Rates Strategy

Bund: Three is a magic number

AUTHOR

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

The German government surprised the market with the announcement of a fiscal easing package that was more aggressive and frontloaded than expected. Although the plan looks ambitious, it seems that the authorities are serious about it, as the recently announced refunding plan for Q3 shows.

While trade policy uncertainty and an expected moderation in growth in Q2 and Q3 will likely slow down any increase in yields in the near term, we think the direction of travel for Bund yields is higher, particularly in the belly of the curve and at longer maturities, and we expect the upward movement will gather momentum once uncertainty around tariffs dissipates.

Accordingly, we remain tactically LONG on Bunds, but we have raised the threshold to switch to NEUTRAL to 2.50-2.60% (previously, the threshold to take profit was set at 2.30-2.40%) and raise the accumulation bar back to 3.0-3.10% (from 2.70-2.80% previously).

While our model suggests that 10Y Bund yields could go as high as 3.50%, we expect a less sizeable increase, owing to our expectations that demand for German bonds will be solid going forward.

Strategically, we remain NEUTRAL, as in the medium term we expect the German fiscal package and its implementation to become the main theme in rates markets, possibly tilting the balance of risks for EA growth and inflation to the upside.

Completed: 21 July 2025

Bunds back in the spotlight

On 24 June, the German government presented its budget for 2025 and its fiscal projections until 2029. The budget surprised markets, as the fiscal stimulus is much more front-loaded compared to expectations at the beginning of March, when the package was first announced. In a nutshell, the government now plans to inject almost EUR 850bn (roughly 19% of GDP) into the economy over the next five years, mainly for investment and defence, of which over EUR 300bn will be spent in 2025 and 2026. Back in March, we were expecting around EUR 600bn of net borrowing over the next five years, of which only EUR 150bn was expected in 2025 and 2026.

Taking into account the timing of parliamentary approval (which will start in late September), money is expected to start flowing into the economy as early as Q4 this year. Indeed, the German debt agency has already revised its Q3 funding plan significantly upwards and has indicated that it will do so again in Q4.

Against this backdrop, **we remain tactically LONG on Bunds, but we have raised the threshold to switch to NEUTRAL to 2.50-2.60%** (previously, the threshold to take profit was set at 2.30-2.40%) **and raise the accumulation bar back to 3.0-3.10%** (from 2.70-2.80% previously). While trade policy uncertainty and an expected moderation in growth in Q2 and Q3 will likely weigh on any increase in yields in the near term, we think the direction of travel for Bund yields is higher, particularly in the belly of the curve and at longer maturities, and we expect the upward movement to gather momentum once the uncertainty around tariffs dissipates.

Strategically, we remain NEUTRAL, as we expect the German fiscal package and its implementation to become the main theme in rates markets over the medium term, potentially tilting the balance of risks for EA growth and inflation to the upside.

1. Germany over-delivers on the 2025 and 2026 budgets

Figure 1 shows that net borrowing is expected to increase to EUR 143bn in 2025 (3.27% of GDP) and to rise further above 3.80% in 2026 (EUR 173bn). This compares to net yearly borrowing of around EUR 40bn in 2024 (0.9% of GDP) and EUR 95bn in the post-Covid years (average 2021-2024). The increase in borrowing will be partly financed through the core budget and partly via two off-budget funds, one for infrastructure and one for defence. Given the high investment component in the new package, analysts generally expect a high multiplier effect, leading to a positive impact on GDP growth over the next few years.

Figure 1

New German budget projections 2025-2029

EUR bn	Core budget	Infrastructure (SF)	Defense Spending (SF)	Net borrowing total	% of GDP
2025	82	37	24	143	3,27%
2026	89	58	26	173	3,82%
2027	88	57	28	172	3,68%
2028	116	58		174	3,59%
2029	126	59		186	3,70%
Tot.	500	270	77	847	18,06%

Source: Bloomberg, German press, ANIMA Research

2. Impact on supply outlook

Figure 2 to 4 show that:

