Daiwa Securities

Daiwa's View

French crisis: Implications for government bonds in Japan and Europe

FICC Research Dept.

- Spreads on French government bonds widened after French Prime Minister Bayrou, who is leading fiscal consolidation, decided to call for confidence vote on 8 Sep
- While vigilance regarding key events will be needed in the near term, if leeway for ECB's rate cuts were to increase due to substantial tightening of FCI in Europe, that could provide good opportunity for investment in hedged foreign bonds
- Meanwhile, USD-denominated asset swap spreads on superlong JGBs have tightened, suggesting no clear evidence of contagion from the French crisis

Eiichiro Tani, CFA
81-3-5555-8780
eiichiro.tani@daiwa.co.jp

Daiwa Securities Co. Ltd.

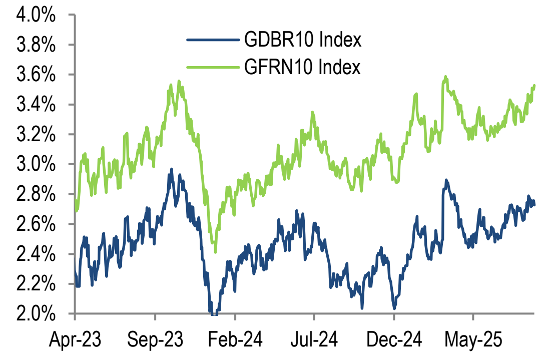
French crisis

Following the US credit downgrade by Moody's (*) in May 2025 and the UK "mini-Truss shock" in July, uncertainty is now growing over the future of Prime Minister François Bayrou, who has been striving to lead fiscal consolidation in France. A vote of confidence in the cabinet is scheduled for 8 September in the lower house there, and the possibility of a mass cabinet resignation has rapidly emerged amid backlash against the proposed austerity budget. In early July, the UK government bond market saw a moment when superlong Gilt yields surged by over 20bp, triggered by UK Prime Minister Keir Starmer avoiding making a clear statement regarding the future of Chancellor Rachel Reeves, who was pushing ahead with fiscal reform. Less than two months later, attention has now turned to a problem in France in which Prime Minister Bayrou has warned that France is facing an "immediate danger" of over-indebtedness. Since the pandemic, populism and fiscal policy have remained deep-seated market topics.

(*) indicates unregistered credit rating agencies. Please see the disclaimer at the end of the document.

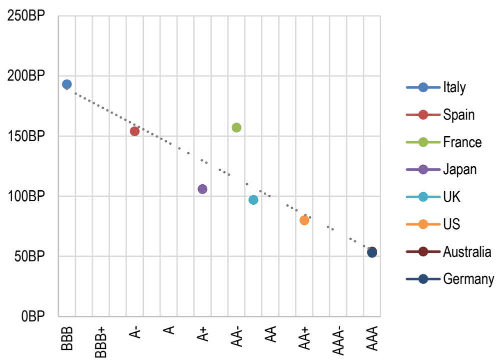
The deterioration in French government bonds is evident across multiple indicators, such as the conventional 10-year spread over German Bunds widening to the 80bp level, and the USD-denominated asset swap (ASW) spread—which we frequently use for global comparisons of bonds in developed nations in Daiwa's View reports—widening to the 150bp level. When evaluated by the latter metric, superlong French bonds are now trading at a level more than 40bp wider than their current AA— rating would suggest. On average, the USD-denominated superlong ASW spread has a tendency (beta) to change by approximately 10-20bp for every single-notch change in the credit rating. Therefore, we surmise that the market is currently pricing in a downgrade of 2-3 notches for French government bonds. (Chart below.)

10yr Gov't Bond Yields in Germany and France



Source: Bloomberg; compiled by Daiwa.

USD-denominated ASW Spreads on Superlong Gov't Bonds in Major Nations



Source: Bloomberg; compiled by Daiwa.

