Rates Spark: Markets cautious in anticipation of German spending

The German election results did little to move rates on Monday. However, under geopolitical pressure, politicians are exploring funding options for a military build-up, which validates the market's cautious approach amid looming supply concerns

Increased German spending not immediately obvious from election outcome, but...

The market reaction to the German election outcome was relatively modest. 10y Bund yields tracked towards 2.5%, underperforming modestly versus swaps. In part, this could just be an unwind of the moves on Friday, but overall it also suggests that markets are not ready to dismiss prospects of significantly higher debt issuance ahead.

The election outcome points to a grand CDU/CSU and SPD coalition. But with regards to a possible reform of the debt brake, the more centrist parties CDU/CSU and SPD, along with the Greens, do not hold the necessary two-thirds majority – any reform would also require votes from the Left. The Left has indicated its openness for reform with a view to infrastructure spending but is likely to oppose any changes to support a significant increase in military spending. The AfD has already opposed any change to the debt brake. The future government could also decide to declare an emergency situation around Ukraine to suspend the debt brake temporarily, but it is questionable whether financing a longer-term reoriented defence strategy would pass the constitutional test.

However, the Greens proposed on Monday to reconvene the current parliament to reform the debt brake or decide on special funds to finance the military – the newly elected parliament convenes only on 25 March. The CDU's Merz has signalled a willingness to engage in talks and a figure of up to €200bn for a special fund has been cited by *Bloomberg*. Markets will not dismiss the possibility that geopolitical developments and changing realities can still push decision-makers down this route.

Still tight EGB spreads versus Bunds signal high hopes for joint EU borrowing

Common EU issuance to finance military spending is of course also an ongoing discussion, but something that the CDU has been sceptical of as well. Europe is seen moving closer together in light of the rising security threats, but we would argue that at least compared to the outgoing government, such a path has become less straightforward. The *FT* reported that the UK and EU finance ministers will hold talks at the upcoming G20 meeting this week, with the Polish minister indicating "it could be a fund or a bank".

As such we do have the feeling that markets are too optimistic about the timelines and political/practical hurdles and see the possibility that financing via national debt looks more likely near term which would call tight European Government Bond valuations, especially versus Bunds, into question.

Today's events and market views

The data highlight will be the European Central Bank's indicator of negotiated wages, of which the last publication still pointed towards a steep 5.4% increase per year. Other ECB indicators, and alternative measures such as the Indeed wage tracker, are already showing more signs of cooling. Markets are therefore likely positioned for a significantly lower reading. Among the US data, we have the Conference Board consumer confidence indices and the Richmond Fed manufacturing index.

The ECB's Schnabel, the Fed's Logan and the BoE's Pill will speak at the Bank of England about the future of central bank balance sheets, which could prove interesting. Later in the day, Barkin from the Fed will speak about inflation.

In terms of supply, we have Spain with an announced syndication of 15y SPGBs for an estimated €7bn. Italy will auction a 2y BTP and an 11y BTPei for a total of €4.25bn and Germany a 28y Green bund for €1.5bn. From the UK we have an 11y Gilt Linker auction for £1.6bn and lastly from the US a new 5y Note for $70bn.

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