Flash Fixed Income

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TwentyFour
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A game-changer for European assets?

- **The incoming German government's removal of the country's infamous "debt brake" is a serious pivot for the typically fiscally conservative country, and one that we think highlights the value on offer in European assets.**
- **In our view, the steepening of the Bund curve reflects market expectations of a boost to growth rather than concerns about higher inflation.**
- **While rates markets have begun to price in this conclusion, European credit continues to offer an additional premium, set against what is arguably a more stable fundamental backdrop than the US.**

With market sentiment year-to-date having been almost exclusively driven by President Trump's actions and rhetoric, this month we can finally offer readers some topic diversification by focusing on the outlook for European assets in the wake of a momentous fiscal pivot in Germany.

The incoming German government moved markets on March 5 with the scale of its proposed reforms to the country's infamous "debt brake". Bellwether German government bonds sold off aggressively and European equities rallied sharply in response to a €500bn infrastructure investment plan and the removal of limits on defence spending.

These constitutional amendments are not yet a done deal (they require a two-thirds majority in the German parliament, which is not guaranteed) and the details are yet to be finalised. However, they represent a structural shift in attitude towards government spending in traditionally fiscally conversative Germany, and one which could have material implications for fixed income investors.

Market reaction driven by growth, not inflation

The news saw German government bonds suffer their biggest weekly sell-off since the 1990s, with 10-year Bund yields rising 40 basis points (bp) to around 2.9%. Does this signal discomfort among investors about a larger German fiscal deficit?

We doubt it. Germany's current debt-to-GDP ratio of 62% is the lowest in the G7; adding €1tr of debt would see its ratio rise to around 83%, still well short of the G7's second least indebted nation, which is the UK at 104% (see Exhibit 1). Absorbing the additional Bund supply will almost certainly require an additional yield to attract more buyers, but this is not a "fear premium". Germany's fiscal sustainability continues to be seen as healthy.

Exhibit 1: Germany has significant debt-to-GDP headroom

G7 country	Debt-to-GDP ratio
Japan	255%
Italy	139%
United States	123%
France	112%
Canada	105%
United Kingdom	104%
Germany	64%

Source: Bloomberg, 31 December 2024

We have also witnessed a notable steepening of the Bund curve, with longer dated yields rising more than the front end. Should we interpret that as a lack of conviction from the bond market on the economic implications?

Credit market performance

	Total return YTD (%)	Total return last 30 days (%)	Yield (%)	Duration (yrs)
EUR IG	-0.27	-0.94	3.3	4.4
GBP IG	0.72	-0.78	5.5	5.8
US IG	1.90	1.14	5.2	6.5
EUR HY	0.94	-0.12	5.7	2.8
GBP HY	1.92	0.03	8.3	3.1
US HY	1.29	-0.13	7.5	3.3
EM HY	2.03	0.58	7.8	3.8
Euro Senior Banks	0.07	-0.73	3.2	3.6
CoCo	1.79	-0.04	6.5	3.4

Past performance is not a reliable indicator of current or future results. Included for illustrative purposes only. Shown in local currency terms. It is not possible to invest directly into an index and they will not be actively managed. Source: Bloomberg, TwentyFour, 11 March 2025


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Again, we doubt it. While curve steepening can be associated with concerns about higher inflation, it is also driven by expectations of higher economic growth. As we've discussed previously, Europe's disinflation progress has been more encouraging this year, so again there's more margin for error on this measure than there is in the US. Especially given the jump higher in equities, the key driver of the steepening looks to be the expectation that Germany's fiscal expansion is pro-growth.

The contrast in market interest rate expectations between the European Central Bank (ECB) and the Federal Reserve (Fed) is instructive here. Currently the Fed is expected to cut rates by 81bp over the next 12 months, while the ECB is expected to cut by just 70bp over the same period. However, consensus inflation expectations for 12 months from now are 2.1% for the Eurozone versus 2.7% for the US – in our view, the bond market expects the Fed to cut faster not because inflation will be eradicated, but because it is projecting a considerable convergence in growth rates between the two regions.

European credit offers premium

But while rates markets have begun to price in this conclusion, credit continues to offer an additional premium for those willing to look at Europe.

As an example, the US Investment Grade ICE BAML Index with an average credit rating of A- yields 5.15% at time of writing, while the Euro Investment Grade Index ICE BAML Index (average rating also A-) yields 5.62% when hedged back to US dollars. The Euro index also benefits from being shorter in duration (4.6 years vs. 6.6 years), which means lower expected volatility.

In addition, starting yield has tended to be the best predictor of multi-year total return in fixed income, and since European credit has tended to offer higher yield historically it is not surprising that the European investment grade (IG), high yield (HY) and financials indices have all outperformed their US equivalents in USD terms over the longer term (see Exhibit 2). Indeed, the European IG and HY indices (when hedged back to USD) have outperformed their US equivalents in nine of the past 12 years.

