*Anima***Insight**

EA Rates Strategy

ON THE HUNT FOR A NEW (HIGHER) EQUILIBRIUM

*Tactically, we remain LONG, **but we have raised the accumulation range to 3.0-3.10%** (from 2.60% previously) **and the take-profit threshold to 2.50-2.60%** (from 1.90-2.0% previously).*

While both fiscal packages and the potential change in the debt brake rule suggest a higher medium-term fair value for the 10-year Bund in the 3.0-3.50% range, we believe the near-term risks aligned with our tactical horizon are skewed to the downside for 10Y Bund yields.

For the following reasons:

1. *Although the new German and European fiscal stance supports growth, the balance sheet expansion is expected to be limited this year, resulting in only a marginal improvement in the economic outlook in 2025.*
2. *While supply risks are heavily skewed to the upside over the medium term, we expect the increase to be moderate this year due to time constraints.*
3. *We still expect the ECB to implement three additional rate cuts this year, while the market is currently pricing in fewer than two.*
4. *Tariff risks from the US may lead investors to focus on safe assets, such as Bunds.*

Chiara Cremonesi
Senior Rates Strategist
chiara.cremonesi@animasgr.it

Matteo Gallone
Junior Macroeconomist
matteo.gallone@animasgr.it

Strategically, we turn NEUTRAL *(previously OVERWEIGHT) as we anticipate Bund yields will rise. The reasoning is two- fold:*

1. *) If fully implemented and effective in driving substantial economic benefits, the German and European defence and fiscal packages will boost growth and growth potential in Germany and Europe.*
2. *Bund and EGB issuance are expected to reach new historical highs, and although near-term factors may temporarily mitigate the increase in supply, we foresee prices adjusting downwards due to this shift.*

TACTICAL VIEW

Tactically, we remain LONG, **but we have raised the accumulation range to 3.0-3.10%** (from 2.60% previously) **and the take-profit threshold to 2.50-2.60%** (from 1.90-2.0% previously).

While both fiscal packages and the potential change in the debt brake rule suggest a higher medium-term fair value for the 10-year Bund in the 3.0-3.50% range, we believe the near-term risks aligned with our tactical horizon are skewed to the downside for 10Y Bund yields. For the following reasons:

1. Although the new German and European fiscal stance supports growth, the balance sheet expansion is expected to be limited this year, resulting in only a marginal improvement in the economic outlook in 2025. We are incorporating a 0.2 percentage point upward revision to our 2025 German growth forecast. As a result, we now anticipate real GDP growth in Germany for 2025 at 0.2% (up from 0.0% previously), compared to a decline of -0.2% in 2024. For the Euro Area, this adjustment raises our 2025 growth forecast from 0.8% to 1.0%, factoring in the positive feedback loop with Germany's main trading partners.

2. While supply risks are heavily skewed to the upside over the medium term, we expect the increase to be moderate this year due to time constraints.

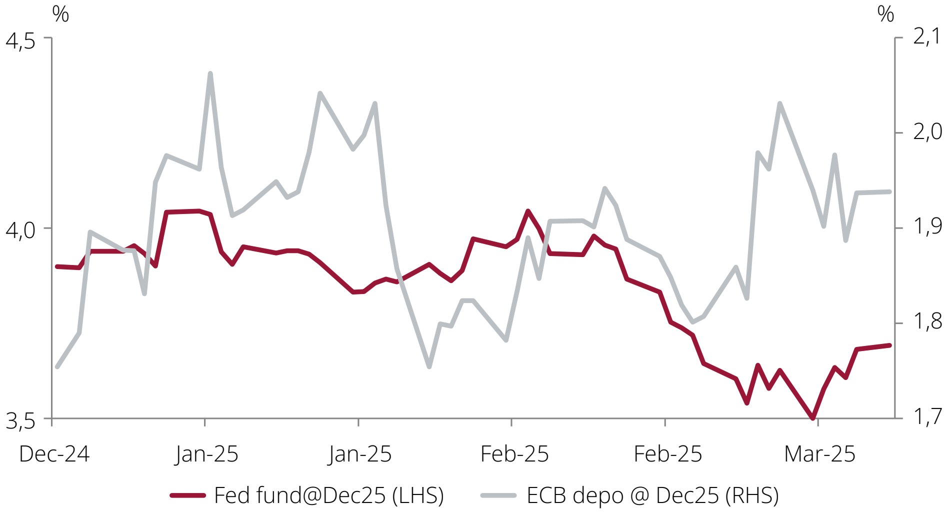
Based on past experience, it is highly probable that Germany will predominantly use T-bills to meet any additional financing requirements this year, given the time constraints. This approach should help alleviate selling pressure on long-term maturities, at least in the short term.