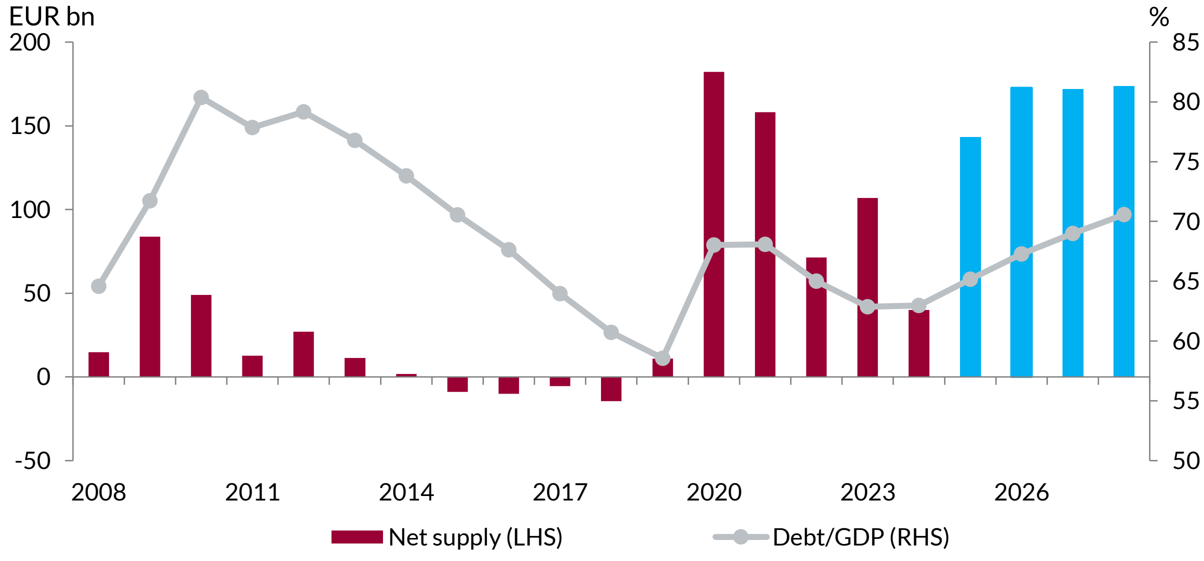
1) Following the fiscal package, Germany will revert back to the level of net borrowing last seen during the Covid crisis (Figure 2). However, unlike the Covid episode, this will not be a one-off increase in supply, but rather a structural shift towards higher supply, starting this year and continuing at least until 2029. The structural increase in net borrowing is expected to lift the debt-to-GDP ratio to over 70% by 2029, up from 62.4% at the end of 2024 (Figure 2).

2) Contrary to 2020, when the sizeable increase in supply was financed mostly through T-bills (Figure 3), this year Germany has decided to finance the EUR 70bn increase in financing needs mainly using a combination of bond supply and other instruments (e.g. cash balances available, borrowing in repo). This is somehow counterintuitive, given that T-Bills represent around 5% of the total stock of debt and that higher net supply will create upward pressure on medium-term funding costs.

3) Accounting for ECB's QT, net-net issuance is projected to increase from an average of EUR 110bn in the period 2020-2024 to EUR 240-270bn yearly in the period 2025-2029 (Figure 4). Figure 4 also clearly shows that Germany will go from heavily negative net supply to heavily positive net supply in less than a decade. We calculate that the free float of Bunds could rise from a low of around 40% in 2022 to a high of around 75% by the end of 2028 (the UST free float is currently 85%).

