EA Rates Strategy

Bunds – Time to start accumulating

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After holding a tactical NEUTRAL position on Bunds since the end of August, ***we now suggest gradually starting to accumulate exposure at the current levels*** *for the following reasons:*

I. *We have lowered our forecasts for growth for the EA region, now anticipating growth of 0.7% in 2024 (down from 0.8%) and 0.9% in 2025 (previously 1.3%). This may encourage investors to anticipate a quicker convergence of EA inflation to its target.*

II. *In the last few weeks the ECB has significantly softened its rhetoric. As a consequence, we now expect the ECB to front-load cuts to neutral and deliver back-to-back 25bp rate cuts until the end of H1 2025, lowering the depo rate to 2.0% by June 2025.*

III. *According to our model, at around 2.2%, 10Y Bund yields are 20bp above fair value. With the ECB cutting rates back to neutral, our model suggests a decline of 10Y yields to around 1.75%, and to around 1.50% in case the ECB cuts rates below neutral.*

IV. *Although it remains outside our baseline scenario, there is growing scepticism among analysts and the ECB regarding whether the neutral rate for the Euro Area falls within the 2-2.5% range. Meanwhile, market pricing suggests that the end of the rate cut cycle is anticipated to occur at a level close to 2%.*

V. *While post-U.S. elections volatility on USTs may spill over to Bunds, we believe that the extent of this pass-through will be more restrained than in earlier instances.*

We continue to be strategically OVERWEIGHT*, anticipating that a deteriorating macroeconomic outlook will likely lead to a faster alignment of inflation with targets.*

The main risks to our projections are: 1) An increase in consumer confidence in EA, resulting in decreased savings and increased personal spending; 2) A boost to investments, not only in countries which are recipients of EU funds, but also in core countries (especially Germany) 3) A shift in fiscal policy stance next year to a more accommodative stance, either at a singlecountry or at the EA level, to allow EA countries to address their structural weaknesses.

However, we believe this is highly unlikely unless there is a significant risk of a deep recession.

We start to gradually accumulate exposure on Bunds

After holding a tactical NEUTRAL position on Bunds since the end of August, we now suggest gradually starting to accumulate exposure at the current levels.

For the following reasons:

I) The recovery in EA will be slower than expected.
Following a deterioration in growth momentum in EA, and given the lack of a clear driver for reacceleration, we have lowered our growth forecast for the EA this year to 0.7% (vs. 0.8% previously) and for 2025 to 0.9% (from 1.3% previously). The main reasons for the downward revisions are:

1) The savings ratio in the EA is on the rise, indicating more cautious consumer behaviour, despite the continued growth of real disposable incomes
2) The industrial sector is experiencing a more prolonged decline, extending beyond just energy-intensive industries 1and across the EA, likely linked to an ongoing slowdown in global demand.

II) We expect the ECB to front-load rate cuts resulting in the depo rate reaching 2% by the end of H1 2025.
In our opinion, the downward revision to EA growth in 2025 will pave the way to a faster and more front-loaded rate-cutting cycle in 2025. We now expect the ECB to cut rates by 25bp at the December meeting, followed by additional cuts at each of the four meetings in H1 2025, resulting in a depo rate of 2% by June (vs. quarterly 25bp rate cuts that would have taken the depo rate to 2% only at the end of 2025, in our previous forecasts). Furthermore, we recognise the growing risks that the ECB may reduce rates even further below the neutral level, for the following reasons:

1) The minutes from ECB's September meeting indicate that its members identified downside risks to the growth forecasts right after their release at that meeting[1]. This, coupled with ECB's rhetoric at the October meeting, suggeststhat the ECB will adjust its growth expectations for 2025 to below potential at the upcoming December meeting. President Lagarde has taken a step further at the October's meeting, by linking the disappointing growth performance to a quicker convergence of inflation towards target (**Figure 1**).
2) The grosssaving rate in the EA remains at historical highs (almost 16% at the EA level, 4pp higher than the pre-Covid average), and has so far prevented the increase in real disposable income from resulting in increased consumption.
3) Fiscal impulse will continue to be negative in the EA in 2025 (**Figure 2**), failing to support the recovery, particularly in core countries that are not experiencing the growth stimulus from the NGEU.

