

Rates Spark: Inflation expectations on the march again

President Trump's words from Monday continue to reverberate, but into a vacuum of ongoing conflict. The oil price has tamed, as has material risk asset angst. But US breakeven inflation and swap spreads are on the march wider. Not great. In the eurozone, the 10Y swap rate is heading for the 3% handle. Here too, a push from inflation expectations



US breakeven inflation and swap spreads are heading wider and the 10Y swap rate in the eurozone is moving up on inflation expectations

Wider front end breakevens and wider back end swap spreads are both problem childs

Monday saw President Trump have a remarkable effect on market pricing, taming the price of oil in particular, mostly on the carrot of an earlier-than-anticipated end to the Iran war. See [here](#). Tuesday saw little change to the onslaught, and words to the effect that the job was not quite done. Wednesday was dominated by the creeping realisation that we were midway through week two, and most likely heading into a third week, at the very minimum.

One positive, post the President's comments on Monday, is the holding pattern for the oil price. It collapsed below Monday's highs, and has held broadly steady since. No doubt this has been helped

by preparedness to release strategic reserves where required. But it also reflects the fact that both of these seemingly conflicting outcomes can be true at the same time. More intense short-term attacks *could well* help to bring the whole thing to an end sooner. To be seen.

Market breakeven inflation rates have decided that things are getting more troubling again

Inflation breakevens managed to flat-line at around 3% through Tuesday (using the 2yr tenor), but through Wednesday, they ratcheted right back up to over 3.1%. And this has come through higher nominal yields (as real yields have been broadly steady). The 10yr yield is now up to over 4.2%, and continues to look up.

The 10yr yield spread to 10yr SOFR (swap spread) has re-widened, also spelling trouble

The 10yr swap spread almost hit 50bp on Monday as the price of oil spiked. It then got back down to the low 40s, but it's now back up to the high 40s, and still showing a tendency to rise. This is not great. No doubt an irritant for Scott Bessent, as the cost of re-funding is higher, and at a wider spread to the risk-free rate (the level that would be paid if the fiscal story was considerably more positive).

The rising breakeven inflation rate on the front end and the wider swap spreads on the back end are both impulses that the administration will be keen to avert becoming a material issue. They are the correct reactions, given what's been happening. Aversion of subsequent extremes will require President Trump to be in a position to get back to the tone he struck on Monday, but this time with considerably more finality than we heard through Monday/Tuesday. Until we do, an extrapolation of these moves ahead is in order.

Three conditions to keep pushing for higher 10Y euro swap rates

The 10Y euro swap rate can continue to climb, but we believe this fragile equilibrium requires multiple conditions to hold. The 10Y is closing in on 3%, which would make it the highest level since 2023. Settling above 3% seems possible, but we identify three factors that should stay in a delicate balance to make this work.

First of all, energy prices would have to remain elevated, but also not too high. The current levels are pushing up the entire curve from the front end through near-term inflation expectations. The longer oil and gas prices stay high, the more markets would price in an inflation pass-through. Having said that, energy prices should also not move much higher either. Moving beyond \$100 per barrel can start weighing on long-term growth expectations and risk sentiment, which in effect may actually push down the back end of the curve.

Secondly, we would need a reasonably hawkish European Central Bank. Simply dismissing the

inflation impact as transitory would be inconsistent with markets pricing in close to 40bp of hikes this year. Whilst some ECB members are more hesitant to offer forward guidance, the most recent remarks from Nagel and Kazimir seem to confirm markets' assessment of a relatively hawkish reaction function. Similar to previous conditions, if the ECB turns too hawkish, however, markets could start building concerns about a policy mistake. In that case, the back end of the curve would actually fall.

The last condition needed to keep pushing up 10Y swap rates would be for market risk sentiment to hold and this could become more challenging over time. So far the S&P 500 is down less than 3% from its peak in February. And that while higher energy costs should be net negative for risk assets over the long term. Meanwhile, AI jitters and private credit can add to investors' worries. A turn in risk sentiment would push investors to more safety and, in that case, 10Y rates would turn lower.

Thursday's events and market views

The market is bound to be even more focused on the geopolitical headlines and oil prices with both the Fed and now also the ECB within their pre-meeting communication blackout periods. Data will come solely from the US, where the weekly initial claims data will provide a contemporaneous read on the state of the jobs market. Other data will be import/export prices, trade balance, as well as housing start numbers for January.

In European government bond primary markets, Italy will auction 3Y, 7Y and 12Y bonds for a total of up to €6bn. Ireland will auction 10Y bonds for up to €1.25bn, the UK ultra-long gilt linkers for £0.5bn while the US will auction US\$22bn in 30Y bonds.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Michiel Tukker

Senior UK & Eurozone Rates Strategist

michiel.tukker@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

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