EUR swap: high real rates and normalisation of inflation

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Outlook for 2027: structurally high real rates

- **The 10-year real EUR swap rate stands at around 1.14 per cent,** a level representing a significant normalisation compared with the negative figures observed between 2014 and 2022, when the ECB's policy and excess liquidity had artificially suppressed real yields.

- **The current exogenous variables** we use in our analysis are:
  - ECB deposit rate at 2.25 per cent;
  - 1-month Euribor at 2.23 per cent
  - 1Y1M EUR forward swap rate close to 3.21 per cent
  - 2Y1M EUR forward swap at 3.13 per cent
  - ECB balance sheet down to 36.6 per cent of Eurozone GDP.

Real 10-year euro swap rate (%)

Source: Bloomberg, Intesa Sanpaolo

Real interest rates linked to monetary policy expectations

- **Real interest rates depend primarily on expectations regarding future official interest rates, rather than on the current level of ECB rates.**
- Quantitative easing has had a significant downward effect on real yields. **The reduction in the ECB's balance sheet continues to exert gradual upward pressure on equilibrium real rates.**
- Our model estimates a theoretical value of around 1.14% for September 2026, very close to the observed level of 1.15%, indicating that the **market appears broadly in line with fundamentals.**
- From a strategic perspective, the market appears to be pricing in:
  - moderate but positive real growth in the eurozone
  - inflation returning to levels close to the ECB's targets in the medium term
  - terminal rates consistent with a neutral level higher than that of the pre-pandemic decade
  - the continuation of *quantitative tightening*.

Date	10-year EUR real swap rate (ISP forecast)
September 2026	1.15%
December 2026	1.05%
December 2027	0.99%

Alternative scenario 1: ECB rates «higher for longer»

Probability: medium

Core inflation proves persistent and the ECB does not cut rates in the medium term.

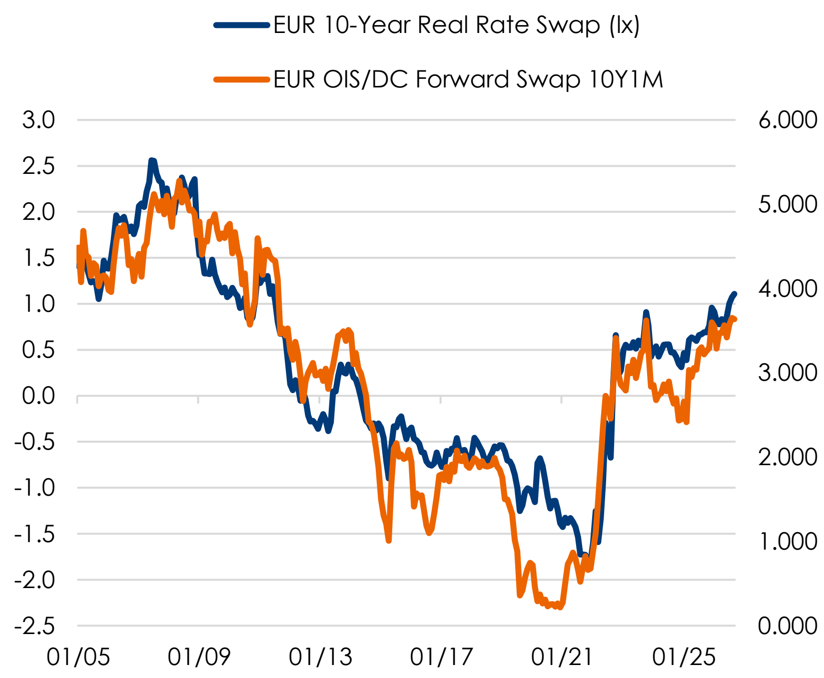
Characteristics:

- deposit rate rising towards 3%
- 1Y1M and 2Y1M forward rates above 3.5%
- Eurozone nominal growth close to 4%.

In this scenario, the market would reassess the European neutral real rate, and the 10-year real swap rate could reach 1.8%–2.0%.

The model does, in fact, show strong sensitivity to the forward components of the money market curve.

