Rates Spark: A fiscal earthquake, and oh yeah, there's an ECB meeting

Rarely if ever have European yields spiked by 30bp while Treasuries yawn. That's a breakdown right there. The market moves in Europe reflect a fundamental repricing of the eurozone outlook and are not just about increased Bund issuance. The ECB will likely give little forward guidance but may lighten the language on rates being restrictive

Remarkable moves in Europe, while the US barely budges – a metaphor for separation

We can't underestimate the enormity of recent developments. There has not been a day, practically ever, where European yields have snapped higher, while Treasury yields barely budge. Germany pushing for the loosening in fiscal rules is such an about turn relative to the years leading up to EMU when the Germans pushed for strict budgetary rules to compensate for the loss of the deutsche mark and embrace of the euro. It seems that the ongoing implied US snub is finally shocking Europe into action. The narrative of US strength versus European malaise is being seriously questioned by the markets. The 10yr Bund yield has a 3% handle as a target (now at almost 2.8%, was 2.45% yesterday).

Even if we calm on Thursday and into the end of the week, a 3% handle for the 10yr remains probable subsequently if Germany does what it intends to do. Moreover, the snap higher in Bund yields was matched right across Europe, on a theory that fiscal deficits are on the up from a defence spending need. Inflation expectations up and curves have snapped steeper. And it does not feel like these moves will be reversed. Bunds trading cheaper to the ESTR curve is another structural thing we should get used to. And the moves have been big. We don't often see 30bp moves in eurozone 10yr yields, and *extremely* rare when completely independent of Treasuries.

The European outlook is repriced, not just the supply

Records were broken by the surge in Bund yields on the news of more German spending. The 10Y Bund yield now stands at 2.8%, the highest level since 2023, and this was when inflation just came down from double-digit numbers. Bloomberg even headlined that Bunds experienced their worst day since the fall of the Berlin Wall.

The market moves are much more fundamental than just revised expectations of Bund issuance. The 10Y swap also rose a significant 23bp on the day, bringing it north of 2.6%. Despite the jump in discount rates euro equities continued to hug record highs. And inflation forwards indicate renewed confidence that the ECB will be able to maintain a 2% target over the long run. Markets also no longer see the need for the European Central Bank to cut below 2% this year.

In a way markets seem to be revising their expectations about Europe's ability to adapt to the future. The sharp bear steepening of yields suggests that the fears of secular stagnation are being challenged while reinforcing the idea that Europe can secure its future independent of the US. This also highlights the risks for a reversal of the recent market moves. Many of the recent headlines have pointed in a positive direction for Europe, but with many lurking risks in the background, any setbacks could quickly undo that.

The sentiment in euro markets seemed to have spilled over to the UK where the 10Y gilt yield rose 14bp to 4.7%. Gilt yields have tended to move very closely together with USTs for the past months, but this correlation broke down entirely. In contrast to Germany, however, the potential for increased defence and infrastructure spending seems limited. This suggests that sentiment about the long-term future is a common denominator driving markets.

The ECB still set to cut this time, but it gets more complicated thereafter

The ECB is still widely expected to cut the deposit facility rate by 25bp to 2.5% on Thursday. But beyond today the market has repriced its expectations, with a cut at the April meeting already only a coin toss and overall the ECB likely to end the cycle at 2%.

The ECB itself is unlikely to speculate on what will happen going forward and cannot base its policies on mere plans. Still, its own updated projections will look outdated already and Lagarde will likely more than ever emphasise that decisions will be taken meeting-by-meeting. Markets will be particularly interested in whether the ECB softens its language on the restrictiveness of its policies or drops any reference to it altogether as key rates close in on the range of neutral estimates. Keeping it – in some softened form – would probably provide the very front end with some relief, and for the ECB itself there should be still enough uncertainties to justify a modicum of caution.

Expect Lagarde still to be questioned about the ECB's stance in light of the recent developments around defence spending needs and the sharp rise in long end yields, especially as many countries are already fiscally constrained.

Thursday's events and market view

The ECB meeting will be the main act in the eurozone and thus the retail sales numbers from January will likely draw little attention. From the US we have trade balance numbers and wholesale inventories, but given these numbers are from January they may not yet offer insights into the impact from Trump's policies. Jobless claims, on the other hand, could be watched more closely since these are from March and therefore give a more timely feel of recent job market developments. Lastly, the Fed's Waller will speak about the economic outlook.

Spain will auction 6Y and 10Y SPGBs and a 9Y SPGBei for a total of €6.25bn. From France we have 10Y and 18Y OATs and a 14Y green OAT for a total of €13bn.

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