

Rates Outlook 2025

December 2024

Rates go back to the future



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Rates outlook for 2025: Rates go back to the future

A key theme in our vision for 2025 is the maintenance of a 'normal' for rates, with some important nuances. Neutral in the US is the Fed at 3% plus a 75-100bp curve, while it's 2% plus a 50-75bp curve in the eurozone. For 2025, the US curve targets neutral rates plus a c.50bp spread, while the eurozone curve dips to its neutral minus a c.50bp spread



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Chuck and Jurgen walk into a bar...

Picture Chuck and Jurgen walking down the road. Chuck, who's been keeping it real, is busy making America great again and tends to naturally walk faster than Jurgen. Jurgen has found himself walking slower than most over the years, partly burdened by ageing. But also by a multi-personality complex that most of the time is a hindrance. Jurgen's few moments of joy have come when Europe beats the US at the Ryder Cup. Otherwise, Jurgen is mostly in awe of Chuck. Chuck is seen as the biggest and best at most things.

Recently Chuck has been helping out Jurgen's close friend Ivan, who has been bullied by Mikhail. In fact, an additional reason for Jurgen's slower pace of late has been on account of Mikhail's behaviour, which has caused Jurgen to cut ties with Mikhail, who used to supply Jurgen with some cheap energy pills. One of Jurgen's more dominant personality complexes, Karl, has been particularly badly hit by the impact of Mikhail's behaviour. When Jurgen's Karl complex is down, then Jurgen is very down.

Chuck has a higher walking heart rate than Jurgen. Both enjoy staying active and dislike being in a state of rest, as it implies stagnation. If they remain inactive, they risk being overtaken by others. The worst-case scenario is their heart rates dropping below resting levels, which poses serious health risks. The best bet is to keep on moving as best they can. Not too fast, as that can't be sustained. But definitely no stopping, as that risks bigger problems.

"Chuck" here, of course, is a parody of America. A 2% normal growth rate, and a normal fed funds rate of around 3%. "Jurgen" is the eurozone. A 1% normal growth rate and a 2% normal ECB deposit rate. The heartbeat represents a complex combination of inflation and interest rates. Walk too fast for too long and the heartbeat elevates, which is good for a bit, but not for too long. At the other extreme, a heartbeat below resting is not desirable at all. Most of the time the central objective is to keep on walking, typically at respective normal paces.

Going into 2025, not only is Chuck moving faster than Jurgen, but Chuck has changed his view of the world. Chuck now wants to pay fewer taxes and does not seem to be concerned about the credit card bill he's running up. He's also weirdly keen to pay more for the wine that Jurgen supplies him, just to spite Jurgen, as he feels that Jurgen is too successful at selling wine to him. Chuck feels upbeat though. Jurgen less so. Jurgen does not quite understand why Chuck is being so mean. Chuck is also threatening to not help Jurgen's friend Ivan any more.

... to find America and the eurozone in a bit of a tussle

Okay! Enough of the Chuck / Jurgen malarky. The point here, from a rates perspective, is to view the US and the eurozone as being on quite different paths as we progress through 2025. The US has a better growth profile, and the policy mix is at the margin inflationary. That means the Fed will not get its funds rate down to a neutral level, and

the 10yr rate should by the same token end up at above its neutral level. That translates to higher longer-term rates, and a preference to shorten duration and/or set fixed rate payers.

The eurozone is different. There is a sub-trend growth underpinning, with little prospect of that improving through 2025. That is liable to see the ECB cut its deposit rate to below normal, and longer tenor rates are also liable to be pressured to trend below normal. One rationale for eurozone longer tenor rates rising is on account of correlation with higher US rates. The other centres on the fact that they're actually quite low, with the 10yr Euribor rate already knocking on the door of a mere 2%. For that reason, we prefer fixed-rate payers in euros too.

The spreads environment in consequence is stark. US market rates are being pressured higher as a theme through 2025. Eurozone rates will feel some of the same pressure as they are already so low. But the end game is the maintenance of high spreads, with a bias if anything for even wider spreads. This presents an opportunity. The challenge is to get the best entry point, specifically on the FX rate.

A silver lining here is spreads within the eurozone are not primed to widen in a generic dramatic sense, as Karl in the core is where the real stress is. And Francois is not much better. Moreover, Alessandro is sitting pretty for a change. Consequently, there is no EMU-breakup worry here. Rather, Karl gets to cosy up with Francois and Alessandro for a bit and take in some of that warm periphery feeling.

