

Rates Spark: Hawkish ECB comments compound fiscal pressures

Prospects of increased EU military spending are keeping bond yields under upward pressure, this time compounded by hawkish comments from the ECB. Hotter UK CPI figures on Wednesday also pushed in the direction of a more hawkish adjustment of BoE rate cut expectations



Hawkish comments from ECB against backdrop of defence spending

Rates are still pushing higher, now compounded by hawkish remarks from the European Central Bank's Isabel Schnabel. While dismissing the possibility of hikes, she mentioned the ECB was getting closer to where rates should be kept on hold or cuts at least paused. Coming from her, such remarks should not surprise as Schnabel has previously been estimating the neutral rate as high as 3%.

But what has changed in the meantime is the perception of the fiscal backdrop, where aside from the immediate supply implications, the prospect for larger defence investments also argues for a more expansionary stance ahead. The question of course remains to what degree such investments translate into economic activity.

Markets have pushed their expectations for the ECB deposit facility rate at year-end towards 2%, trimming chances that the ECB could end up in more accommodative territory. While front-end rates nudged up 3bp, the back-end bond yields still rose even more against the backdrop of higher debt issuance expectations. German Bunds underperformed versus swaps with the 10y yield back at more than 7bp above swaps – on closing levels that is the cheapest valuation to date.

This time around, however, the hawkish ECB tone has also prompted other sovereign spreads over Bunds to widen out – but not much yet. A 10y Italy-Bund spread of 108bp is still very tight coming from 115bp at the start of the year and levels over 150bp in June last year. However, we still feel the market may be a bit optimistic about the degree common EU issuance can cover the additional military spending needs, at least in the short run.

Markets are taking hotter UK inflation at face value

The UK's headline CPI number for January came in at 3.0%, up from 2.5% the month before and above the consensus of 2.8%. Rates ticked higher, but in our view the underlying message from the data was actually more on the dovish side. Services inflation is admittedly still high, but at 5%, just about undershot consensus. And our estimate of core services inflation would now be just 4.2%, well below the 4.7% from two months back.

The 10y gilt yield rose by some 4bp to 4.6%, but markets are still close to fully pricing in a 25bp rate cut in May. A rate cut in March seems off the table and we tend to agree that the Bank of England will opt to cut rates gradually at a quarterly pace. With inflation still trending down, we think risks are tilted to the downside and any growth headwinds could quickly accelerate the path of easing. For the front end, we maintain an overall bullish view, and given the back end is more tied to the US, the next move will likely be a steepening of curves.

Today's events and market view

The data calendars remain relatively light. After the German PPI in the morning, attention shifts to the US weekly jobless claims data and the Philadelphia Fed's manufacturing index. More market-moving headlines could be coming from a *Bloomberg* interview with US Treasury Secretary Bessent and there will also be appearances from Fed officials such as Goolsbee, Musalem and Kugler. The Fed's Barr will speak on regulation. From the ECB, Ireland's Makhoul and Germany's Nagel are scheduled to speak.

News headlines also have plenty of potential to move markets, including more on the German elections, US trade tariffs and Trump's intentions to cut government spending down.

Primary markets are busier with auctions from Spain and France. Spain will sell 3y, 5y and 9y bonds for up to €5.5bn. France sells a new 3y bond and taps two 5y lines for up to €13.5bn. Alongside, it will also sell up to €2.25bn in existing inflation-linked bonds. In Italy, books for the BTP Valore retail bond are open for the fourth day. Subscriptions on day three amounted to €2.8bn, taking the total to €12.1bn. The US Treasury will auction new 30y TIPS for US\$9bn after a softer 20Y auction yesterday.

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