10-year euro real swap rate and 10Y1M forward swap rate (right, %)



Source: Bloomberg, Intesa Sanpaolo

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Alternative scenario 2: sharp rise in the term premium

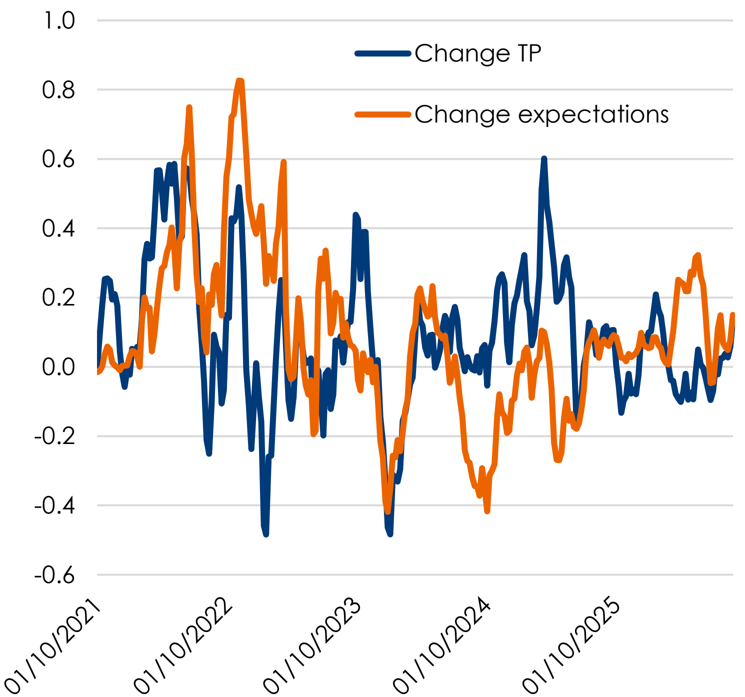
Probability: medium to high in the long term

In recent years, QE has compressed the term- premium. Markets may begin to demand a higher premium for holding duration.

In this case, long-term nominal yields would rise more than inflation expectations, and the real rate could move above 2.0 per cent.

This could be the most realistic scenario in the medium term.

3-month change in the term premium and Bund inflation expectations



Source: Bloomberg, Intesa Sanpaolo

Alternative scenario 3: European fiscal shock

Probability: medium

A permanent increase in public spending linked to:

- defence spending;
- the energy transition;
- infrastructure;
- European industrial programmes.

The medium-term consequences would be:

- a higher deficit;
- increased debt issuance;
- an increase in the real equilibrium rate to absorb available savings.

In this context, the 10-year real rate could stabilise between 1.2% and 1.5%.

Alternative scenario 4: acceleration of European productivity

Probability: low

Higher potential growth increases the real equilibrium rate (r-star).

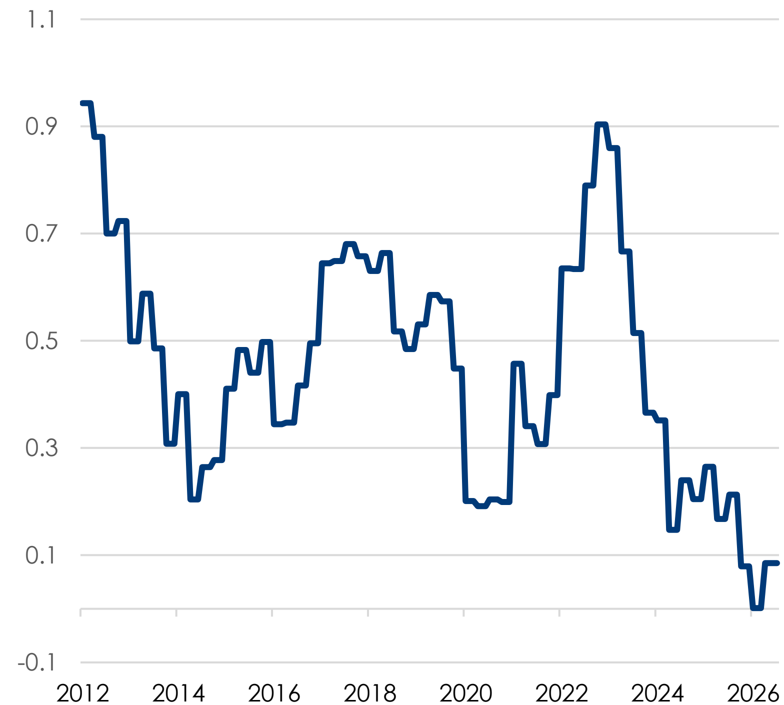
Possible catalysts:

- widespread adoption of AI;
- increase in private investment;
- greater integration of the European capital market;
- tax and labour market reforms.

If potential real growth were to rise from around 1% to 1.5%–2.0%, the markets might price in a significantly higher structural real rate.

Target for the 10-year real swap rate at 1.5%–2.0%.

Eurozone natural rate (Holston-Laubach-Williams model, %)



Source: Bloomberg, Intesa Sanpaolo

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What is the most plausible scenario for 10-year real interest rates?