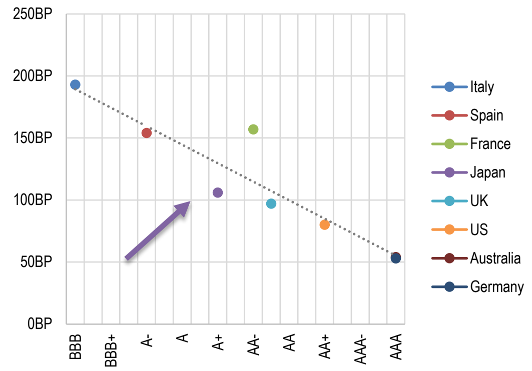
FICC

Limited contagion to Japan (JGBs)

However, as for whether this French crisis is causing widespread contagion, we believe that, at least for now, there is no contagion to JGBs. In fact, the USD-denominated ASW spread on 30-year JGBs has recently tightened to 107bp, a significant tightening of 20bp from 127bp about a month ago. Even on a conventional JPY basis, the swap spread (JYSO30 — GJGC30) has improved by about 10bp over the past month, and the superlong USD/JPY cross-currency basis swap has also narrowed. These movements suggest that foreign investors' preference for superlong JGBs may actually be growing.

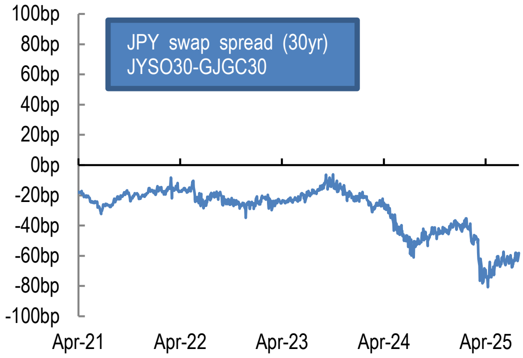
Of course, there are specific circumstances at play. In the 30-year JGB zone, the supply/demand balance for the on-the-run issue (CTJPY30Y) has tightened due to the MOF's reduction in the issuance of superlong bonds on a calendar basis since July, while the supply/demand conditions for off-the-run issues have continued to deteriorate. Therefore, comparisons using only the on-the-run issue may tend to slightly overestimate current conditions with JGBs. In either case, based on these metrics, there is no clear evidence that the current French crisis is spreading to JGBs.

USD-denominated ASW Spreads on Superlong Gov't Bonds in Major Nations (reposting)



Source: Bloomberg; compiled by Daiwa.

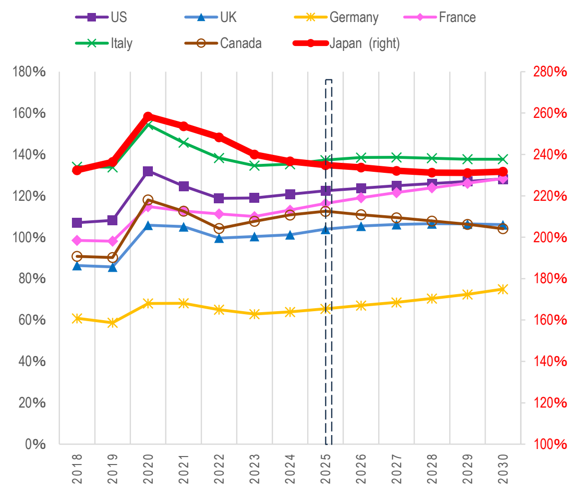
30yr JPY Swap Spread



Source: Bloomberg; compiled by Daiwa.

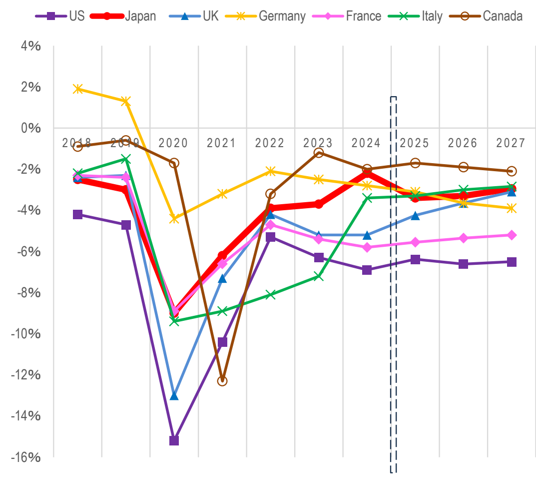
The current direction of these market movements is also supported by key metrics from the IMF and Bloomberg consensus, which are closely watched by rating agencies. In terms of trends and forecasts for crucial indicators, such as the government debt-to-GDP ratio and the fiscal balance-to-GDP ratio, Japan is currently viewed more favorably than Europe. This is broadly consistent with the above-mentioned underperformance of European bonds and the outperformance of JGBs. (See charts below.)