Now for the serious stuff...

For the rest of this report, I promise no more Chucks or Jurgens. We now turn to serious analysis, where we'll churn out specific levels to chime with the narrative above. We'll be specific about curve shapes, the detailed spreads environment in derivatives and the eurozone SSA space. We'll also go deep into US debt dynamics and funding pressures, and dip into the Dutch pension fund rule changes and why they are important. So much so that maybe, just maybe, you'll end up pining for more Chuck and Jurgen analogies. Enjoy!

The US 10yr heads back to 4%, but then it's 5%+ for 2025

Front-end yields can get lower and remain low, but will still end up at least 50bp above what we see as neutral (2yr at 3.3% is neutral). The 10yr yield is ending 2024 below neutral, but will revert to above neutral by around 50bp to 100bp as we progress through 2025 (10yr at 4% to 4.5% is neutral). The 2yr trends around 4% while the 10yr heads for 5%+ in 2025



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US market rates reached local highs following Trump's win but have been drifting lower since

The US 10yr should settle above neutrality, heading for 5%+

US market rates reached local highs following Trump's win but have been drifting lower since. A significant retracement is appropriate after the nearly 100bp rise in the 10yr yield, which was triggered by the first Fed rate cut in mid-September. This move culminated in Trump's clean sweep in the November elections. But as we pushed through December, we returned to basic data watching. To the extent that if the data softens, there is justification for testing lower yields.

Another factor is the end-of-year effect. It's not uncommon for bonds to do well into the turn of the year. Cash is often parked as risk trades are wound down to some extent. January is often a month in which liquidity comes back into the market, acting to help all types of bond products. That said, we identify a floor at 4% for both the 2yr and the 10yr yield. The rationale for the 4% floor centres on the market discount for the funds rate, which is only just under 4% by late 2025 (now around 3.75%).

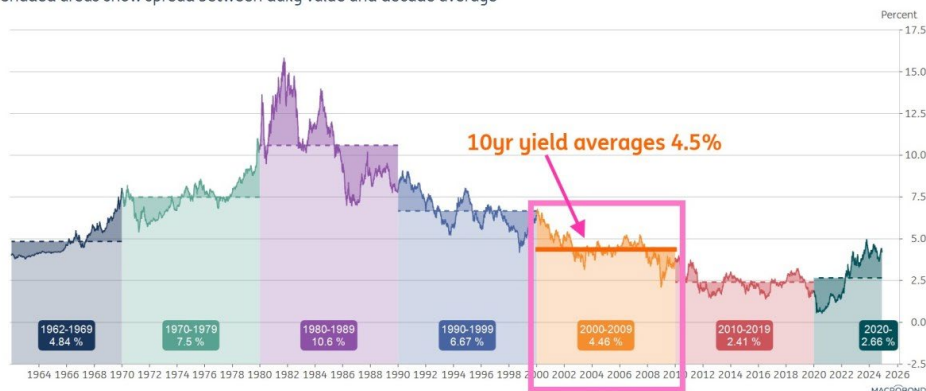
As we progress through 2025, our vision is for the US 10yr Treasury yield to head toward the 5-5.5% range. Today a 4% SOFR rate coincides with a 4.5% 10yr Treasury yield (50bp spread vs SOFR), and 4.5% was the average Treasury yield seen during the noughties. We find this relevant as during this decade, US inflation averaged 2.5% and the Fed funds rate averaged 3%, which smacks of an equilibrium (on average).

The noughties as a neutral reference?

During the noughties (2000-09) inflation averaged 2.5% and the funds rate averaged 3%. And the 10yr?

Treasury 10-year yield

Shaded areas show spread between daily value and decade average



Source: Macrobond, ING estimates

The difference between the 2yr and the 10yr is that the latter is far too low

Trump's tax-cutting agenda likely means the Federal Reserve lands above neutrality by some 50bp. Specifically, at 3.50%-3.75%. We also think the 10yr rate should end up above neutral. Given the inflation risk from tariffs and issues relating to the fiscal deficit, logic suggests that the 10yr rates should land at least 50bp north of neutrality. The 5-5.5% range translates to 50-100bp above a neutral 10yr yield, and translates to 10yr SOFR getting to at least 4.5%.

