

Rates Spark: Markets struggle to keep up with Trump

Global risk sentiment is being challenged by a flurry of headlines triggering a significant steepening of curves. The EU's defence spending numbers look big at face value, but rely heavily on national funding. But Germany seems eager to deliver



Steeper curves as global frictions intensify

Global risk sentiment struggled with all major equity markets ending the day in the red. Not only is Trump following up on his tariff threats, but also military support to the Ukraine was halted overnight. The euro equity Stoxx hit record highs earlier this week, but already within 24 hours reversed and posted a 3% loss. The pace at which Trump is redefining the world order is difficult for markets to digest.

Meanwhile, the 2s10s curve steepened significantly as rates priced in more European Central Bank rate cuts whilst also accounting for supply pressures from defence spending. Tariff retaliations add another layer of complexity, since these can also have an inflationary side effect. For euro rates we see that the 2Y outperformed shorter maturities, reflecting markets' awareness that the ECB's

hands are still somewhat tied by recent inflation numbers. Further out the curve the added supply expectations start dominating.

We think the [5s10s can still steepen further](#) in this volatile environment as the curve is still very flat in a historical context. If the risks facing the eurozone fail to materialise, then the move steeper would come from the back end. If, on the other hand, the near-term concerns intensify, then the belly of the curve would outperform. When looking at the 5s10s in 2-year forwards, another 20bp of steepening doesn't seem unrealistic.

The Commission proposal shows a heavy reliance on national defence efforts

European Commission President [von der Leyen presented her plans](#) to boost European defence spending. Key pillars are the triggering of the national escape clauses and a "new instrument" to provide up to €150bn loans.

The new instrument is reminiscent of the EU's SURE programme. The main interest for such loans could come from eastern European countries where the conditions will likely be most attractive versus their own borrowing. What it does not address is that it still adds to a country's debt.

This is where the escape clauses from the EU fiscal rules will come in. Von der Leyen makes an example calculation that, if used to raise military expenditure by 1.5% of GDP on average, it could mobilise up to €650bn over four years. Many countries with already higher deficit/debt levels might be reluctant to join in on the effort quickly, so that the €650bn headline figure looks optimistic. The hope – or fear – is that the special council summit on Thursday can still reveal bolder plans in light of the US having halted its aid to Ukraine.

As for [German plans, CDU/CSU and SPD have agreed on plans](#) to set up an infrastructure special fund of €500bn with a time frame of 10 years and to reform the debt brake to allow for higher defence and security spending. The currently more rigid debt brake for the federal states will also be eased. The plan is to pass all decisions next week still within the current legislature, but here CDU/CSU and SPD will also need the votes of the Greens.

All the big headline figures in the press so far will likely lead to interesting questions for Lagarde at Thursday's press conference with regards to the ECB's stance amid the looming supply. For now, EGB spreads over Bunds remain relatively resilient to the looming supply story and have widened only marginally amid the broader risk-off on Tuesday. While Bunds traded softer during the day with yields edging up towards 2.50%, the drop of the 10Y Bund futures in evening trade implied a 10bp yield increase.

Wednesday's events and market view

Headlines are likely to dominate markets, but in terms of data we first have Spanish and Italian PMIs on the agenda. All of these are expected to remain at 50 or above. From the eurozone we have PPI numbers for January, which could be watched for surprises given the ECB's communication has shifted more hawkish on inflation. From the US we have the ISM services index which is expected to remain resilient at 52.5. Other US data includes ADP employment numbers, factory and durable good orders. With Trump's policies under scrutiny, markets may use these numbers as a gauge for his economic impact thus far. Lastly, we also have the Fed's Beige Book which contains more qualitative statements about

US business sentiment.

Supply includes a new 30Y German Bund syndication for an estimated €6bn. The UK will auction £4.25bn of Gilt.

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