Figure 2

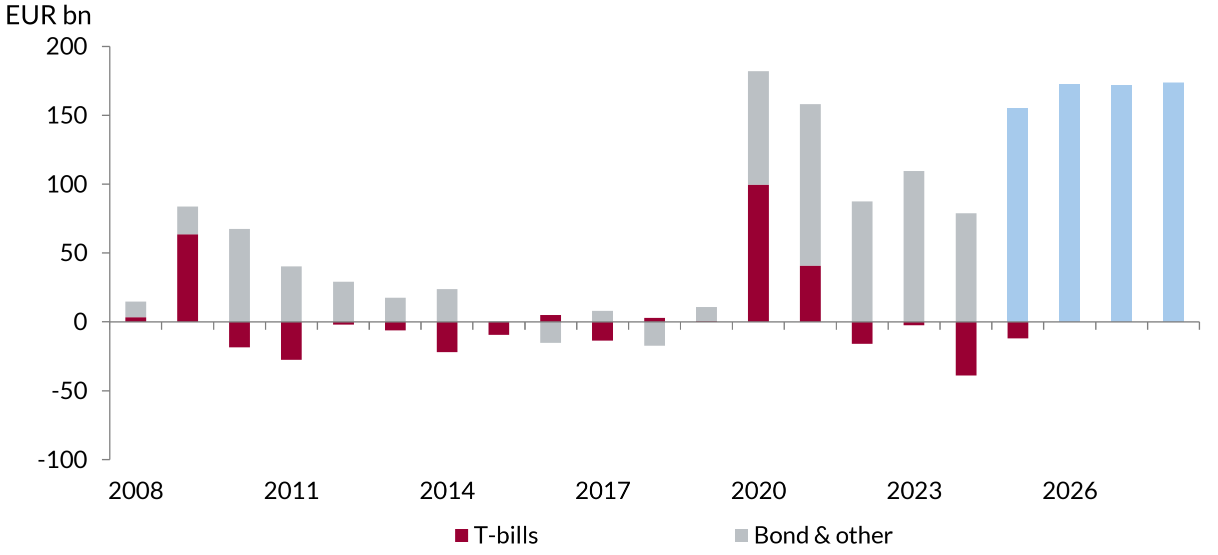
Net borrowing will rise to levels observed during the Covid crisis



Source: Bloomberg, Haver Analytics, German press, ANIMA Research

Figure 3

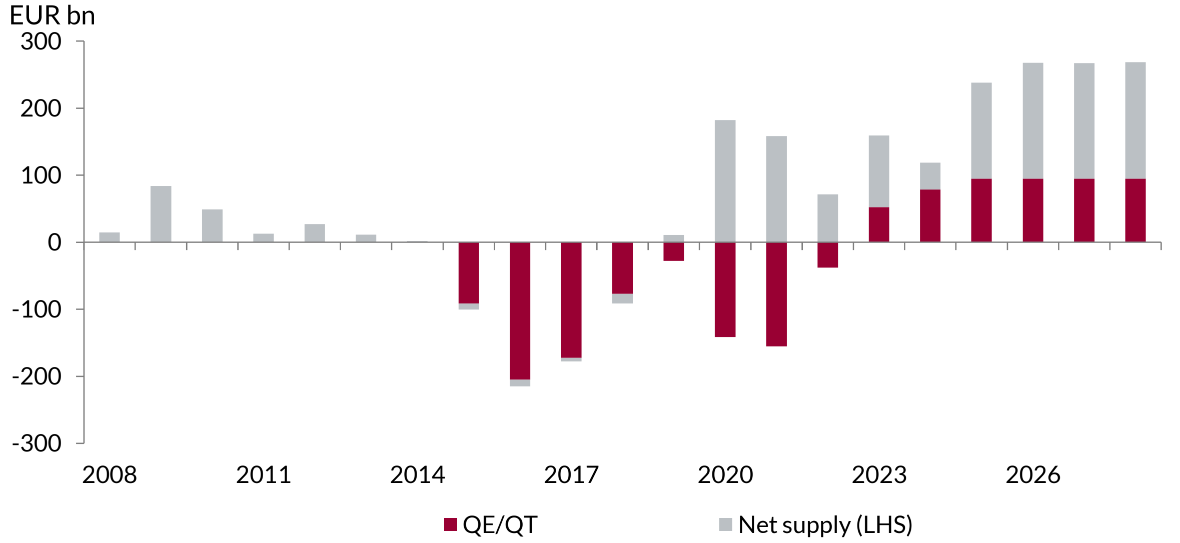
Germany has decided to finance the increase in supply mostly via M/L term instruments



Source: Bloomberg, Haver Analytics, German press, ANIMA Research

Figure 4

Net-net supply will rise from an average of EUR 110bn during 2021-2024 to EUR 240-270bn in 2025-2029



Source: Bloomberg, Haver Analytics, German press, ANIMA Research

3. Higher Bund yields are in the cards

According to our fair value model (Figure 5), the current level of 10Y Bund yields is well above where it should trade according to fundamentals and excluding the upcoming fiscal package. This suggests that markets are already pricing in at least part of the impact of the German package.