When we look to the front end, we find that the 2yr Treasury yield averaged 3.3% during the noughties, effectively at a 30bp spread over the funds rate. Currently, the 2yr yield trades some 40bp through the effective funds rate. If, as we expect, the Fed cuts by 100bp and nothing else happens, that would pitch the funds rate at 60bp through the 2yr yield. Based on that, there is some room for the 2yr yield to test lower, likely to the 4% area. And there is scope to dip below 4%, even if briefly.

The difference between the 2yr yield and the 10yr yield is that the 2yr yield is more likely to be held down by the pull of the funds rate as it dips below 4% and likely stays there as a theme for a decent chunk of 2025. In contrast, if the 10yr yield gets down to 4%, it's unlikely to stay there. It's far more likely to get pulled higher, up to the 5-5.5% area, partly on a pull from deficit pressure. That can be negated to the extent that the Trump administration manages to take action on it. It remains to be seen.

Deficit pressure, tax cuts and tariffs are all issues for longer rates to worry about

Even if the deficit pressure is reduced (and we won't assume this just yet), the rates market will still have to contend with the impact of a tax-cutting agenda to be legislated in 2025, taking effect from 2026. On top of that is the threatened implementation of tariffs, whose effect on prices would be a thing through the second half of 2025 and 2026. We view 2026 as being closer to a 3% inflation environment than a 2% one based on this.

Currently, we have a 2% real 10yr yield. On top of that, there's a 3% inflation risk and that brings the nominal 10yr yield to 5%. Then bear in mind that the 10yr real yield averaged 2.3% during the noughties (our preferred neutral reference), and that adds another 30bp to our 10yr yield. Hence the 5% to 5.5% range.

The direction of travel for the funds rate beyond the bottoming process envisaged is a tad opaque. Normally, a bottom in the funds rate would mean just that, a bottoming. And that would mean the next move is up. The markets will likely view it this way until or unless there is a material impulse in the other direction. At this juncture, we don't have enough policy clarity to develop a conviction view in either direction. No doubt this will evolve as we progress through 2025.

We like structural fixed-rate payers and short duration positioning for 2025

In the meantime, the call is for the 10yr yield to touch 4% around the turn of the year, but then to target 5% to 5.5% as we progress through 2025. And for the 2yr yield to hit 4% but then to retrace back up towards 4.5%. The implied curve hits 100bp. This applies to the 2/10yr Treasury curve, and the Fed funds to 10yr SOFR curve, as the 10yr SOFR rate ultimately heads to 4.5%. Based on that and our neutral references, we like structural fixed-rate payers and short-duration positioning for 2025.

US debt dynamics look scary. Effective policy is critical

The problem for Treasuries is a 3% primary deficit plus 3% interest rate costs exceeds the typical 4.5% GDP expansion. That broadly equates to an ongoing 1.5% increase in the debt/GDP ratio. And this continues forever unless the primary deficit is cut. If not, our 5% + call for the 10yr yield can become a threat for 6%...



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US Secretary of the Treasury Janet Yellen

The primary deficit is the swing factor that dominates worsening debt dynamics

We're at a key juncture when it comes to US debt dynamics. Government debt is approximately equal to the value of GDP. In other words, there's a c.100% debt/GDP ratio. This makes the mathematics relatively easy. Basically, when debt is the same size as GDP, debt dynamics are broadly determined by whether the growth in nominal GDP is above or below the average coupon print on the debt. Provided the former is higher than the latter, then the debt/GDP ratio can trend lower.

That is the case where the primary deficit is in balance, which is not the case for the US. The primary deficit is the fiscal deficit excluding interest payments. In the US, the primary deficit ran at around 4% of GDP in 2024 and is projected at around 3% of GDP in 2025. If we assume a 3% primary deficit, for the debt/GDP ratio to fall, then the value of GDP must grow by more than the average coupon print plus 3%. That's a tough circle to square. For 2024, the value of GDP likely rose by almost 4.5% (not enough).

The weighted average fixed coupon print right now is around 2.85%. Bills then tend to account for around 20% of total debt and are rolling over at a cost of around 4.25%. That comes to an average interest rate cost of a little over 3%. The risk case is a trend towards 4% over time, as the yield on the weighted average 7yr maturity is over 4%, and the funds rate is not projected to get too far below 4% through 2025/26. Conservatively we should assume at least a 3% interest rate cost.

