# Geopolitical and geoeconomic report

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A fortnight ago I closed this report by saying that if I could watch only one number, it would be the US 30-year bond. Well, the 30-year has fallen. According to the Treasury, it closed on Wednesday at 5.42%, twenty-four basis points lower than two weeks ago, with the 10-year at 5.13%. And it did so in a fortnight in which US inflation rose to 3.7%, Brent went from $100 to more than $112 and the Fed made it clear that it intends to raise rates again. Readers could be forgiven for thinking I picked the wrong number.

I don't think I did, though I admit I was surprised by where the move showed up. The stress in sovereign debt has not gone away. It has crossed the Atlantic. On Thursday the French 10-year bond yielded as much as 5.14%, its highest since July 2002, and its spread over the German Bund widened to 173.58 basis points, the widest since November 2011, at the height of the euro crisis. Put another way, Paris now borrows for ten years at practically the same rate as Washington.

The United States has more debt, a bigger deficit and an open war. France is not at war. Yet they pay the same.

## FRANCE, FROM THE SPREAD TO THE STREETS

In the previous report I said that France would be the market that showed us most clearly how much fiscal risk investors were prepared to tolerate. It took them two weeks to answer, and the answer came by a route I did not expect. Over the weekend of 17 and 18 October there were riots in several French cities over the cost of living, fuel prices and education. According to AP, more than 2,500 people were detained, Limoges town hall was set on fire and curfews were imposed in Paris, Bordeaux, Nice and Lyon. The protests have spread to Italy, Spain, Portugal, Belgium and Greece, and more have been called for this Saturday.

This is where an energy shock stops being an inflation problem and becomes a political one. Expensive diesel does not stay at the pump. It reaches the haulier, the farmer, the supermarket bill and, in the end, the street. And a minority government with the streets on fire has even less room to push through cuts. The vote on the revenue side of the budget has been postponed to 27 October, and according to Reuters the amendments already passed in the National Assembly widen the deficit by €10 billion, the exact opposite of the €54 billion in savings that Lecornu is seeking.

The market has not been too fussy about the causes. On Thursday the Italian spread rose to 123 basis points, Belgium's reached its widest since 2012 and Spain's widened to 71 basis points. Euro-area banks fell 4.2%, their worst session since March, and Spain's Ibex 35 lost 2.12% to 18,913.5 points, with Bankinter down 7.6% and Santander and BBVA down around 4%. Meanwhile Bund yields fell, because the money leaving Paris is looking for shelter in Frankfurt. Moody's is scheduled to review France's rating this Friday.

Lagarde said something in Bangkok that is worth reading slowly. Financing conditions have tightened, and the bond sell-off will slow growth and the pass-through of inflation by more than projected in September. That is a polite way of saying that the bond market is doing part of the ECB's job. Even so, markets still expect a hike in December, pricing the deposit rate at 2.73%

against 2.50% today. Eurostat confirmed September inflation at 3.8%, with energy up 18.9% and Spain, incidentally, at 5%, the highest rate among the large euro economies.

## WHY TREASURY YIELDS HAVE FALLEN

Back to US Treasuries. The move does make sense, just not the sense you might expect. The data over these two weeks have been the kind that frighten a central bank. September CPI rose 0.6% on the month and 3.7% on the year, with energy prices up 20.4% and gasoline up 34.2%. Producer prices rose 1.3% in a single month and 6.3% year on year. Core inflation came in at 2.6%, still contained, but the Fed's Beige Book reports that higher oil and diesel prices have hit all twelve districts and that firms expect to keep raising prices.

And the labour market, which a fortnight ago seemed to be stalling, has stopped causing alarm. Weekly jobless claims fell to 194,000, and the Atlanta Fed's GDPNow model puts third-quarter growth at an annualised 3.5%. With that data in hand, Hammack said the Fed might need to do even more, Williams spoke of one more hike this year and Logan of at least two. Warsh, asked in Bangkok, refused to commit to anything. According to the Reuters poll, almost no economist expects a move on 28 October and all of them expect a hike in December.