3. We still expect the ECB to implement three additional rate cuts this year, while the market is currently pricing in fewer than two.

As shown in **Figure 1**, since the end of February, there has been a noticeable decoupling in monetary policy expectations across the Atlantic. While the market has adopted a more hawkish stance on the ECB, driven by the announcement of the fiscal package in Germany and European package on defense, it has taken a more dovish view on the Fed. Given our growth and inflation forecasts for the EA this year, we believe the ECB will continue to lower rates slightly below neutral, irrespective of the final size of the fiscal package in Germany.

4. Tariff risks from the US may lead investors to focus on safe assets, such as Bunds.

FIGURE 1.
Markets have become overly hawkish on the ECB



Source: Bloomberg, ANIMA Research

TOWARDS A NEW LONG-TERM EQUILIBRIUM

Strategically, we turn NEUTRAL (previously OVERWEIGHT) as we anticipate Bund yields will rise. The reasoning is two- fold:

1. If fully implemented and effective in driving substantial economic benefits, the German and European defence and fiscal packages will boost growth and growth potential in Germany and Europe.
2. Bund and EGB issuance are expected to reach new historical highs, and although near-term factors may temporarily mitigate the increase in supply, we foresee prices adjusting downwards due to this shift.

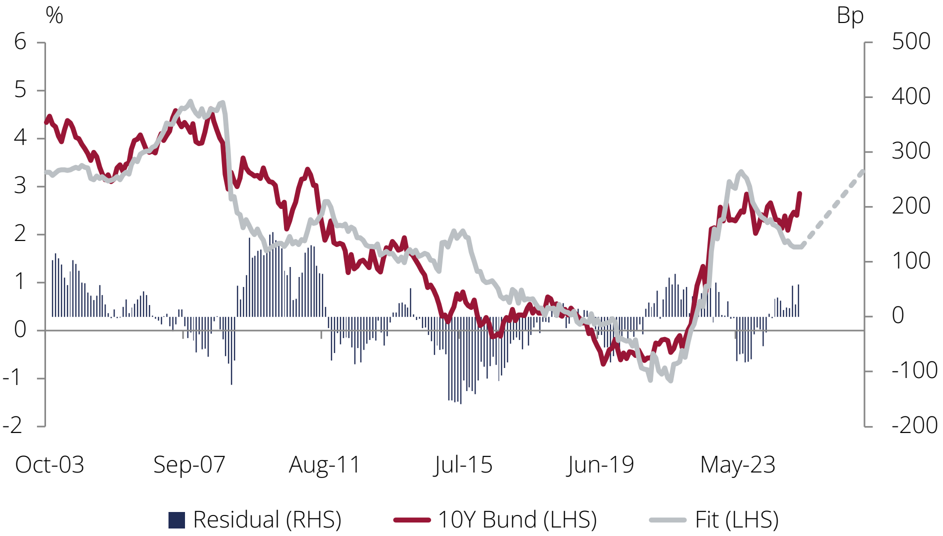
1. 10Y Bund fair value could rise well above 3%

