Rates Spark: Europe bracing to spend on defence

Support for more defence spending is growing in Europe as the US takes a step back. Joint EU borrowing could be a way forward and the latest on German politics will therefore be watched closely, with long end Bund yields already nudging higher. Dutch pension funds might face complex choices if the final version of the legal proposal finds political support

French President Emmanuel Macron and UK Prime Minister Keir Starmer in Paris, France

Spending needs clear as EU security landscape rapidly evolves

The US pushing ahead and engaging with Russia over a deal in Ukraine has instilled a sense of urgency among European leaders. Events are evolving fast with US and Russian officials meeting in Saudi Arabia today to discuss ending the war in Ukraine – with neither Europe nor Ukraine having a seat at the table.

At least at the start of the week, the rates market's focus appeared to be on the supply implications of Europe's drastically changing security landscape, as EU officials signalled the need for an immediate ramping up of military spending and an easing of fiscal rules to accommodate the added funding need.

The prospect of joint borrowing to fund the EU's defence needs had also received more tailwinds as the frontrunner of the upcoming German elections indicated some openness to the idea. It may still take months, with Friedrich Merz of the German CDU pointing to upcoming discussions at the NATO summit in the Hague in June. The outcome of the German elections on 23 February are part of the puzzle. The composition of parliament will determine how easy it will be for Germany to reform its debt brake, which needs a 2/3 majority.

Long end Bund yields rose by up to 6bp, also partially unwinding the outperformance versus swaps that was witnessed at the end of last week. The 30Y Bund yields at 2.74% is still some 10bp off from January's peaks when European Central Bank (ECB) pricing was at its most hawkish point. For now, the front end reaction has been more muted, with the terminal rate pricing for the ECB still anchored at around 2% to slightly lower.

Final proposal for change in Dutch pension reforms has been published

The New Social Contract (NSC) coalition party in the Netherlands published a final version of its legal proposal last week, which could potentially disrupt the ongoing Dutch pension fund reforms. The latest adjustments to the proposal would allow pension funds to avoid a vote of approval by offering an opt-out to each participant instead. Those that object would only see their new contributions move to the reformed defined contributions system; existing assets would remain under the defined benefits scheme. For pension funds, the downside of choosing the opt-out path would be the need to run two pension pots in parallel, while a successful vote would allow a complete transition of assets to the new system. Parliament will discuss the proposed amendment in early March.

The potential impact from this additional feature remains difficult to assess, as the outcome would rely on the choices made by both pension funds and their participants. Assuming the legal amendment makes it through both parliament and the senate (which still seems unlikely), then pension funds would have to decide which path to take. Surveys suggest that finding a majority to vote in favour of the new defined contributions system will prove difficult. If for that reason many funds decide to offer an opt-out option, then we could see a more fragmented pool of assets. Given the uncertainty, we can imagine that pension funds will take a more passive approach to rebalancing their interest rate hedges for the moment. As such, any steepening pressure due to changes in longer-dated fixed receiver demand may ease for now.

Tuesday's events and market view

US markets will be back from their holiday yesterday. With German politics in the spotlight, the outcome from the ZEW survey expectations will be closely watched. Consensus sees the expectations component improving moderately from 10 to 20. From the US, we have the empire manufacturing index and TIC data. Overall, we expect news headlines to grab more attention than data releases.

Supply-wise, Germany is auctioning a 2Y Schatz for €4.5bn and Finland 5Y & 10Y RFGBs for a total of €1.5bn. In Italy books are opened for the second day for the 8Y BTP Valore retail bond – subscriptions on the Monday reached €5.6bn. The UK will auction a 39Y Gilt for £1.75bn.

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