Here's how US debt dynamics continue to worsen, driven by the primary deficit...

$$\frac{d}{dt} \left(\frac{D}{Y} \right) = \frac{D}{Y} (r - g) + \frac{PD}{Y}$$

$1.5\% = 3\% - 4.5\% + 3\%$

D = fiscal deficit
Y = nominal GDP (value)
r = rate of interest paid on debt
g = change in value of GDP
PD = primary deficit (deficit less interest)

- Debt/GDP ratio = c.100%
- Change in nominal GDP is around 4.5%
- Interest rate cost is around 3%
- US runs a primary deficit of around 3% of debt



US debt/GDP rises by 1.5% pa ...

(Until or unless something changes)

Source: Macrobond, ING estimates

If the primary deficit is not cut, there is an accelerated worsening to come

The final mathematics is as shown above. We have a primary deficit of some 3% of GDP and interest rate costs of some 3% on total debt. With the debt/GDP ratio at around 100%, that means the value of nominal GDP needs to rise by some 6% for the debt/GDP ratio to stabilise. A repeat of 2024's c.4.5% value increase risks adding 1.5% to the debt/GDP ratio on an annual basis. Something similar for 2025, and over subsequent years would continue to build the debt/GDP ratio.

Moreover, as the debt/GDP ratio rises above 100%, the problem is amplified. Take an extreme - a 200% debt/GDP ratio would require the growth in the value of GDP to be double that of the annual coupon cost (plus half of the primary deficit ratio). This is a nightmare scenario we don't want to see, but it's one we trend towards on CBO estimates if nothing changes on the various components as described above. And so far, there is little in the works to divert us from this path.

Typically, what happens in crises seen elsewhere is the market begins to believe the negative spiral well ahead of it occurring. We saw this for example when the Greek debt dynamics began to gap in the wrong direction. Once the debt/GDP ratio hit 130%, the markets quickly saw 150% and beyond coming, and jumped to price a default scenario.

The US is no Greece, but yield concessional risk is very elevated

The US is not Greece. And we don't at all anticipate a spiralling out of control. But at the same time, the markets will absolutely look for and require some comfort that we should not even be talking this way. If the markets do not get that, we run the risk that on any given day, the Treasury market could decide that now's the time to price in a material concession. And that's how a 5% 10yr yield can threaten to hit 6%+.

US bond market on the precipice when it comes to funding the deficit

Re-funding pressures are already elevated for Treasuries. So much so that we identify a 25bp concession already implicit in the 10yr Treasury yield. We use the spread from 10yr SOFR to the 10yr Treasury yield as a barometer of stress. That's at c.50bp, and on no policy change, is at risk of further widening



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US Federal Reserve Board Chairman Jerome Powell. The Federal Reserve's quantitative tightening has already reintroduced approximately US\$2tr worth of Treasuries into the market

Quarterly re-funding is running at some \$1tr and expected to hold there

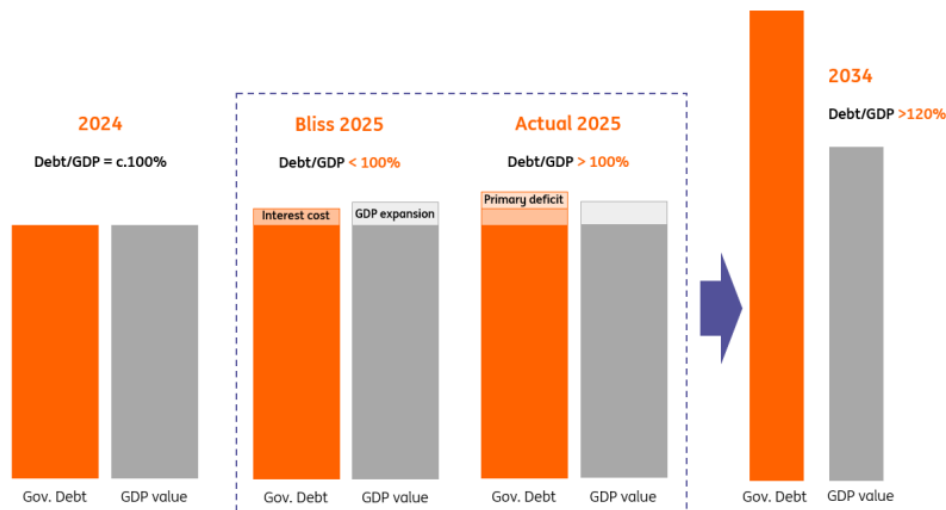
In cash terms, the US fiscal deficit is running at around \$2tr. Of this, about half is net interest and the other half is the primary deficit. On top of that, debt redemptions run at around \$2tr, which translates into an annual re-funding requirement of a little more than \$4tr. That breaks down to a quarterly re-funding of US\$1tr. That was running at around \$0.4tr in the fourth quarter of 2016 when Donald Trump was first elected president, when the deficit was running at some 3% of GDP (versus 6%+ now).