That said, our view is that there's still room for German rates to rise from the current level, as we think the market has yet to fully price in the recently announced fiscal package. For the following reasons:

1) Taking into account that the government has now proposed a much more aggressive implementation schedule compared to expectations at the beginning of March, we see the possibility that markets could price in a faster and greater impact on growth and growth potential (in Germany and the EA), as well as a slightly higher neutral rate compared to March (in the 2.25-2.50% area). Consistent with this, our model points to a fair value of 10Y Bund yields around 3.50%, which is at the upper range of what we indicated back in March (Figure 5).

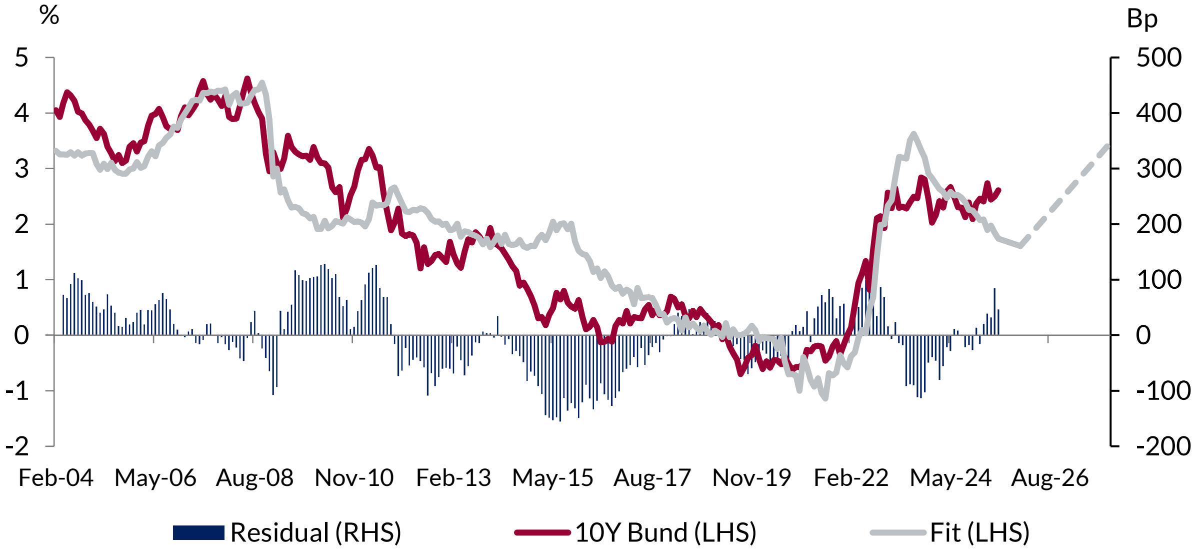
2) While investors believe that the package could lift growth in the medium term and lead to a higher free float of Bunds, investor behaviour is still heavily dominated by uncertainty over tariffs. This, in our view, explains why the sell-off at the long end of the curve has not gathered more momentum and why yields at the short end have declined since the end of February (Figure 6).

3) At the moment, investors believe that the fiscal package will have no impact on the EA inflation outlook, as indicated by the lack of change in breakeven rates since the end of February and the low level of breakeven rates (Figure 6). We agree with this view for the time being, given that capacity utilization in the German economy is historically low (at 76.9% in Q2 2025, it is much lower than the 83.25% average in the period 2021-2024 and 84-88% in the pre-Covid period). That said, if the German government delivers in line with its promises, inflationary pressure could build up, for instance from an increase in wages in sectors where the labour market is particularly tight. While this is not our baseline, it is worth keeping in mind that this poses an asymmetric risk to government yields that markets are not currently pricing in.