Money markets are discounting an ECB rate cut to 2% by June 2025, aligning closely with our updated forecasts. Still, they are not pricing in a depo rate drop much below neutral after June 2025.

Against this backdrop, we believe Bund yields are likely to decrease in the coming months, especially if economic data comes in below expectations.

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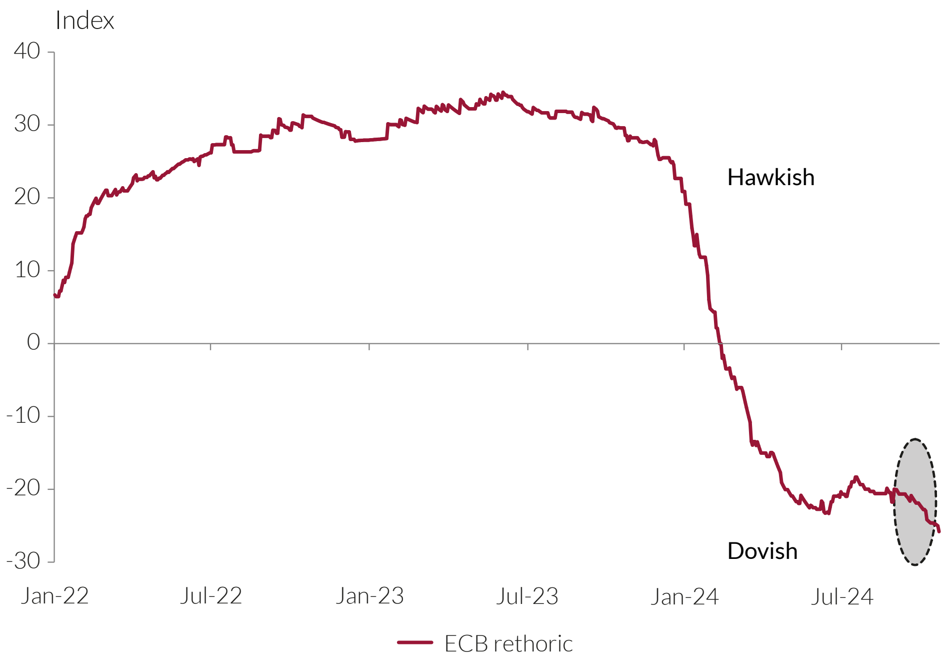
[1] - The cut-off date for the Staff projections is three weeks before the meeting

FIGURE 1.

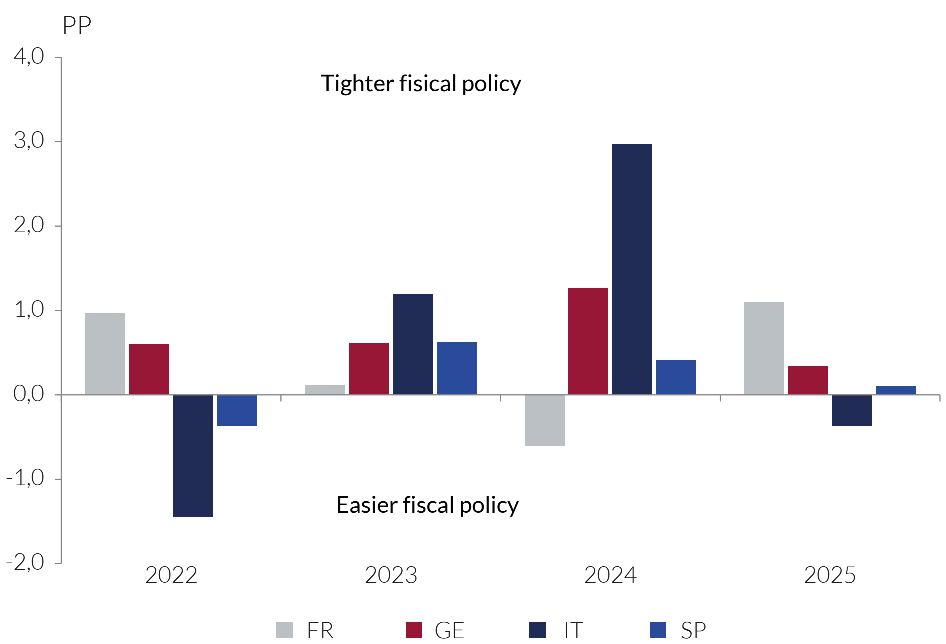
ECB's rhetoric has considerably softened



