

## Rates Spark: Finding room for increased defence spending

Bund yields ticked higher again as markets price in higher issuance on the back of defence spending. A tightening of eurozone sovereign spreads suggests markets are focused on joint EU borrowing. ECB comments imply that more easing may be needed to offset QT effects. We discuss the front end of the EUR, USD and GBP curve in our [Money Markets outlook](#)



EU and NATO flags. Markets expect increased defence spending in Europe

### Markets focus on joint EU borrowing for defence spending

10Y Bund yields notched higher on Tuesday as bond markets weighed the prospect of rising debt issuance. Although joint European Union borrowing options are being contemplated, the EU Commission has also been mulling activating national escape clauses to its fiscal rules to allow for defence spending beyond the prescribed sovereign borrowing limits. Economy Commissioner Valdis Dombrovskis said a proposal would be presented in the "coming weeks" and indicated that the exceptions could remain in place for "several years".

Taking the 2024 spending levels as a starting point, the countries that have the most catching up to do to even reach NATO's current 2% target level are the periphery countries Spain, Italy,

Portugal, and Belgium. Even in countries that have met the 2% criteria, significantly higher defence spending appears to be in store – on top of any other investment backlogs that have been identified. Looking at Germany's debt metrics, it is probably one of the few issuers with the fiscal room to stem additional funding needs. For a country like Italy, the EU forecasted last November that the debt-to-GDP ratio could approach 140% in the coming years.

For now, the tightening of eurozone sovereign spreads points to a market that is focusing more on the push towards additional joint borrowing, narrowing 10y Italian spreads over Bunds to their tightest since 2021. The prospect of higher Italian sovereign issuance seems to have taken a back seat amid hopes for the bloc moving ever closer together.

The front end of the EUR curve continues to look more anchored with markets still priced for the European Central Bank reaching 2% in the deposit facility rates by the end of the year. On Tuesday, the ECB's Piero Cippolone made the point that the central bank's rate-setting would also have to take into account its shrinking balance sheet amid quantitative tightening – specifically also its impact on long-end yields which we would interpret as a clear nod to the swap spread developments e.g. in Bunds. In our [money market outlook](#) published yesterday, we also look at the implications for very front-end spreads.

## Today's events and market view

UK CPI came in mixed this morning with headline inflation hotter than anticipated, but core and services in line to slightly cooler. No notable data is expected from the eurozone, and from the US we only have housing starts and building permits. From the FOMC, we do receive the minutes from January's meeting later in the day.

In terms of supply, from Italy we have a third day of open books for 8Y BTP Valore retail bonds. Monday saw €5.6bn worth of subscriptions and Tuesday €3.6bn. Slovakia has announced a syndication for new 15Y SLOVGBs, for an estimated €2-3bn. Germany has slated a 10Y Bund auction for €4.5bn. From the UK we have a 3Y gilt auction totalling £4.25bn, and lastly from the US a new 20Y Bond for \$1.2bn.

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