Scenario	EUR Real 10Y
Base	0.9%–1.0%
ECB 'Higher for Longer'	1.8%–2.0%
Increase in term premium	1.6%–2.0%
Productivity boom	1.5%–2.0%
European fiscal shock	1.2%–1.5%

- The riskiest scenario at present is not that of structurally higher inflation, but rather a rise in the term premium resulting from the normalisation of central bank balance sheets and an increase in the supply of government debt.

- To reach a level consistently above 1.5%, what is needed today is primarily a combination of a higher term premium and a higher neutral real rate, not necessarily higher inflation.

- **In our base-case scenario, the 10-year real euro rate gradually falls below 1 per cent by the end of 2027, driven by the ECB's policy of holding rates steady and inflation stabilising around 2 per cent.**

10-year euro inflation swap: stabilisation in 2026 and gradual normalisation in 2027

The current level of around 2.3 per cent appears high relative to forward-looking fundamentals. Our model's forecasts indicate a moderate overvaluation of long-term inflation expectations, which is set to be gradually absorbed during 2027.

The expected decline does not reflect a return to deflationary risks, but rather a gradual convergence of expected inflation towards levels more consistent with the ECB's target.

Three factors contribute to this trend:

1. Normalisation of actual inflation

European inflation is expected to continue to slow as energy prices stabilise.

2. Monetary policy remains restrictive in real terms

The ECB is expected to maintain positive real interest rates, helping to anchor long-term expectations.

3. Reduction in the inflation premium

Following the energy and geopolitical shocks of 2022–2023, the market continues to price in an inflation risk premium above the historical average. In the baseline scenario, this premium is expected to gradually narrow.

10-year euro inflation swap: base case scenario

The model's central scenario forecasts that the 10-year EUR inflation swap will remain around 2.20% in the latter part of 2026, before gradually falling below 2% by December 2027. The market continues to price in a higher inflation environment than in the pre-Covid period, but the underlying trend remains one of gradual convergence towards levels more compatible with the price stability pursued by the ECB.

Date	10-year EUR inflation swap ISP Forecasts
September 2026	2.28%
December 2026	2.18%
December 2027	1.98%

From an operational perspective, the implications are:

- the potential for a further rise in the inflation swap appears limited in the central scenario;
- inflation-linked securities continue to offer protection, but at a less attractive valuation than in the past;
- the main risk to the normalisation outlook remains new energy shocks or a more expansionary European fiscal policy than expected.

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Alternative scenario 1: European fiscal reflation

Probability: medium-high

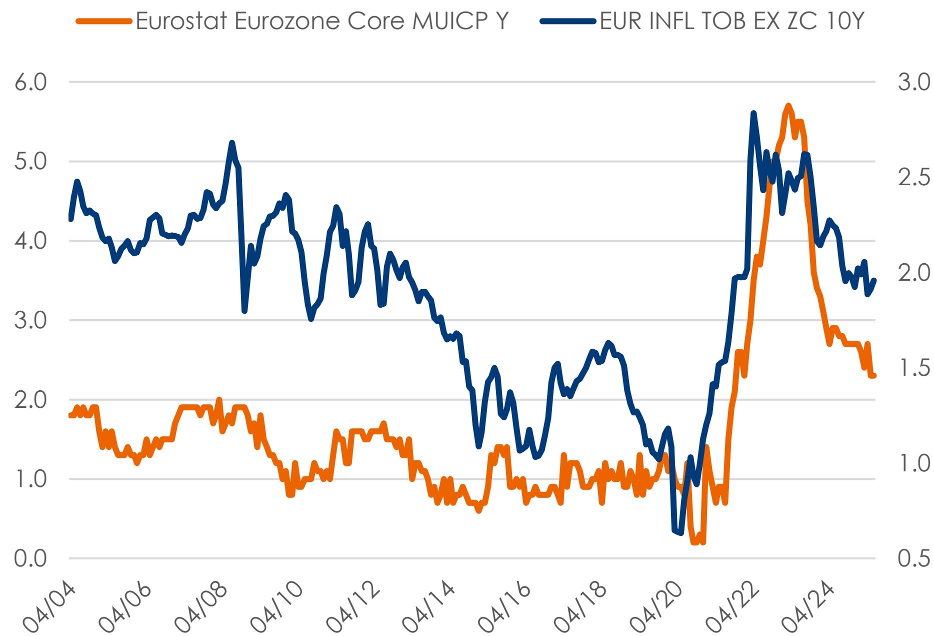
Europe is gradually increasing public spending on
defence, the energy transition, infrastructure and industrial policy.
If these programmes were to become permanent, the market might begin to price in a higher equilibrium inflation rate.

Effects:

- stronger aggregate demand
- persistently high public deficits
- reduced disinflationary capacity of the economic cycle.

In this scenario, the 10-year inflation swap rate could stabilise between 2.4% and 2.7%.