Source: Bloomberg, ANIMA Research

FIGURE 2.

Fiscal impulse: YoY change in cyclically adjusted net lending



Source: Haver Analytics, EC, France Ministry of economics and finance, ANIMA Research

III) Bunds look moderately cheap, with yields expected to drop as the ECB cuts rates to neutral.

Figure 3 indicates that, according to our model, 10Y nominal Bund yields are currently trading around 20bp higher than their fair value. Moreover, the model indicates a clear direction for yields: as the ECB lowers rates to neutral (around 2%), 10Y Bund yields are expected to fall towards 1.75%. In case the ECB cuts rates below neutral, our model points to Bund yields declining towards 1.50%.

These yield levels might appear too low, given that by the end of the rate-cutting cycle, we expect 10-year Bund yields to be roughly in line with monetary policy rates. Historically, long-term Bund yields have always traded significantly higher than policy rates at the close of a cutting cycle (**Figure 4**). We do not support this argument due to the following reasons:

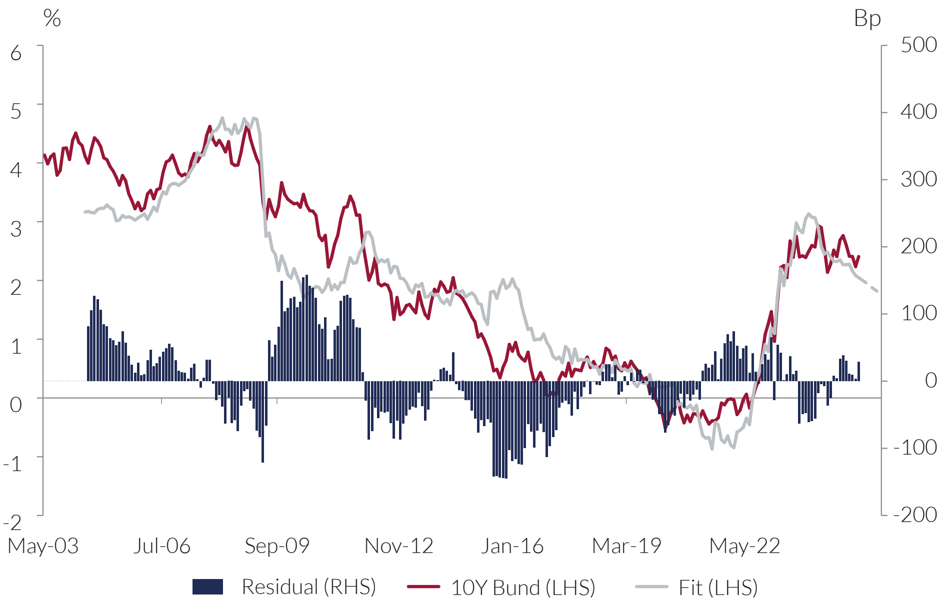
1) While QT is set to accelerate next year, we estimate that by the end of 2025, about 18% of the Bund stock will still be held by the Bundesbank. Additionally, net Bund issuance is unlikely to increase significantly in 2025 compared to 2024.

2) While we believe that German growth will recover next year, the extent of the recovery is still uncertain. Moreover, Germany's growth potential has likely declined over the past couple of years.