So why is the long bond falling? Because the market has once again come round to believing that the Fed will do the dirty work. The 2-year has barely moved, from 4.84% to 4.81%, while the 30-year fell twenty-four basis points. The curve has flattened, and that is what happens when investors think the central bank will raise rates enough to cool the economy and, with it, future inflation. There is a second, less reassuring reason too. When tech stocks wobble and Aramco evacuates its headquarters in Saudi Arabia, Treasuries are still where frightened money runs. On Thursday the 10-year touched 5% in that flight to quality.

I wouldn't put much faith in this relief. In its new report the IMF includes a scenario in which Hormuz and Bab el-Mandeb remain largely closed until mid-2027, with oil at $130 and term premia sixty basis points higher. It is not the Fund's central case, but the fact that it bothered to put numbers on it says a good deal. And the IMF does not see US core inflation back at 2% until mid-2028. A 30-year at 5.42% with that outlook is not a cheap bond. It is a bond the market is willing to hold for as long as it believes in the Fed.

## IN THE GULF, THE FRONT THAT MATTERS NOW IS SAUDI ARABIA

The December Brent contract settled at $100.20 on 7 October and on Thursday reached $112.68, its highest since May. The odd thing is that more oil is now passing through Hormuz than a month ago. According to Kpler data cited by Reuters, October flows are running at around 11.7 million barrels a day, against 9.75 million in September, roughly 82% of pre-war levels. More barrels and a higher price. How does that add up?

It adds up because the risk has moved. The Houthis have turned Saudi Arabia into the second front that was already taking shape a fortnight ago. On 10 October an attack on Riyadh airport killed at least 12 people, according to the Saudi aviation authority, and the airport did not partly reopen until the 21st. On that same day Dammam airport was hit, there were fatalities near the Shaybah oilfield and the State Department ordered non-emergency staff to leave the country. On Thursday, according to Reuters, Aramco told staff to evacuate its Dhahran headquarters for the first time in the war. No damage to production has been reported. The market, however, is no

longer pricing what passes through the strait. It is pricing what could happen to those who pump it.

The strait is not calm either. Lloyd's List counted at least 26 attacks or incidents against merchant ships in the first fifteen days of October, the highest monthly total of the war, and on the 13th a container ship sank. War-risk insurance now costs around 10% of the cargo's value, against 3% before the conflict, and chartering a supertanker from the Gulf to China costs more than twelve times what it did before the war. The barrels are getting through, but at a much higher cost.

What interests me most is the calendar. Trump announced on 8 October that he would not attack Iran before the midterm elections. According to Iranian officials quoted by Reuters, Tehran is deliberately stalling any negotiation so as not to hand Trump a win before 3 November. And The New York Times reports that Washington and Israel have drawn up plans for a short, intense operation after that date, which the president has not approved. Both sides, in other words, are playing against the same clock. Trump needs cheap gasoline before the vote, and Iran, which has not exported a single barrel since September and whose shadow fleet ran out of crude in mid-October according to Kpler, has only one card left, and the most effective way to play it is to keep the passage unsafe until then. That Trump is now accusing Iran of inventing attacks to push up oil before the election tells you a lot about what worries him.

## WASHINGTON BUYS DIESEL FROM MOSCOW

Diesel is once again the weak link. According to the EIA, the US average price rose again on 19 October to $6.276 a gallon, after easing back from the record $6.529 set on 21 September. The IEA argues in its monthly report that the shortage of middle distillates will last into 2027, and it is not hard to see why. Middle Eastern exports of refined products fell in September to 1.9 million barrels a day, against 4.7 million before the war. That is why the agency has accelerated the release of the roughly 100 million barrels of reserves it has left, with more than 20 million barrels of diesel going first, and why Washington has offered to lend a third of its Northeast Home Heating Oil Reserve.

Washington's other response has been more controversial. On 9 October Trump announced purchases of Russian diesel, and the Treasury suspended sanctions on that product until April 2027. A week later he signed an order waiving almost all the sanctions and tariffs in the Graham Act against buyers of Russian oil, two days before they were due to take effect. European leaders criticised the diesel deal at their summit on 15 and 16 October, a few days after the EU had approved its largest-ever package of individual sanctions against Russia's military industry.