4) Consistent with point 3, markets do not currently price any meaningful impact of the fiscal package on the ECB's monetary policy stance. Figure 7 illustrates the OIS forward curve both prior to the previous government's proposal of the German package and as it stands now. While, at longer term horizons, investors are pricing just 25bp more in rate hikes compared to the end of February, they have become much more dovish on the ECB's monetary policy stance over the next year, pricing a much more accommodative outlook.

Figure 5

Bunds are trading at yields well above fundamentals, but currently only reflect part of the fiscal package's impact



The model regresses 10Y nominal Bund yields on the depo rate, potential growth in EA, core inflation in EA, oil prices, the ECB's indicator of systematic stress, and the amont of EGBs held by the Eurosystem. It is estimated using monthly data from 2004 to the present.

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

Figure 6

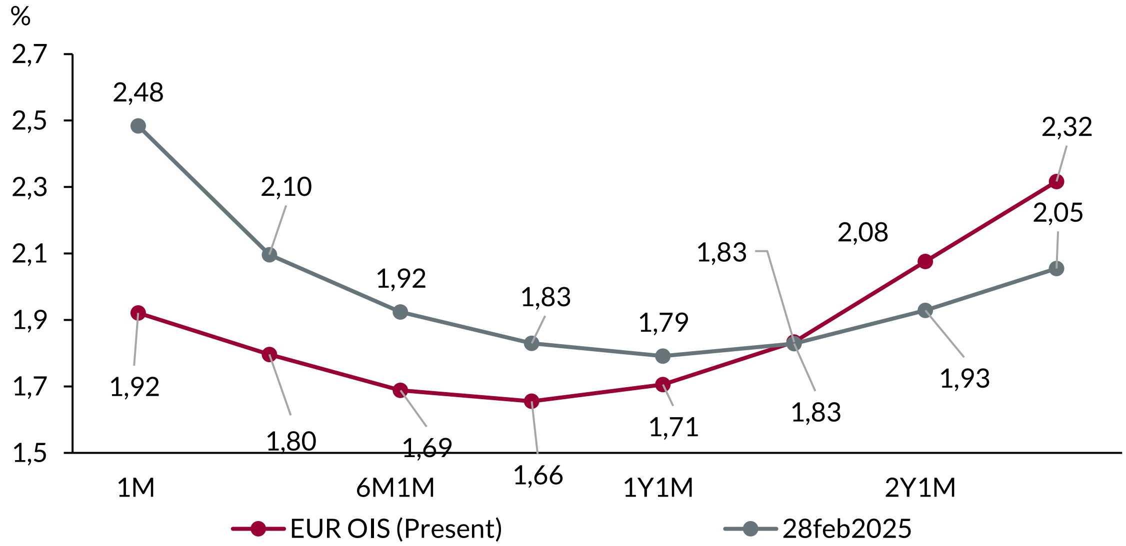
Market impact of the German fiscal package (and all related matters)

		2Y Bund	5Y Bund	10Y Bund	10Y swap real	5Y swap real	10Y swap infl.	5Y swap infl.	2Y T-Bund	5Y T-Bund	10Y T-Bund	1Y1Y OIS fwd	5Y1Y OIS fwd
28feb-11mar	1st sell-off on fiscal package	17,4	36,9	49,1	25,8	18,7	17,0	15,9	-22,0	-35,3	-41,9	27,7	43,6
11mar-22apr	Repricing/Liberation day	-53,8	-53,7	-45,4	-5,1	-8,3	-25,7	-32,5	41,3	49,4	57,6	-54,3	-33,7
22apr-23giu	Range trading	17,7	12,8	6,4	-8,4	-10,8	15,3	20,0	-13,3	-20,7	-11,8	18,6	4,6
23giu-13lug	2nd sell-off on fiscal package	2,4	11,9	16,8	17,4	14,3	-4,5	-6,2	1,8	-4,3	-6,4	3,3	11,7
	Total	-16,3	7,9	26,9	29,7	14,0	2,0	-2,9	7,8	-10,9	-2,5	-4,6	26,2

Source: Bloomberg, ANIMA Research

Figure 7

Money markets are pricing very little change to the ECB outlook as a result of the German fiscal package



Source: Bloomberg, ANIMA Research

4. We anticipate solid demand for European bonds

While we believe that Bund yields have more room to increase, we do not expect 10Y yields to rise to 3.50%, either in the short-term or in the medium-term (all else equal). The reason is two-fold:

1) In the near-term, uncertainty over tariffs will continue to weigh on sentiment, capping any increase in yields at the long end and preventing the pricing of a more aggressive ECB.