Against this backdrop, the term premium on Bunds is expected to stay relatively compressed, supporting our projection of 10Y Bund yields remaining flat against the deposit rate by the end of the rate-cutting cycle.

FIGURE 3.

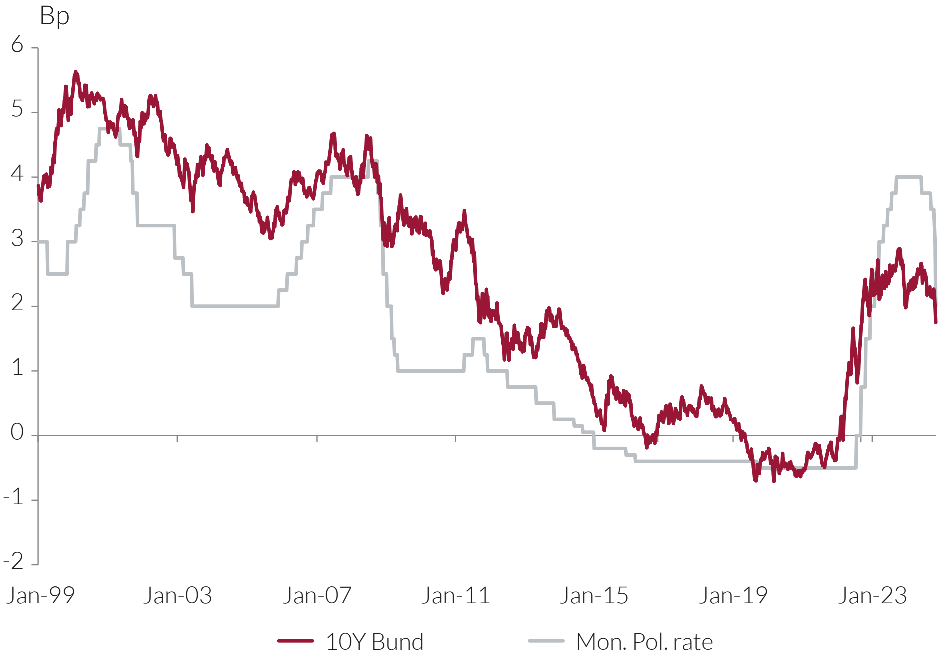
Our model points to a decline in Bund yields



Source: Haver Analytics, IMF, ANIMA Research

FIGURE 4.

We project that 10Y Bund yields will be nearly aligned with monetary policy rates by the end of the cutting cycle



Source: Bloomberg, ANIMA Research

IV) The neutral rate might be below the 2-2.5% range

While all evidence suggests that the neutral rate has increased compared to pre-Covid levels in US, this remains more uncertain in the EA. So much so that in the minutes of the September meeting *"Members underlined that it was still unclear to what extent low productivity was cyclical or might reflect structural changes with an impact on growth potential"*. If, in the coming months, we receive growing evidence that the neutral rate in the EA is likely lower than current estimates (2-2.50%), this would provide another rationale for markets to anticipate a more aggressive ECB rate cut cycle and for Bund yields to decrease further.

FIGURE 5.

Analysts' estimates of the neutral rate in EA are already lower than the ECB's and markets' ones

Source: Bloomberg, Anima Research

V) We expect the pass-through of post-US election volatility from USTs to Bunds to be more contained than in the past.