What can I say? From the point of view of an American gas station, the decision makes sense. From Kyiv's, it is a gift to Moscow, and that is exactly what Zelensky called it. The Iran war has turned Russia into a useful supplier just as Europe was trying to cut it off. The "energy ceasefire" Trump announced on 11 October lasted a day. Ukraine then hit the Ryazan refinery, and on the 18th launched the largest drone attack of the entire war against oil facilities in the St Petersburg region. The next day Russia struck 28 Ukrainian energy facilities. Putin and Witkoff agreed on the 21st to resume three-way talks after 10 November. The technical talks expected for October never took place, and Russia's draft budget for 2027 devotes 44% of spending to defence and security.

## CHINA IS EXPORTING AS NEVER BEFORE

While the West argues about inflation, China has reported third-quarter growth of 4.5%, retail sales up just 1.1% and property investment down 20.6% so far this year. Weak consumption and

real estate in free fall, in other words. Exports, on the other hand, grew 36.3% year on year in September, according to Reuters, with a trade surplus of $133.53 billion in the month and $938.11 billion so far this year. The surplus with the United States hit a twenty-month high.

The yuan has strengthened to 6.68 per dollar, its strongest since June 2022, and the People's Bank of China is setting its daily fixing weaker than expected to slow the rise. A country that sells this much and consumes this little ends up clashing with its partners, and the European summit has already called for trade-defence tools against Chinese chemicals and machinery. The truce with Washington holds until 10 January, but China's suspension of its rare-earth controls expires on 10 November and the APEC summit in Shenzhen opens on the 18th. Beijing holds more cards than a year ago and seems in no hurry to play them.

## EQUITIES, THE SINGLE STORY IS STARTING TO COST

A fortnight ago I wrote that the US stock market was paying a great deal for a single story, artificial intelligence. This fortnight we have seen what happens when that story has to be financed with bond yields above 5%. The week to 16 October was the S&P 500's worst since June, with the Nasdaq down 4.5%, and semiconductors led the falls. On Thursday Meta was down around 7% after announcing capital spending of between $135 billion and $145 billion this year, and Tesla has cut its own. The S&P closed on Wednesday at 7,757.17 and the Nasdaq at 26,702.86, below their 6 October highs, and both were falling again on Thursday.

I don't believe artificial intelligence has stopped being a good story. What has changed is its cost of capital. A company borrowing to build data centres with the 10-year at 5% needs those investments to pay off much sooner than it would with the bond at 3%, and the market has started to ask when. The IMF explicitly lists an AI correction among the risks in its financial stability report. The winners of the fortnight have been elsewhere, in energy, defence and healthcare. Lockheed Martin was up around 9% on Thursday. Credit, for its part, remains calm. The US high-yield spread stood at 3.33% on 20 October, still very tight.

## COMMODITIES, GOLD IS STILL NOT DOING ITS JOB

What I said about gold a fortnight ago has been more than confirmed. With the Gulf at war, France on the streets and tech stocks falling, gold was trading below $4,100 an ounce on Thursday, its lowest since August, and silver is down 10% so far this month. As long as the market is pricing a Fed that is raising rates and Treasuries yielding close to 5%, the safe haven has a competitor that also pays a coupon.

Copper tells a different, and somewhat misleading, story. According to Reuters, COMEX inventories are at record highs and LME stocks in US warehouses are at their highest since 2014. It is not that there is too much copper. It is that everyone is rushing to get it into the United States before the tariffs proposed for 2027 and 2028 take effect. That stockpiling distorts the price and pulls demand forward, and it should not be mistaken for an improving economy.

European gas, meanwhile, is heading into winter in worse shape than one would like. EU storage was at around 75% on 19 October, according to Gas Infrastructure Europe data, when at this point in the year it is normally close to 90%, and TTF prices are back at levels not seen since late 2022. Qatar, still unable to meet its contracts because of the war, has just signed a deal to buy US LNG until 2054. When one of the world's largest exporters has to buy abroad, that says it all.