2) In the medium term, we expect solid demand for European bonds to offset some of the impact of higher supply.

We see healthy demand for EGBs from European (and non-European) investors for the following reasons:

A) Bund yields are becoming appealing both outright, given the higher yield, but also in comparison to USTs for European investors wishing to hedge currency risk (Figure 8).

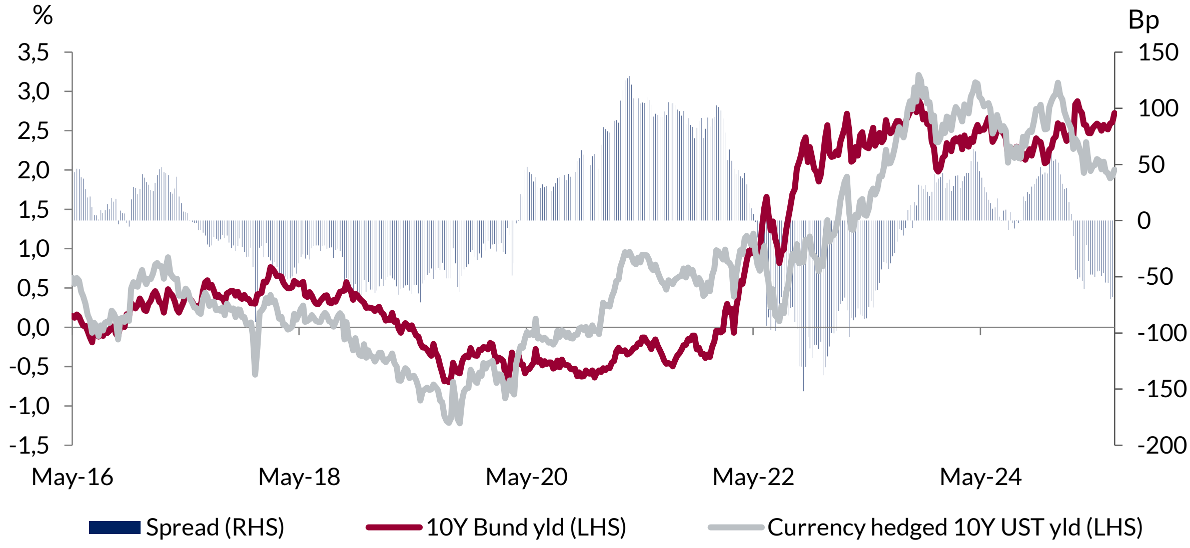
B) Compared to the pre-QE period, all traditional investors are still underweight EA debt (Figure 9).

C) While IIP data show that foreign investors have been actively buying European assets, they have been much more active in equities than in bonds (Figure 10).

A caveat in this respect is that the EA debt market is less significant in terms of size, liquidity and depth than the US market. What would be needed, in our view, to give a further boost to the popularity of EGBs among all types of investors is the issuance of common debt and further progress in the institutional framework of the EA.