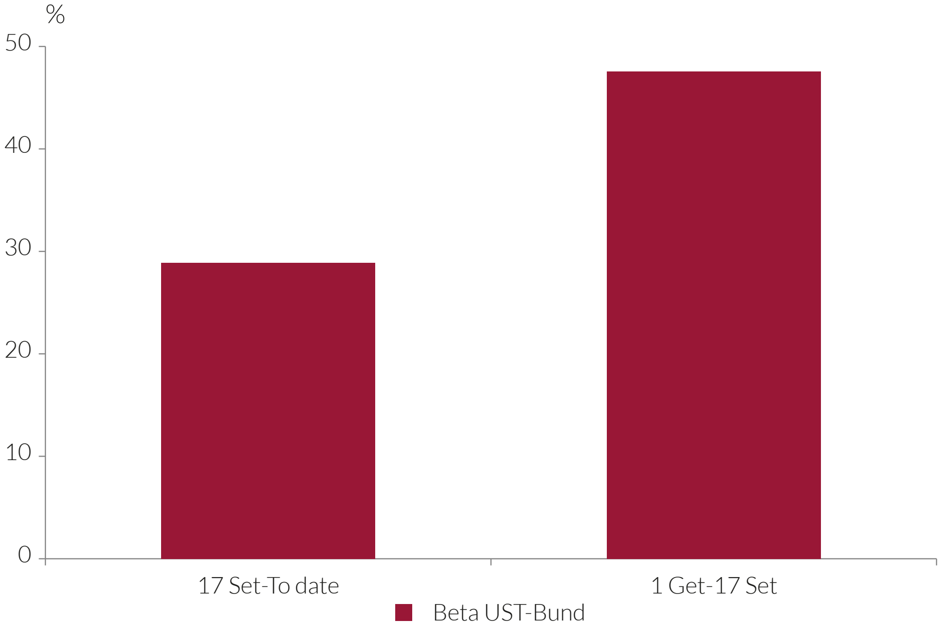
The reason is two-fold:

1) **Beta between USTs and Bunds has sharply declined.**
Figure 6 illustrates that during the most recent sell-off, the beta between USTs and Bunds has sharply decreased, now sitting at 27% compared to nearly 50% during the January to September period. Given the decoupling in economic performance in the two economic areas, we foresee that the spillover effects from USTs to Bunds will continue to be well below the historical norm post-US election.
Excluding the scenario of a Republican sweep (see next section for more details), we expect the UST yield increase post-elections to be capped to around 40-50bp2. Against this backdrop, the pass-through of higher UST yields to Bunds should be capped at 10-15bp and be temporary in nature.

[2] - This would happen in our view in the scenario of a Trump presidency with split Congress, which would be worse in terms of impact on USTs than any scenario under Harris presidency

FIGURE 6.

A sharp decline in UST-Bund beta in the most recent sell-off compared to the first part of 2024



Source: Bloomberg, ANIMA Research

2) **Higher rates in the US might trigger more dovish expectations for the ECB, further reducing the spill-over effects of higher UST yields on Bunds, particularly in a Republican sweep scenario.**
The beta between UST and Bunds after the US elections might be even lower than our earlier analysis indicates, as the spill-over of higher UST yields to Bunds could lead to tighter financial conditions in the EA. This situation would further tighten the ECB's already restrictive monetary policy amid poor economic performance. As a result, investors could begin to factor in a more forceful rate-cutting cycle from the ECB, leading to a quicker decoupling of UST and Bund yields. This reaction would be especially pronounced under a Republican sweep scenario, which we consider the most detrimental US election outcome for EA growth and inflation, and one that would almost certainly lead to a swift decline in Bund yields, driven by expectations of a more aggressive ECB policy in the near future.

Risk management considerations

If we mark-to-market a long position on the 5Y Bunds at the current levels at year-end, there would be a relatively small margin for a sell-off before the P&L turns negative, estimated at approximately 8bp. That said, we still believe that the risk-reward ratio for initiating a long position in Bunds at this point is favourable, particularly considering the ECB's increasingly dovish stance and the uncertainties surrounding growth in the EA.

We remain strategically OVERWEIGHT

We remain strategically OVERWEIGHT, as a deteriorating macroeconomic outlook is expected to facilitate a faster convergence of inflation towards its target.

The main risks to our projections are:

1) An increase in consumer confidence in EA, resulting in decreased savings and increased personal spending
2) A boost to investments, not only in countries which are recipients of EU funds, but also in core countries (especially Germany)
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