Government Debt-to-GDP Ratio



Source: Bloomberg; compiled by Daiwa.
Note: Forecasts based on IMF projections.

Fiscal Balance-to-GDP Ratio



Source: Bloomberg; compiled by Daiwa.
Note: Forecasts based on Bloomberg consensus (ECFC).

Of course, even if concerns about Japan being downgraded are limited at present, market confidence can be lost in an instant. Therefore, with its large government debt, it is crucial for Japan to continue demonstrating to the market its ability and willingness to tackle fiscal consolidation. The nation must remain vigilant. However, based on an overview of these economic and fiscal indicators, it is reasonable to assess that there are no new downward pressures on Japan's creditworthiness, at least in the near term.

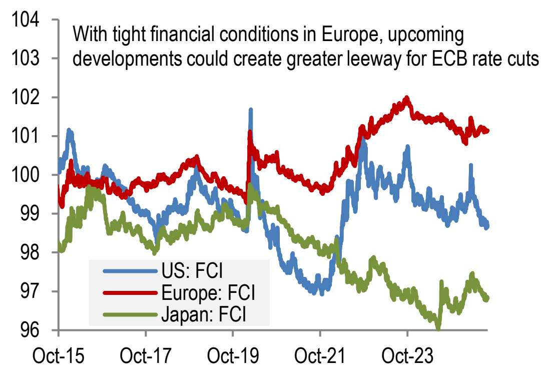
While the above-mentioned lack of contagion to JGBs is good news to some extent, the flip side is that if a new contagion were to occur, triggered by political developments in Japan, there would be a latent risk (magma chamber) that superlong JGB yields could rise by around 10-20bp. Compared to about a month ago, the USD-denominated ASW spread between French bonds and JGBs has widened significantly, while the gap between UK Gilts and JGBs has narrowed, reducing relative investment appeal.

Investment appeal of French government bonds?

Could we regard the widening of French government bond spreads as an opportunity for higher investment returns? In the short term, the market adage "Don't catch a falling knife" is likely to prevail. With the confidence vote slated for 8 September and a credit downgrade widely anticipated after parliament convenes in late September, careful consideration is needed before "pulling chestnuts out of the fire."

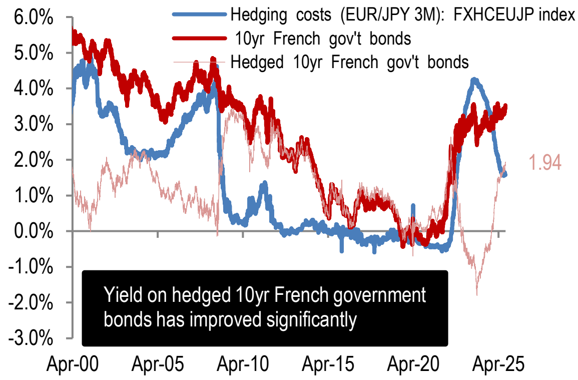
However, this perspective might change if the ECB could be prompted to cut rates through a tightening of financial conditions (Financial Conditions Index: FCI). In Europe, while inflation concerns are subsiding, the financial conditions have tightened somewhat due to factors such as the euro strengthening in the wake of the April tariff shock. If the French crisis were to worsen under these circumstances, the FCI could tighten further, potentially creating greater leeway for rate cuts by the ECB due to weak concerns about inflation. The yield for hedged 10-year French government bonds, which has already risen to around 2%, would become more attractive if we could expect a substantial improvement in hedging costs due to (1) a rate hike by the BOJ and (2) a rate cut by the ECB, in addition to a significant steepening of the French government bond yield curve due to wider spreads. We should keep in mind that French government bonds, for which a significant 2-3 notch downgrade has already been priced in, might see a "buy the fact" movement take place once key events—the confidence vote and sovereign downgrade—have taken place.

Goldman Sachs Financial Conditions Index (FCI)



Source: Bloomberg; compiled by Daiwa.

Yield on Hedged 10yr French Gov't Bonds



Source: Bloomberg; compiled by Daiwa.

IMPORTANT DISCLOSURES

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities
Please refer to https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at: https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/credit_ratings.pdf. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association