Looking ahead to 2025, it remains to be seen whether there is material success in cutting discretionary spending. This is currently running at around 6% of GDP. In fact, it's around the same level as the fiscal deficit itself. It's important that discretionary spending as a percentage of GDP gets cut in the years ahead as compensation for the rise in interest payments. The Congressional Budget Office projects that interest spending rises from 3% of GDP today to 4% of GDP in the coming decade. Discretionary spending must fall as an offset.

Even as discretionary spending falls as a percentage of GDP to offset the rise in interest rate spending, it won't be enough to cut the fiscal deficit, unless some material action is taken. The tax cuts executed during the first Trump presidency were advertised as self-financing but weren't. There is nothing to suggest that projected tax cuts this time around will be any different. And the jury is out on the extent to which tariffs can bring in material revenue income. And if nothing changes, the debt/GDP ratio keeps rising.

Re-funding at current levels still ends up in a bad place for overall debt ...

The debt/GDP ratio, and how it can get out of control in a cumulative sense



Source: Macrobond, ING estimates

The spread from 10yr SOFR to 10yr Treasury yield at 50bp contains a 25bp concession already

These are issues the Treasury market must grapple with as we progress through 2025. And indeed into 2026 as tax cuts that get through the legislative process will take effect from January 2026 onwards. Meanwhile, the rising fiscal deficit continues to increase the supply of Treasuries in the market. This is occurring alongside the Federal Reserve’s quantitative tightening, which has already reintroduced approximately \$2tr worth of Treasuries into the market.

The main impact of this fiscal pressure has been to cheapen Treasury yields relative to SOFR rates. For example, in the 10yr tenor, the spread from the SOFR rate to the Treasury yield is now about 50bp. That was averaging around 25bp through to the middle of 2023. Since then, there has been a ratchet higher in the spread. It has not been destabilising. Rather it’s been a slow and steady process. In its simplest terms, it effectively translates to an extra 25bp demanded by investors to take down Treasuries.

As we progress through 2025 there is no reason to expect this spread to narrow unless there is some material progress made in terms of deficit reduction. Even deficit containment is liable to pressure the spread wider, as this still equates to a growing supply of cumulative Treasury bonds on the market. Should the fiscal deficit numbers worsen, the risk is the 50bp spread trends wider by another 25bp to the 75bp area. There is no real science to this beyond a possible repeat of the widening seen so far.

We view this as the most likely mechanism whereby the elevated fiscal deficit position impacts the Treasury market. There would not be much market tolerance for a ratcheting higher in the quarterly re-funding requirement. The basic market assumption is that the re-funding amounts have broadly peaked, apart from a natural rise in line with the size of the economy. Any rise from here is a pure reflection of fiscal pressure risks pushing Treasuries participants toward demanding more price concessions.

Watch the SOFR to Treasury yield spread as a measure of fiscal stress

The bottom line is it's too early to conclude that there is about to be a blowout in the Treasury market on account of deficit pressure. But such pressures clearly risk mounting should action to cut the deficit not materialise, or worse, should the deficit go on a rising pattern. It seems, in fact, that this is more of a risk for 2026 when the proposed tax cuts kick in. But even a lack of action to get the deficit on a downward path through 2025 can still spill over into Treasury market vulnerability.

That being said, an impact is already being felt through the prism of the wider spread of Treasuries over SOFR. Watch this spread as the clearest barometer of stress (or de-stress) through 2025.

Spreads to the US to widen for most of 2025

Spreads to US rates have shot wider, and we see little reason for them to narrow any time soon. In fact, the trend suggests even wider spreads. This presents an opportunity to engage with these spreads, such as receiving USD and paying EUR or JPY amongst others. However, timing may depend on achieving more favourable FX levels



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US market rates will find it hard to avoid discounting the price risk coming from the tariff story

The oomph coming out of the US has manifested in wider spreads across the board

Even though market rates have been trending lower into the turn of the year, the dominant theme following the first Fed rate cut in September has been a material ratchet higher in US market rates. This reflected: 1. A firm September payrolls report, 2. An edge higher in some inflation metrics, and 3. The discount and delivery of a Trump election win. This also acted to downsize expected Fed rate cuts, while at the same time macro malaise in the eurozone and elsewhere upsized expected cuts there. Consequently, spreads to the US marched materially higher, coinciding with US dollar strength.