Our fair value model indicates that 10Y Bund yields may rise to the 3.0-3.50% range over the medium-term (**Figure 2**) provided that:

- EA long-term growth potential will rise from 1.3% to 1.5%, although still below the pre-Global Financial Crisis level of 1.8%.
- Germany will opt to finance defence investments domestically rather than through the EU fund, as issuing domestic debt proves to be more convenient.
- Beginning in 2025, Germany is expected to gradually increase infrastructure spending, with EUR 5bn planned for 2025, EUR 20bn in 2026, EUR 40bn in 2027, and EUR 50bn in 2028.
- Starting in 2025, Germany will progressively raise defence spending from the current 1.6% to 3-3.5% of GDP, utilising the entire debt brake allowance (0.35% of GDP) to fund other expenditures.

- The ECB will persist with its QT approach, allowing all PSPP and PEPP redemptions to expire, which will account for approximately EUR 75bn of Bund redemptions annually.
- In the medium-term, the ECB's deposit rate will remain at the lower end of the neutral range, around 2%.

FIGURE 2.
Our model projects a fair value of 3.0-3.50% for 10Y Bund

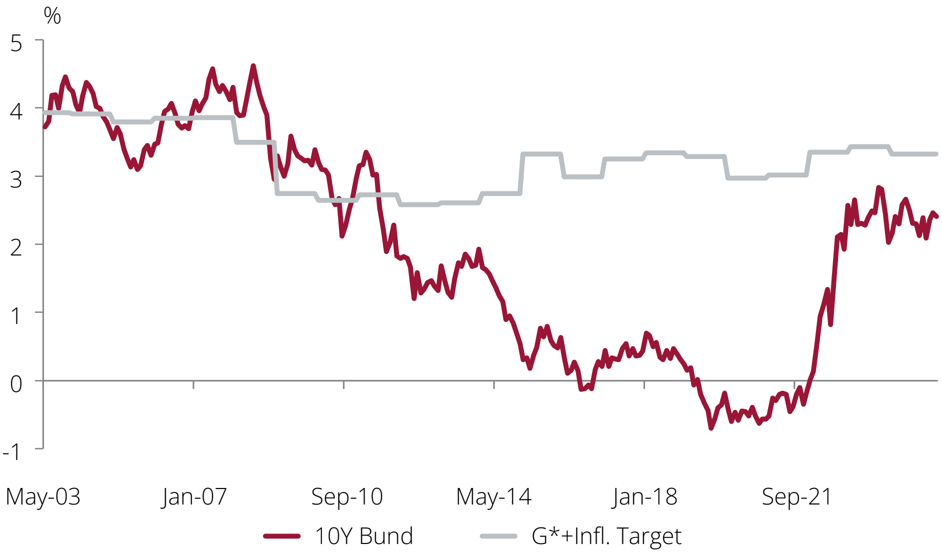


Source: IMF, EC, Haver Analytics, Bloomberg, ANIMA Research

Our analysis of macro fundamentals yields a similar fair value for Bund yields. As the scarcity of Bunds diminishes more rapidly than anticipated (with the Bundesbank expected to reduce its holdings from around 24% of total outstanding Bunds to just 5% by 2028), long-term Bund yields are likely to align with their long-term equilibrium, driven by Eurozone growth potential and the ECB's inflation target, as we have seen in the US.

As shown in **Figure 3**, prior to the Global Financial Crisis, 10Y Bund yields were trading in line with the combined Eurozone growth potential and the ECB's inflation target. This aligns with our model's suggestion that the fair value of the 10Y Bund yield could rise to the 3-3.5% range in the medium to long term.

