

## Why the next direction for Bund yields is up

The 10Y Bund yield now stands at 2.2%, well below the summer peaks of around 2.6% – but structural inflation risks and the term premium both point back towards higher yields going into 2025. With the first Fed cut underway, we see little room for euro rates to go lower and the timing therefore seems right for fixed payers

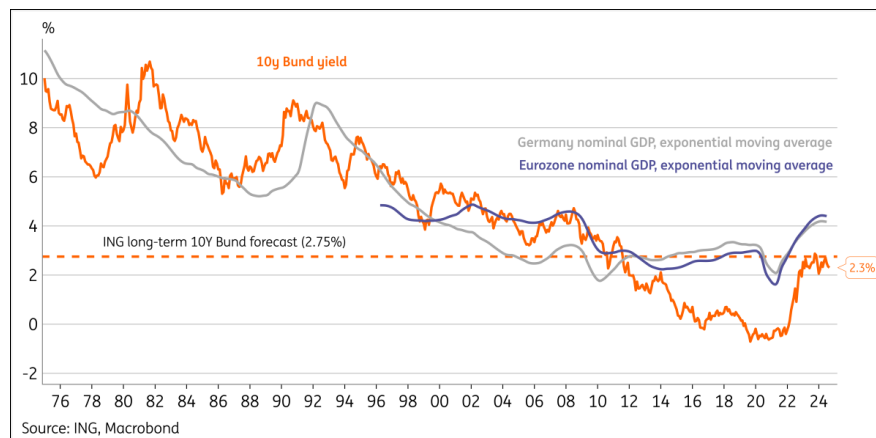


### Nominal trend growth anchors 10Y Bund yields to 2-3% range

As a starting point, we compare Bund yields to trend nominal growth, which historically provides a rough but robust anchor of interest rates. Since the introduction of the euro, Bund yields have closely followed the smoothed path of nominal growth. Only since the global financial crisis and subsequent euro debt crisis did this relationship break.

Even during much of the post-GFC period, the moving average of nominal GDP remained between 2% and 3%, and is in our view a reasonable range for long-term rates. The wedge between 10Y yields and nominal GDP during this period can be explained by extraordinary circumstances causing a sustained demand shock. First we had the banking crisis and then the sovereign debt crisis, while austerity was the principle guiding global governments.

## Trend growth suggests 2-3% is reasonable range for 10Y Bund yield



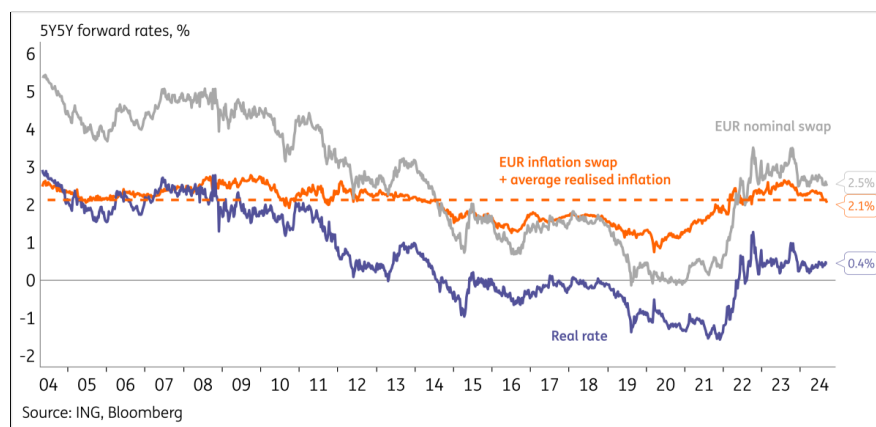
## Broader fiscal support decreases downside risks to rates

Governments have learned from past mistakes and the political backing for fiscal support during economic downturns appears to be much broader since. Where traditionally right-wing parties strongly opposed running deficits, Covid-19 showed that the willingness of counter-cyclical fiscal policy is now much stronger. And more recently, Draghi's plea for more investment aligns well with this movement.