Not only has there been a widening in spreads in the past number of weeks, but spreads are significantly wider versus their 5yr averages. For example, in the 5yr area, eurozone spreads are 50bp wider versus the 5yr average, Canada is 100bp wider, and Japan is 80bp wider, to name a few. The latest absolute spreads are identified in the table below using risk-free rates (where available), where positive spreads are pick-ups to SOFR rates. The question now is where we are going to go from here.

The simple answer is spreads are liable to remain wide as a theme through 2025, with, if anything, a bias to widen further. The central antagonist here is the Trump administration and the reaction to it, from the Federal Reserve and international players of all guises. The Fed's first issue centres on the stimulative effect coming from proposed tax cuts, which will go through a legislative process in 2025 for full enactment from January 2026. To the extent that the tax cuts include ending taxes on tips, overtime and

social security, there is a stimulative effect on the type of consumer that has a high propensity to spend.

The wide gaps that have opened up between low yielders and the US

The spreads are based on risk-free rates (and include the cross-currency basis)

	2yr	3yr	4yr	5yr	7yr	10yr
Switzerland	408	395	385	378	370	367
Japan	375	362	353	348	339	324
Taiwan	300	290	282	278	268	247
Denmark	244	230	220	212	201	186
Sweden	237	226	216	206	190	176
Eurozone	223	214	205	182	189	180
S Korea	198	188	181	177	174	172
China	188	178	170	167	162	161
Singapore	165	164	163	162	160	162
Canada	123	114	109	105	95	82
Czech	95	91	84	79	64	50
Hong Kong	55	61	68	72	74	75
Norway	52	53	56	53	54	64
Australia	3	-4	-11	-19	-37	-70
UK	-9	-6	-4	-3	1	-1
Poland	-92	-80	-79	-84	-92	-103
Hungary	-202	-208	-215	-220	-232	-245
Indonesia	-241	-261	-271	-279	-276	-267
Mexico	-491	-474	-470	-471	-470	-461

Source: Macrobond, ING estimates

Tariff price risks are an additional factor, while the eurozone simultaneously goes through macro malaise

An additional concern is the tariff policy. While we remain far from a settled outcome on this, there are some key observations to be made. First, US imports are less than 15% of US GDP. In that sense, they are not dramatically impactful. Second, low import propensity also reduces the size of the impact of tariffs on average economy-wide prices. Third, there is still a likely price rise/inflation effect to be concerned with, and likely something to watch for in 2026, and perhaps through late 2025. We simulate an aggregate price impact of something like 0.5% to 1% on a broad 10% tariff.

This may or may not be 'inflationary', but US market rates will find it hard to avoid discounting the price risk coming from the tariff story. Essentially, we have a tax-cutting/tariff combination that will concern longer tenor rates, specifically to the extent that these price rises eat into the value of a fixed rate coupon paid out on any given bond. This also limits the appetite for the Federal Reserve to cut by too much as we move through 2025. That's the argument for US market rates remaining elevated. And then there is also the fiscal side to consider (see the previous articles in this bundle for more on this).

From the non-US perspective, there is outsized angst coming from the Trump administration's tariff ambitions and the isolation threat to boot. The eurozone economy is already weak and suffering a degree of political vulnerability e.g. the forced holding patterns ongoing in Germany and France. Meanwhile, Meloni's right-leaning Italian administration is remarkably looking more like a picture of stability. Fundamentally, eurozone inflation is proving stubbornly sticky, just a tab above where it needs to be. But the European Central Bank will be minded to cut rates by enough to ensure no return to a dis-inflationary spiral that might come from macro malaise. That continues to argue for far more rate cuts from the ECB than from the Federal Reserve, in turn keeping the spreads differential wide.

The wide spreads theme presents opportunity in the classic positive carry play

This presents an opportunity to engage with these spreads. For liability managers, the opportunity is there to receive USD and pay EUR, or say JPY amongst others, for a significant reduction in funding costs. The same trade obtains for asset managers where the outcome is a pick-up in yield from lower yielders into US dollars. The challenge is that EUR and JPY are quite weak relative to long-term history, and any mean reversion in the years ahead would eat into the value of this positive carry trade.