FIGURE 3.
10Y Bund yields are expected to revert to levels suggested by macro fundamentals

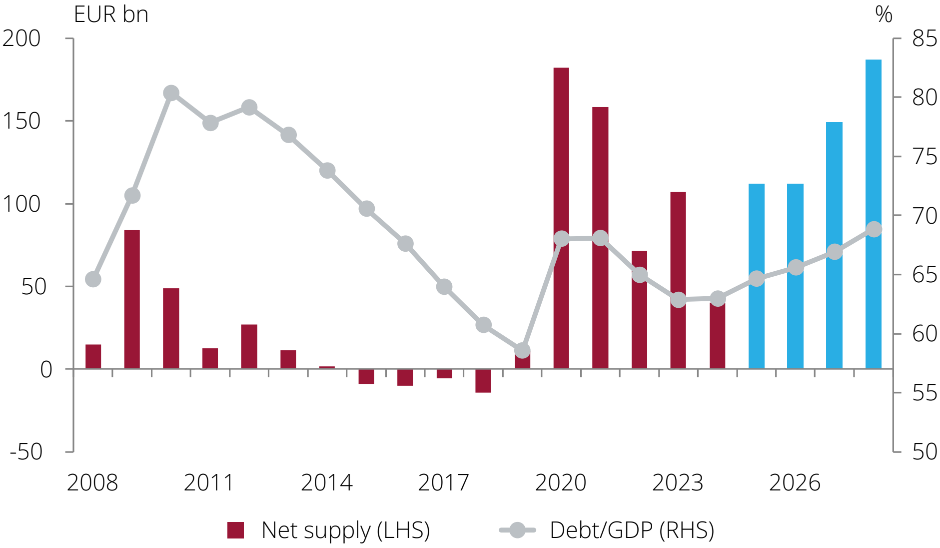


Source: Bloomberg, Haver analytics, ANIMA Research

2. Scarcity ends, paving the way for higher Bund (and EGBs) supply

According to our projections, as shown in **Figure 4**, the new fiscal package could increase Germany's net supply from an average of EUR 70bn in 2022-2024 to over EUR 150bn in the coming years, which would push the debt/GDP ratio from approximately 63% in 2024 to 69% by 2028. Although such high levels of yearly net supply are not unprecedented (e.g., during the Covid-19 crisis), Quantitative Tightening (QT) is currently operating at full capacity (unlike the QE during the Covid-19 crisis). This means, in addition to net issuance, private investors will need to absorb an extra EUR 75bn of Bunds held by the Eurosystem each year (**Figure 5**). This will generate an exceptional supply pressure over the next few years.

FIGURE 4.
Net supply set to increase to above EUR 150bn



Source: Bloomberg, Haver analytics, ANIMA Research

FIGURE 5.
QT will exacerbate the increase in issuance

Source: Bloomberg, Haver analytics, ANIMA Research

While this trend will primarily affect Germany, other EA countries will also see similar, though smaller, effects. With the European Commission proposing the activation of the Stability and Growth Pact's escape clause, EA countries are expected to increase defense spending to 3%. This could lead to an additional EUR 190bn in annual net issuance, raising EGB net issuance (including QT) from EUR 830bn in 2025 to more than EUR 1tn from 2026 onwards.

We calculate that in the CBO baseline scenario, the free float of USTs would increase by 1.25pp next year and pass 1.5pp in case of fiscal expansion measures. This would translate, all else being equal, in around 13-15bp (or even higher) TP increase.

3. **Mitigating factors: demand and bill issuance**

Although we anticipate that investors will require higher yields to accommodate the significant rise in net supply from Germany in the coming years, we have identified several mitigating factors that may limit the increase in yields.

A. **Bunds becoming more attractive as an asset class.** With 10Y yields nearing 3%, Bunds are becoming a more attractive asset class, especially as growth in Germany and the Eurozone may strengthen in the coming years. Furthermore, despite a substantial increase in its deficit, Germany will still have one of the lowest debt-to-GDP ratios in the developed world.

