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Rates Spark: Fiscal trumps geopolitics

The market reaction to the latest transatlantic tensions has been mild so far, with Japanese forces actually dominating in rates. But uncertainty remains high, which should keep the bullish mood in EUR rates. Meanwhile, French spreads can tighten on the passing of the 2026 budget, even as global fiscal concerns linger

The tensions between the US and EU are only having a mild impact on markets thus far, but we do expected a bullish mood in rates

Global fiscal concerns rear their head again...

Fiscal concerns reared their head overnight as Japanese bond investors eyed the Japanese government's tax plans. 10y Japanese government bond yields have risen 15bp from the end of last week, and 30y yields a whopping 37bp. Some spill-over was also felt as US Treasuries resumed trading in Asia after Monday's US holiday. The 10y UST yield climbing to 4.27% puts it back firmly into the range last observed in summer 2025. While more elevated US yields are in part a macro story, an undercurrent of deficit concerns and renewed wariness around the dollar amid Greenland tensions also remains. But European yields were also not immune, with the 30y Bunds up 5bp.

...but French spreads get some relief as a 2026 budget looks set to pass

Amid markets showing signs of increased caution, the tightening of French government bond spreads against a broader trend was an encouraging sign that geopolitics are not yet the overriding factor, and domestic stories still play a role. The French Prime Minister announced on Monday that, after negotiations had stalled, he would use a constitutional provision allowing passage of the 2026 budget without a parliamentary vote. While opening the government to a confidence vote, enough concessions have been made to see the relevant parties abstain from any such vote.

In the near term, that could provide some room for a moderate re-tightening of French spreads after the recent underperformance, especially versus Italian bonds. But overall, we think the scope for a major rally of French risk seems limited, and a range-bound scenario in the 60-80bp area over 10y Bunds in the coming months and quarters looks more likely to be sustained. The main political strategising will likely happen around the 2027 budget, eyeing the presidential election early in 2027.

Bullish mood in rates should stay as risks remain for further escalation

Once again, a flurry of geopolitical headlines has failed to upset rate markets in any major way, and yet we do think a more bullish mood could stick. Before this weekend, equity markets hit new highs, and risk indicators like the VIX also pointed to very strong sentiment. This optimism helped euro rates higher over the past months, including the pricing out of possible European Central Bank rate cuts. Now that uncertainty is returning to markets, we do think slightly lower rates are justified in the near term.

But the reaction from rates may remain moderate as markets are now better aware of the likely moderate economic impact from tariffs. Since 'Liberation Day' last April, the eurozone's growth outlook has continued to improve, and economic data has consistently managed to beat expectations. Meanwhile, the stock market seems more focused on NVIDIA's profitability than a potential break in transatlantic relations.

Having said that, we're still dealing with significant known unknowns, such as the possible escalation paths going forward. Both the US and the EU have the ability to inflict significant economic damage on each other outside trade tariffs. But a mere 1.6% drop in the euro STOXX index on Monday still suggests markets are expecting a de-escalation. Which raises concerns about complacency. From this perspective, one could argue that safe assets like 10Y Bunds should see yields come down further.

Tuesday's events and market views

Davos discussions will probably take the spotlight, especially as the situation around Greenland continues to develop. In terms of data, we have Germany's ZEW survey outcomes, which should continue to paint an improving growth outlook.

For issuance, we have Spain with a 10Y SPGB syndication for an estimated €15bn, and also the UK has a syndication scheduled with 15Y Gilts amounting to £6bn.

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