The way to deal with this risk is to set out with a view to taking profit in the coming few months (say as the EUR/USD FX rate heads towards parity), or set the trade in a long enough tenor where the forward FX rate offers a tolerable implied breakeven level. For example, on a 7yr tenor there is FX comfort to 1.2 in EUR or 120 in JPY. Either way, get used to a wider-spread environment as an ongoing theme for 2025.

Steeper EUR curves from both sides

We see the landing point of the European Central Bank at 1.75%, reaching that level by mid-2025, but the path towards this may be bumpy. From the back end, EUR swap curves will feel upward pressure from higher UST yields, especially in the second half of 2025. Our forecast is therefore a further steepening of curves, more so than forwards imply



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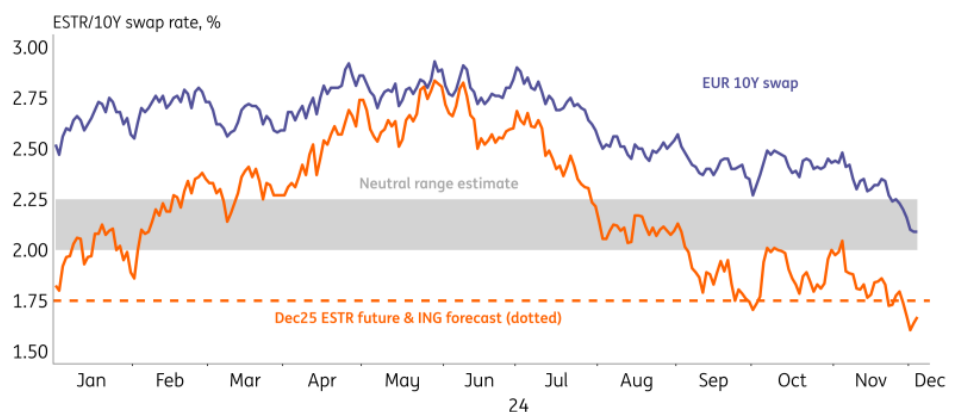


Christine Lagarde, president of the European Central Bank. The ECB's communication has turned more dovish as we enter 2025

A bumpy ride down to the ECB's landing zone

The key theme for EUR rates this year will be the ECB's easing cycle, whereby the projected landing point will drive much of the moves. Throughout 2024, the 10Y swap rate was strongly driven by the market's expectation of where the ECB would settle in 2025. We think the ECB will cut just below our neutral range estimate of 2-2.25%, leaving us with a policy rate of 1.75%, in line with current market pricing.

The ECB's willingness to ease supports an endpoint just below neutral



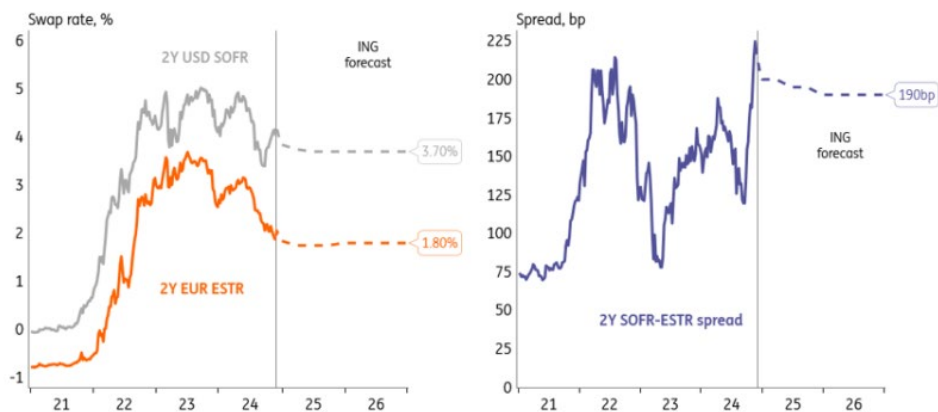
Source: ING, Macrobond

The path to reaching that terminal policy rate could be a bumpy one, as we see plenty of risks that may materialise. On the downside, we see recession worries and Trump-

triggered trade tensions as the key risks. The ECB’s communication has turned more dovish as we enter 2025 and markets will thus be quick to turn any headwinds into more easing expectations. As an upside risk, we still have stubborn inflation numbers. In particular, wage growth could pose a challenge to the ECB.

The 2Y EUR swap rate should find a floor at 1.75% in 2025, but we could see frequent undershoots as risk sentiment is challenged. The correlation with US rates on the front end of the curve should be less going forward and therefore we expect the USD-EUR 2Y swap spread to remain close to 200bp throughout the year.