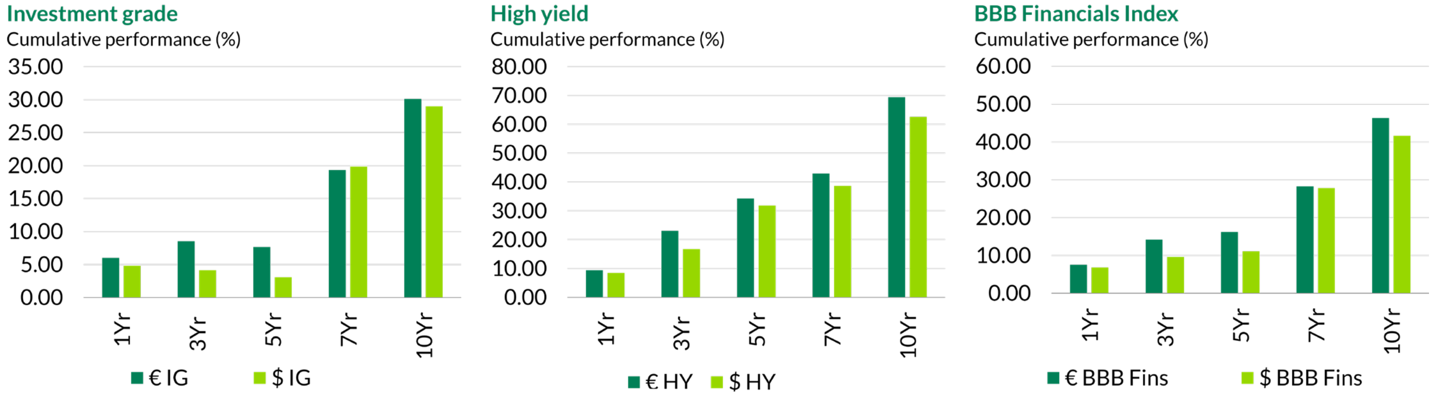
Fundamental case for Europe is strong

From a credit fundamentals perspective, we believe the European market currently looks more favourable to fixed income investors than the US. As well as an improving growth outlook and benign inflation, data from S&P shows European corporates and financial institutions saw more upgrades than downgrades in both 2023 and 2024, a trend which has continued year-to-date.[1] By contrast, US corporates and financials have both seen more downgrades than upgrades year-to-date, which signals a gradual weakening of credit fundamentals.

While excessive regulation has historically been seen as a brake on economic growth in Europe, making the region a less compelling story for equity investors, high growth isn't required to avoid defaults, which is a bigger driver of sentiment for fixed

1. S&P data sourced via Bloomberg, data as at 11 March 2025

Exhibit 2: Higher yields have meant higher returns for European credit



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Rates dashboard

			Change (bp)		
		Current (%)	1w	1m	YTD
US Treasury	2yr	3.94	-5	-33	-30
	10yr	4.28	4	-22	-25
	30yr	4.59	6	-11	-15
UK Gilt	2yr	4.17	-1	3	-28
	10yr	4.67	14	22	6
	30yr	5.28	16	23	11
German Bund	2yr	2.20	16	17	12
	10yr	2.90	40	54	53
	30yr	3.19	34	57	59

			Change (bp)		
	Market projection	Current (%)	1w	1m	YTD
Base rate 4.50%	end-2025	3.61	-2	-39	-33
	end-2026	3.52	-5	-41	-44
Base rate 4.50%	end-2025	3.86	-10	5	-27
	end-2026	3.85	-11	8	-14
Base rate 2.50%	end-2025	2.08	-8	19	18
	end-2026	2.28	-8	28	22

Past performance is not a reliable indicator of current or future results. Included for illustrative purposes only. Shown in local currency terms. It is not possible to invest directly into an index and they will not be actively managed. Source: Bloomberg, TwentyFour, 11 March 2025 income investors. Moreover, consumers in Europe benefit from a more protective welfare system and exhibit higher savings rates, which are 15% in the Eurozone versus just 5% in the US. Both borrowers and lenders in Europe tend to be more conservative, reinforcing credit stability. More stringent regulation has also been a net positive for bondholders in Europe by strengthening financial institutions. European bank balance sheets are generally stronger than in the US, with capital levels significantly exceeding regulatory requirements and low non-performing loan levels. European banks are enjoying their best return on equity levels in over a decade, thanks to margin expansion from successive rate hikes, and they are on the whole less exposed to the troubled commercial sector than their US peers.

Carry an attractive buffer to rates volatility

One of the key themes we highlighted at the beginning of this year was continued volatility in rates markets, and Germany's fiscal pivot has certainly delivered more of that.

While the scale of this change and its impact on Bunds is unlikely be repeated, many sources of rates volatility remain, not least geopolitical risks; the Trump administration's tariffs policy and associated fears around US growth being the latest.

However, another of the key fixed income themes we highlighted for 2025 was our expectation that carry will be the main driver of returns. So while it is too early to call for plain sailing in government bond markets, we would be remiss not to point out that there is now additional carry on offer in Europe, set against what is arguably a more stable fundamental backdrop than the US at present.

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