## WHAT TO WATCH UNTIL THE NEXT REPORT

This Friday Moody's reviews France's rating, and new protests have been called for Saturday. On 27 October the National Assembly votes on the revenue side of the budget and Israel holds its election, which could change Jerusalem's appetite for attacking Iran again.

Then the central banks follow one after another. The Fed on 27 and 28 October, the UK budget on the 28th, the ECB on the 29th, the Bank of Japan on the 29th and 30th, OPEC+ on 1 November and the Bank of England on the 5th. The market takes the Fed's decision for granted. What matters is whether Warsh endorses a December hike or leaves the door open to more.

And above all, 3 November. With Trump's approval at 31% according to Reuters/Ipsos, the lowest of his two terms, and seven Senate races up for grabs, the election will decide whether the president arrives at the Shenzhen APEC summit with a majority in Congress or without one and also, if we believe what both sides are saying, whether the Gulf returns to open war the following week.

A fortnight ago the market was starting to ask who would fund governments over the next thirty years, and at what price. This fortnight it has started to answer a more uncomfortable question, namely which governments. And the answer does not follow the ranking of debt ratios. If it did, Washington would be paying a good deal more than Paris.

Accounting does not explain that. What explains it is confidence that, when the moment comes, someone will be able to pass a budget.

## MAP OF AFFECTED ASSETS

A reading of the assets most exposed to the situation described above. Those marked ★ are of special interest this fortnight.

| ASSET | BIAS | MECHANISM | WHAT TO WATCH |
|---|---|---|---|
| ★ **French government bonds (OATs)** | **Negative** | Spread over the Bund at 173.58 bp, the widest since 2011. Minority government, protests on the streets and amendments that widen the deficit. | Moody's on 23 October and the budget vote on 27 October |
| ★ **Euro-area banks (e.g. BNP Paribas, Société Générale, Bankinter, Santander)** | **Short-term negative** | Sovereign contagion from France. Worst session since March, down 4.2% on 22 October. | Italian, Belgian and Spanish spreads |
| ★ **Refining and middle distillates (e.g. Valero, Marathon Petroleum, Repsol)** | **Positive** | Diesel rising again and Middle East product exports at 1.9 mb/d, against 4.7 mb/d before the war. The IEA sees shortages into 2027. | IEA diesel releases and purchases of Russian diesel |
| ★ **Semiconductors and AI** | **Short-term negative** | Massive capex financed with bond yields near 5%. Worst Nasdaq week since June and Meta lower on its spending plan. | Q4 results and capex guidance |
| Brent | **Bullish, volatile** | More barrels through Hormuz, but the risk has shifted to Saudi facilities. Highest since May at $112.68. | Houthi attacks and the calendar after 3 November |
| 10 and 30-year Treasuries | **Neutral** | Flatter curve as the market trusts the Fed and seeks shelter. Inflation at 3.7% limits the rally. | FOMC on 27 and 28 October |

| ASSET | BIAS | MECHANISM | WHAT TO WATCH |
|---|---|---|---|
| European natural gas (TTF) | **Bullish** | Storage around 75% against the usual 90%, and Qatar unable to meet its contracts. | Temperatures and the arrival of winter |
| Defence (US and Europe) | **Positive** | War in the Gulf, European rearmament and a refuge within equities. | Israeli election and Ukraine talks |
| Utilities with nuclear generation (e.g. Constellation Energy) | **Positive** | Stable demand from data centres, though sensitive to an AI correction. | Hyperscaler capex plans |
| Airlines, transport and European chemicals | **Negative** | Expensive fuel and gas with little scope for substitution. | Diesel and TTF |
| Gold | **Neutral** | At its lowest since August. Competes with Treasuries yielding close to 5% and a Fed that is raising rates. | Real rates |
| Copper | **Positive** | Structural demand, with the price distorted by record stockpiling in the US ahead of the tariffs proposed for 2027 and 2028. | Tariff decision and mine supply |
| Chinese yuan | **Strong** | Strongest since June 2022 on the trade surplus, held back by the People's Bank of China. | APEC in Shenzhen and rare earths |

## NOTES

★ asset of special interest this fortnight

## SOURCES


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