10-year EUR swap inflation and actual inflation (left, %)



Source: Bloomberg, Intesa Sanpaolo

Alternative scenario 2: continuation of the energy crisis

Probability: medium

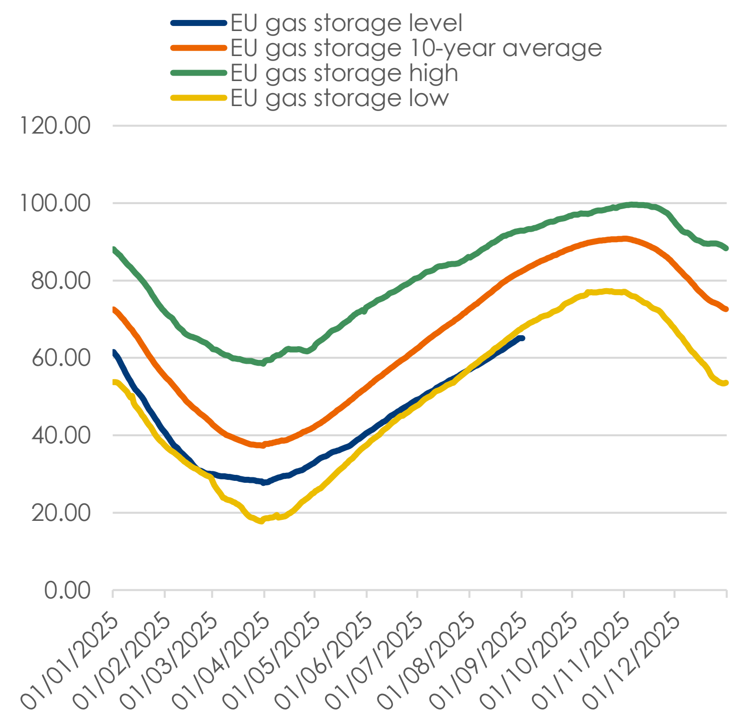
One of the main risks to European inflation remains the energy sector.

Possible catalysts:
- geopolitical escalation in the Middle East;
- gas supply issues;
- new global trade tensions;
- a structural rise in electricity prices.

Even if the effects on current inflation were temporary, the market might revise upwards the risk of future supply shocks.

The 10-year inflation swap could rise towards 2.5%–2.8%.

Eurozone gas stock levels



Source: Bloomberg, Intesa Sanpaolo

Alternative scenario 3: deglobalisation

Probability: medium to high in the long term

Over the last twenty years, globalisation has helped to keep inflation in check.

Conversely, several factors could keep production costs structurally higher, including:

- the regionalisation of production chains;
- reduced trade integration;
- the relocation of manufacturing;
- rising tariff barriers.

In this context, the market could begin to price in an implied inflation target of around 2.5%–3% rather than 2%.

The 10-year inflation swap range is between 2.5% and 2.8%.

Alternative scenario 4: The ECB is more tolerant of inflation above target

Probability: low but significant

The markets may come to believe that:

- **the ECB is less aggressive in combating moderately high inflation;**
- the stability of public debt has become a more important constraint;
- the tolerance threshold has implicitly shifted above 2 per cent.

In that case, **the inflation risk premium embedded in market inflation would rise.**

10-year inflation swap targets between 2.6% and 3.0%.

Alternative scenario 5: a regime of structurally higher inflation

Probability: very low

This would be a shift similar to that seen in the 1970s, fuelled by:

- geopolitical fragmentation;
- highly expansionary fiscal policies;
- a costly energy transition;
- a loss of credibility on the part of central banks.

In this scenario, the markets might begin to price in long-term inflation well above the ECB's target.

10-year inflation swap targets between 3.0% and 3.5%. This would represent a radical regime shift, a far cry from our central scenario.

Which scenario seems most likely today?

Scenario	10-year inflation swap
Base	2.0%–2.1%
Fiscal reflation	2.4%–2.7%
Persistent energy shock	2.5%–2.8%
Deglobalisation	2.5%–2.8%
More accommodative ECB	2.6%–3.0%
Structural inflationary regime	3.0%–3.5%

- **The main risk does not appear to be a new cyclical surge in inflation, but a gradual rise in structural inflation in Europe.**
- The factors to monitor are:
    - an increase in European fiscal spending;
    - energy prices;
    - wage trends;
    - deglobalisation;
    - the ECB's credibility in maintaining the 2 per cent target.
- **The baseline scenario remains one of long-term inflation moderately above target but under control.**
- The risk scenario incorporates a costly energy transition, accompanied by a loss of credibility for central banks.
- In this case, the markets could begin to price in long-term inflation well above the ECB's target.

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