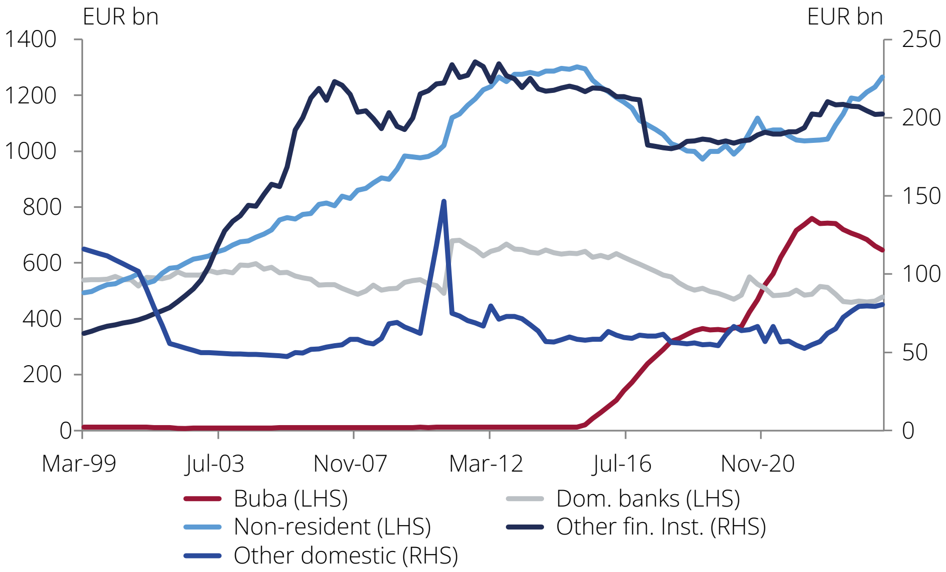
B. **Diversifying into USTs seems less logical.** Bund yields at 3% present a strong case for European investors to move from a currency-hedged long position in USTs (where the 10Y UST hedged for currency offers around 2.40%) to a long position in Bunds. This is the first instance since mid-2023 when long-end Bund yields exceed those of currency-hedged 10Y USTs.

C. **Domestic investor demand.** **Figure 6** shows that domestic investors, especially financial institutions and banks, remain moderately underweight in Bunds. Additionally, **Figure 7** highlights that domestic investors are still significantly invested in currency and deposits (particularly households) as well as equities (notably pension and insurance funds, along with financial institutions outside of banks), compared to the period before the Covid-19 pandemic. Their debt holdings have remained relatively unchanged since the start of 2015.

D. **Demand from international investors.** Foreigners (non-resident) investors have almost returned to their pre-QE levels of exposure to Bunds, as seen in Figure 6. According to the IMF, foreign official institutions have notably increased their German debt holdings in recent years. That said, we could see rising demand for EUR-denominated safe assets from foreign officials in the future. Foreign officials have refrained from expanding their USD holdings recently, and since Trump's election, many have indicated a potential shift away from USD assets, seeking to diversify into other investment options (**Figure 8**).

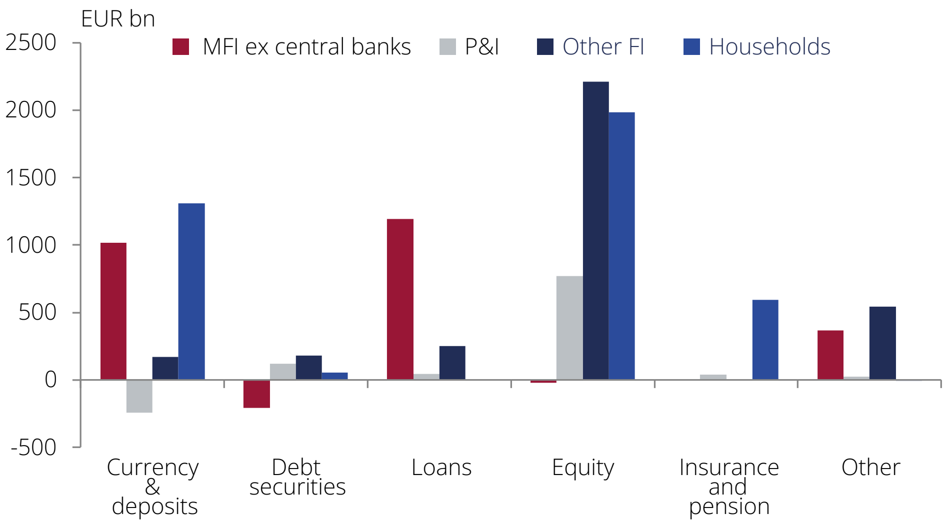
E. **Bill issuance.** German T-bills currently account for just about 5% of total marketable federal debt, compared to over 20% in the US, making them a feasible instrument for funding significant increases in issuance. This was the strategy Germany used during the Covid-19 crisis (**Figure 9**). Such a funding approach could help alleviate supply pressure at the longer end of the yield curve, though we expect Germany to adopt this method only for a short period (one to two years) to allow markets time to adjust to the increased issuance.

