

Rates Spark: The problem children get more cranky

The problem children of higher US break-even inflation and wider US swap spreads remains problematic – we explore. Overall, market sentiment is not happy with oil testing above \$100. Should risk sentiment sour further, we could see spillovers in the form of wider EGB spreads (which ultimately could actually argue against an overly hawkish ECB)



US rates dipped while sterling rates hit new highs

The rise in US yields looks absolutely the right move, until it isn't

As feared, the two concerns that we highlighted on Wednesday only intensified through Thursday – the two problem children of higher US break-even inflation rates and higher US swap spreads. First, the 2yr breakeven is now back up to 3.2%. Given that this is an average number over the next two years, it impliedly suggests that US inflation is heading to 3.5%, at least. Second, the 10yr swap spread is knocking on the door of 50bp. This rot is liable to continue for as long as the war angst remains elevated.

Perhaps the anomalous piece here is the tendency for real yields to rise. Short-dated real yields did

fall on Monday, but are up since. Out the curve, the 10yr real yield has basically just risen. When inflation-linked bonds are bought, that should place downward pressure on real yields. Here, it seems that the rise in nominal yield is the dominant driver, which equates to selling of nominal regular Treasuries. This is not "Sell America", as the US dollar is being bought. Rather, it is the build of an inflation / deficit-risk discount, with a waning rate-cut expectation to boot.

For the Treasury market bulls out there, it's unlikely that inflation expectations will tame any time soon, at least given where we are in the ongoing war. If there is going to be a material fall back in yields, it must come from a fall in real yields. That, in turn, could be sparked by a material elevation in real growth concerns, or a jump to discount such concerns through a big risk asset sell-off. We've seen some of this, but not a big absolute flop lower. That *could* happen. But until then, yields ratchet higher.

Fragile risk sentiment could stop markets from turning overly hawkish on central banks

Headlines out of the Middle East remain the main driver of rates markets. As Brent has moved above US\$100/bbl again with the notion of a longer disruption sinking in, inflation expectations have risen alongside and markets pricing a correspondent central bank reaction.

2y EUR inflation swaps rose 14bp on the day and are closing in on 2.6% while the market is discounting 41bp of policy tightening by the end of the year. It is not back to fully pricing two hikes as the market did briefly at the start of the week on the back of oil prices closer to US\$110/bbl.

More importantly, we saw risk-off reflexes kicking back in with more prominence. Real interest rates (calculated from the differential of nominal OIS vs inflation swaps) were dropping along the curve, some 10bp in the 2y tenor and still some 6bp in the 10y.

More troublesome for the ECB should be that government bond spreads are coming under renewed pressure. Italian spreads were worst hit as the 10y spread over German peers widened back to 80bp. The possible direct burden on budgets from the energy market turmoil paired with rising refinancing costs poses a clear risk to sovereign credits, though for now we suspect that moves are still more reflective of deleveraging amid more volatile markets.

Ultimately, we think the feedback loop via risk sentiment – and in the eurozone with growing concerns around widening government bond spreads – is likely to keep markets from pricing a too hawkish ECB. We can imagine a scenario where the ECB continues to signal "vigilance" throughout the turmoil, but in the end never acts on it.

Friday's events and market views

In terms of data, we have industrial production coming from the eurozone. But given these figures will be from January, markets are unlikely to react. More interesting data will come from the US, where we have the PCE deflator for January alongside personal spending, second GDP estimates for 4Q25, durable goods orders and JOLTS jobs data.

Even though the University of Michigan sentiment survey would usually receive less attention against such a busy release schedule, that may be different this time. The survey should capture the beginning of the Middle East conflict and could give insights into

consumers' initial reaction. Having said that, the end date of the Survey was 9 March and thus the impact of higher gas prices would be limited.

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