Figure 8

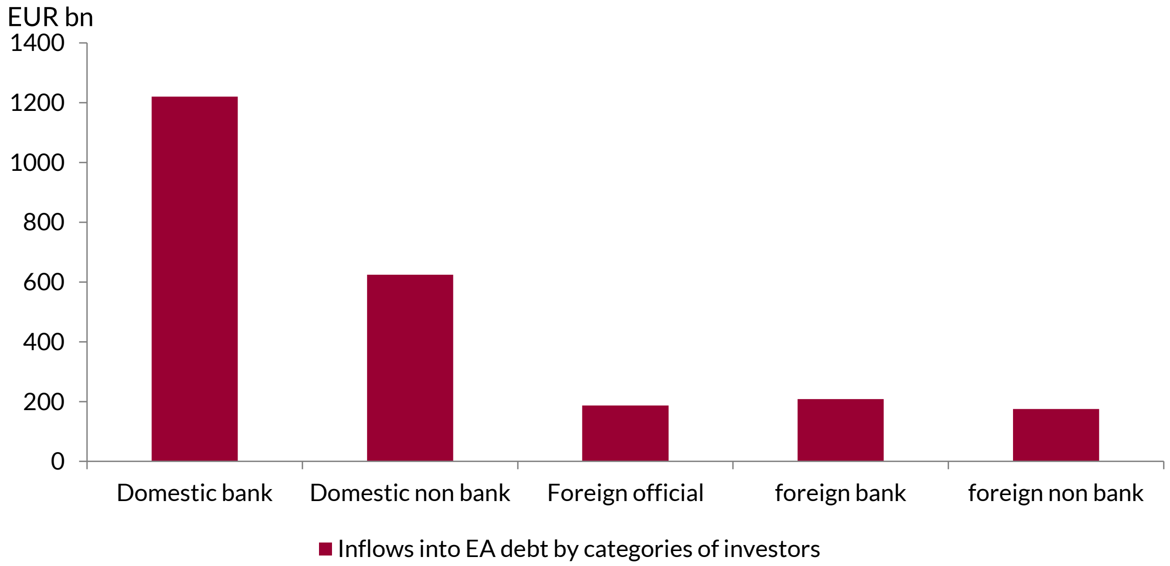
Bunds are becoming increasingly attractive to European investors compared to FX-hedged USTs



Source: Bloomberg, ANIMA Research

Figure 9

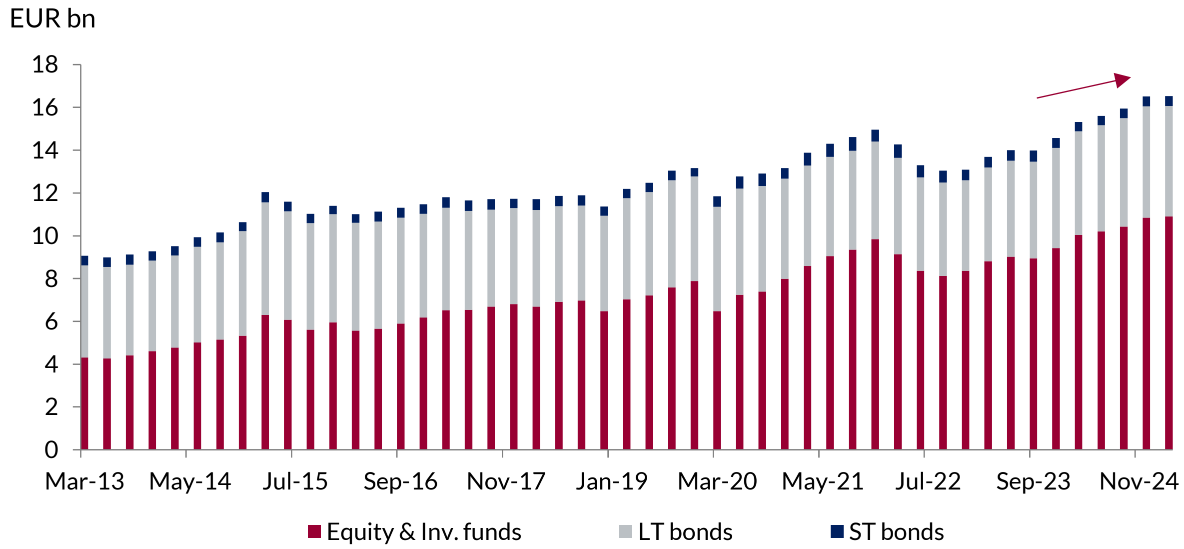
Estimated inflows required to restore pre-QE ownership levels of EA debt (EUR bn)



Source: IMF, ANIMA Research

Figure 10

Foreigners' inflows have been stronger into equities than into bonds



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