FIGURE 6.
Domestic banks and financial institutions remain moderately underexposed to Bunds



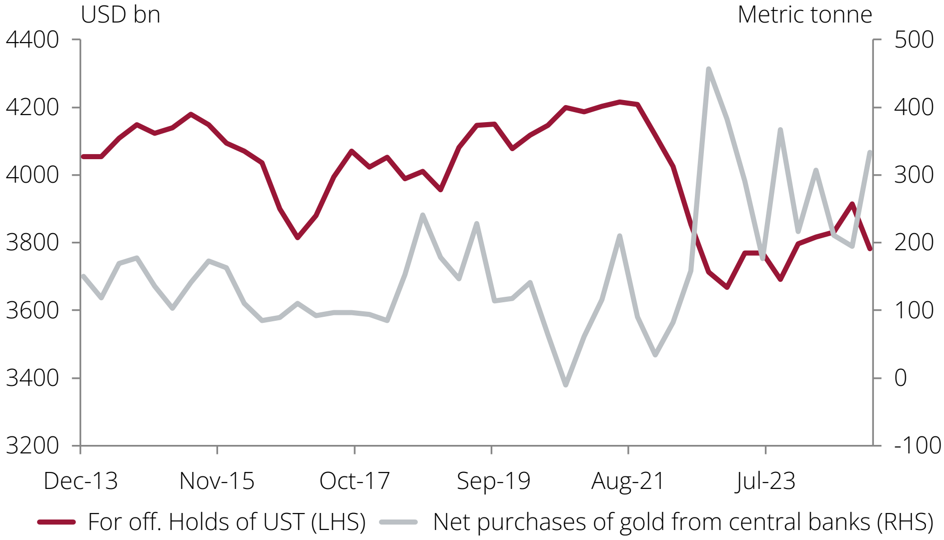
Source: Haver Analytics, ANIMA Research

FIGURE 7.
Households, pension and insurance funds (P&I) and financial institutions are still heavily invested in deposits and equity (Change between Q1 2015 and 3Q 2024)



Source: Haver Analytics, ANIMA Research

FIGURE 8.
Foreign officials are slowly diversifying away from USTs



Source: Bloomberg, ANIMA Research

FIGURE 9.
Germany has historically relied on T-bills to cover substantial deficit increases

Source: Haver Analytics, ANIMA Research

ANIMA INVESTMENT RESEARCH

FABIO FOIS
Head of Investment Research & Advisory
fabio.fois@animasgr.it

CHIARA CREMONESI
Senior Rates Strategist
chiara.cremonesi@animasgr.it

FRANCESCO PONZANO
Junior Equity Strategist
francesco.ponzano@animasgr.it

VALERIO CEOLONI
Senior EM/FX Strategist
valerio.ceoloni@animasgr.it

MATTEO GALLONE
Junior Macroeconomist
matteo.gallone@animasgr.it

COSIMO RECCHIA
Senior Equity Strategist
cosimo.recchia@animasgr.it