In effect this can have important implications for rate markets, as monetary policy will no longer be the primary tool used to address demand shocks. In the aftermath of the euro crisis, the European Central Bank was pushed towards negative rates and other unconventional tools because fiscal austerity measures were suppressing demand. More willingness for fiscal support should shift up the probability distribution of policy rates in the future and also means that future inflation will, on average, be higher.

As such, we see more upside risk for inflation going forward, and yet markets don't seem to be pricing in a risk premium for this. The average inflation since 2004 is around 2.1% in the eurozone, which aligns exactly with the current 5Y5Y forward inflation swap.

## Broader fiscal support decreases downside risks to rates



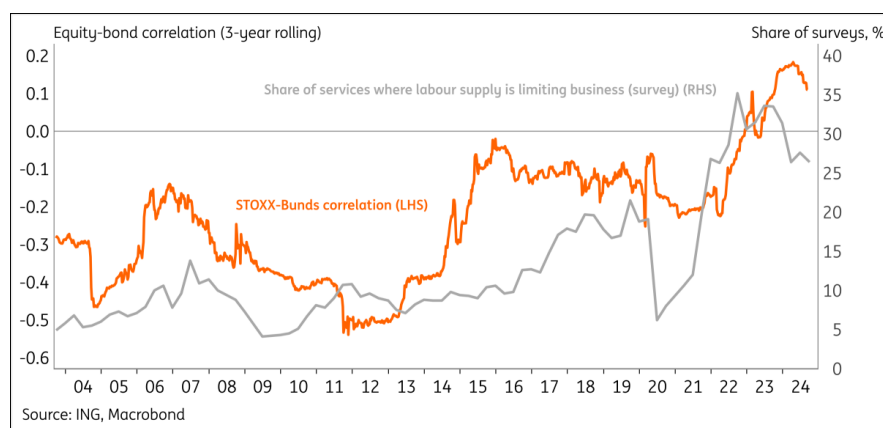
In addition, where demand shocks can be addressed by monetary policy, supply shocks will remain a challenge. The inflation spikes from supply chain issues or the war in the Ukraine are two recent examples. If anything, such inflationary supply shocks can become more common against a backdrop of ageing populations and deglobalisation. The ageing population limits the labour supply and deglobalisation makes it even more difficult to shift production across borders.

## Bonds are bad portfolio hedge against more frequent supply shocks

Survey data from the eurozone also shows that labour supply is increasingly limiting business, making the economy more vulnerable to supply shocks. More frequent supply shocks not only increase bond yields through inflation risks, but they also push yields up structurally through the term risk premium.

Supply shocks are characterised by low growth and high inflation, which impact both equities and bonds in a negative way. Bonds therefore do not provide an effective hedge, as they would during demand shocks (due to falling inflation), and higher yields in turn will be demanded by investors. The correlation between the STOXX equity index and Bunds may remain higher in the future, which would reduce the attractiveness of bonds in a diversified portfolio – hence the term risk premium potentially ending up structurally higher.

## Increasing supply constraints may keep bond-equities correlation elevated



## More upside risks to the 10Y Bund yield than priced in

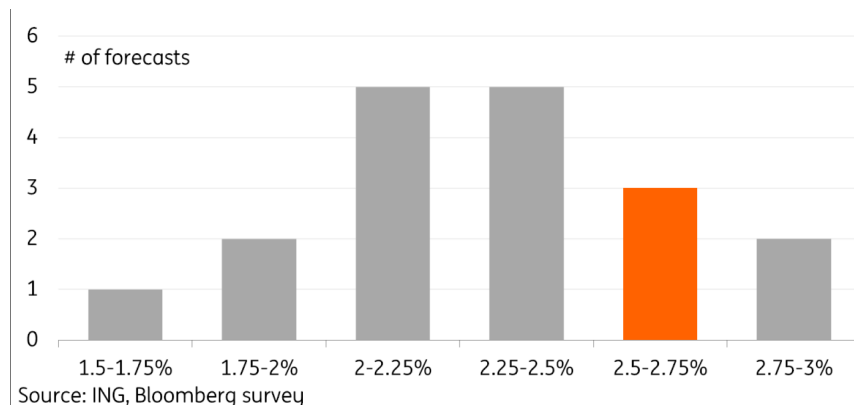
Within our range of 2-3% based on our nominal growth forecasts, we expect the 10Y Bund yield to converge closer to the top of the range due to an increasing term risk premium. Besides the arguments on supply shocks becoming more common, we also highlight [QT and ECB cuts will increase the term risk premium](#) going forward.

