Rates Spark: Push and pull between US and Euro rates

Euro rates jumped higher on defence spending expectations and higher-than-hoped-for inflation. On Thursday we can expect questions about the ECB's role in European defence spending. Meanwhile, US Treasuries continue to rally. Not much room south of 4% on the 10yr, unless payrolls provide some room. There's an angst trade too in long Treasuries for now

US Treasuries home in on 4%, but around that should really be it

The US 10yr has 4% in its sights. Momentum certainly has that area as the next big level to aim for, following a run of data and events that have conspired to propel yields lower. The latest was Monday's ISM report. Below 50's on many parts of this report were a theme in 2023 that never resulted in a material weakening tendency for the wider economy. But this time it's been interlaced with an element of US tariff interpretation focused on potential future negatives. And last Friday's showdown in the White House has acted to sustain the undercurrent of angst, again propelling Treasuries.

That said, we doubt there is room for the 10yr yield to get much below 4%. The implied floor being

set by the funds rate futures strip is in the area of 3.5%. This is some 25-50bp below where it was a few weeks back, thus making enough room for the 10yr yield to ease lower of late. But if the strip hold here, and adding on top of that the current 10yr swap spread of 40bp, it pitches an implied floor for the 10yr yield at 3.95%. And that is then virtually flat to the implied funds rate floor, with no yield curve. This can only be rationalised if the fund strip were to shift lower still. On the assumption that it doesn't, the 4% area should be the low for the 10yr yield.

Euro rates higher on upside CPI surprise and defence spending

Euro rates bumped higher on increased defence spending expectations and hotter-than-hoped inflation numbers. The core CPI reading for the eurozone came in at 2.6% year-on-year, just a tad higher than the 2.5% consensus. The upside surprise echoes strongly with the European Central Bank's more hawkish tone of late, justifying the relatively large market reaction. The sticky inflation simply reduces the ECB's flexibility to accelerate rate cuts if needed. A policy cut this week is still fully priced, but the path thereafter is more open. Instead of consecutive cuts, markets are homing in on a quarterly cutting schedule going forward. With such inflation numbers limiting the ECB's flexibility in the very near term, we can expect any growth headwinds to translate into increased cutting expectations by markets later in 2025.

We don't think the ECB will give much forward guidance in terms of future rate cuts on Thursday, but we may expect questions in relation to the European defence spending ambitions. So far the reaction in rates markets have centred around Bund yields, whereas the impact on say periphery spreads have been limited. With the fiscal space of many countries constrained, markets may get increasingly nervous when plans get more concrete. The ECB's Transmission Protection Instrument (TPI) could play a role here, but is conditional on "sound and sustainable fiscal and macroeconomic policies" of a country. A potential question therefore could be whether the EU's plans to loosen the deficit rules via national escape clauses would also impact the conditionality of the TPI backstop.

Will the big numbers stick?

Headlines abound about the size of the spending spree ahead: French President Macron had signalled €200bn from the EU to boost defence spending and countries are urged to increase their defence expenditure to 3% to 3.5% of GDP from the current NATO guideline of 2%. A back-of-the-envelope calculation using the 2024 data could amount to €150bn to €220bn from the euro area NATO members. Taking into account the 5Y to 10Y horizon that is eyed for the European defence push, it is not difficult to arrive at the €400bn figure that was reportedly the basis for discussions of a special defence fund in Germany. On top of that come reports of a German infrastructure fund of €400-500bn.

It is especially the German figures that have spooked the market. And there is a sense of urgency, not just because of the geopolitical developments, but also because political realities will change after 25 March when the newly elected Bundestag convenes for the first time and will then make any bold plans much more difficult – if not impossible for defence. Size is also intended as signal. But as is often in politics the numbers floating about now might just be the starting point of negotiations – here an expert recommendation from German economic institutes and universities – and they might well end up noticeably lower in the vicinity of the originally cited €200bn figure for the defence fund for instance. Importantly, we do not know any of the crucial details of the funds such as their envisaged time frames. Markets – and us – will stay cautious until more is known with special attention paid to the defence summit this Thursday. Even if justified by the

situation, we would not be surprised to see some of the very large figures get watered down. And actually realised spending in the end is an entirely different story.

Tuesday's events and market views

The eurozone will publish the unemployment rate for January, which is expected to remain 6.3%, close to the all-time low of 6.2%. From the US no notable data is scheduled, but we do have the Fed's Williams speaking to Bloomberg.

Plenty of supply scheduled. We have Belgium with a 15Y OLO syndication for an estimated €5bn. The Netherlands will auction €4-6bn of a new 10Y DSL and Austria has scheduled 10Y and 29Y RAGBs totalling €2bn. From Germany we also have a 5Y Bobl for a total of €4.5bn and the UK has scheduled a £2.25bn 29Y Gilt auction.

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