ultimately, experience has taught us that there will always be opportunities to buy when others are panicking and running for the exit.

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