Quantifying the term risk premium is difficult, but our analysis combined with historical excess return estimates (see box) sees a fair value 10Y Bund yield of around 2.8%. This implies a 2Y10Y term spread of around 40bp.

Given these fair value estimates, we see the 10Y Bund yield back at 2.6% by the end of 2025, much

higher than Bloomberg consensus. Also forwards price in a significantly lower 10Y by the fourth quarter of 2025 of 2.2%.

## ING forecast for 10Y Bund forecasts for end of 2025 well above average



In terms of opportunities, we think fixing in EUR payers now is a good timing. EUR rates might nudge lower in the near term due to US recession risks, but the balance of risk is clearly tilted towards higher yields in our view. A relative trade to capture the build-up of the term premium would be a 5Y10Y curve steepener (see trade ideas publications on our GMR website for more detail). Furthermore, the long-term inflation risks appear underpriced and therefore paying 5Y5Y inflation swaps seem to provide good value too.

### Estimating the term risk premium and associated term structure

Realised excess returns for holding 10Y Bunds versus a shorter dated risk-free rate (1Y Bund) is a good starting point for estimating the term risk premium. The equation below is the standard method of calculating excess returns (in logged terms).

$$\text{Excess return}_t = 10Y_{t-1}^{(10)} - 9Y_t^{(9)} - Y_{t-1}^{(1)}$$

But to complicate matters, this would strongly overestimate the risk premium due to the structural decline of the “neutral” policy rate since the 90s. To adjust for this, we first subtract the returns that can be attributed to the change in markets' expectations of the neutral rate, which we proxy with a 1Y tenor three years forward.

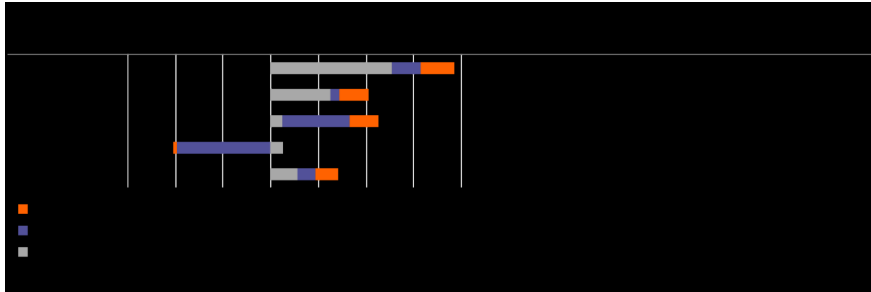
$$\text{Adjusted excess return}_t = 10Y_{t-1}^{(10)} - 9Y_t^{(9)} - Y_{t-1}^{(1)} - 9\Delta 1Y3Y_t$$

The adjusted excess return for the period 2000-2024 is 1.2% (without adjustment this would be 2.0%). One can see in the table below that the unadjusted method would lead to an overestimation of the QE period and an underestimation after Covid.

The excess return is a total return, and is therefore comprised of both a carry and roll down component. By fitting a Nelson-Siegel curve to our forecasts we estimate the entire curve and calibrate this to obtain an expected excess return of around 1.0% for 10Y Bunds

(whereby roll down to 9Y is included). This produces a 2Y10Y spread of approximately 40bp.

## Decomposition of total 10Y Bund returns



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