Diverging outlooks means 2Y USD-EUR OIS spreads can remain wide

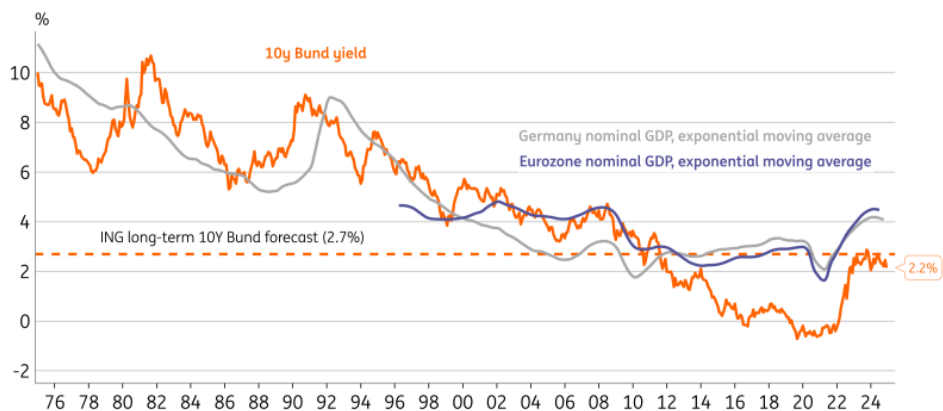


Source: ING, Macrobond

Our fair value of 10Y rates is above current levels

The 10Y swap rate should start settling closer to its long-term fair value as the ECB normalises monetary policy. As a very rough anchor for the fair-value estimate, we can look at the historical relationship of government bond yields with nominal trend growth. When plotting smoothed nominal GDP growth for Germany over a longer horizon, we can see a close alignment with the 10Y Bund yield. Since the introduction of the euro, eurozone GDP shows a better fit.

Fair value of 10Y rates as a function of trend nominal GDP growth



Source: ING, Macrobond

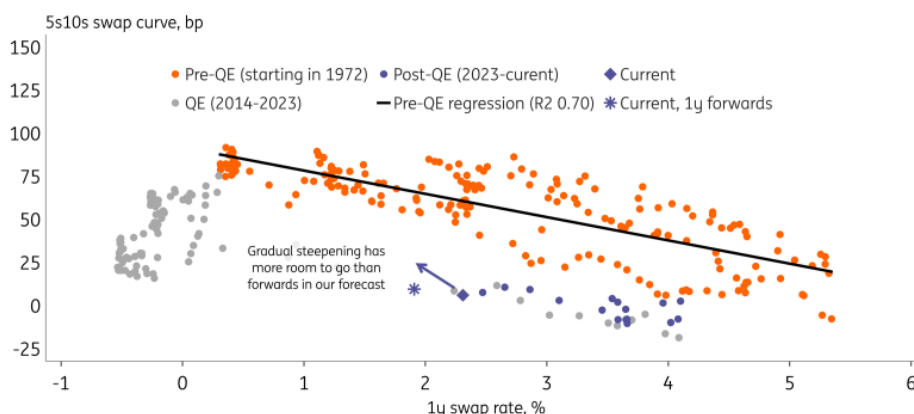
Based on our outlook on nominal growth, we think that 2.7% as the fair value of the 10Y Bund yield is justified, which is well above the current 2.2% level. When taking into account the Bund swap spread (more on that later), these estimates should roughly correspond to the 10Y swap. In our view, the period of low rates before Covid-19 was an exception rather than the new norm. Going forward, we see more political willingness to provide economic support through fiscal measures and we have structural drivers of inflation, including demographics, deglobalisation and decarbonisation. In effect, the return to the zero lower bound with QE is unlikely.

Steeper curves as part of the normalisation process

Curves have started steepening going into the ECB's easing cycle and we think there is room for more. The inverted 2s5s and 10s30s remain an anomaly in historical terms and a normalisation of policy should help these into positive territory again. When looking at what forwards are pricing in, the 2s5s are expected to disinvert in 2025. Further out on the curve less movement is priced in, but we think markets are underestimating steepening potential here.

We see various [structural drivers](#) for steeper EUR curves in 2025. Firstly, supply pressures will remain high as QT continues and we foresee another year of high government bond issuances. Secondly, UST yields are expected to see significant upward pressure throughout 2025 and especially the back end of the EUR curve is still tightly linked to such global factors. Lastly, for longer-dated swaps, i.e. 30 years and beyond, we see lower structural demand from Dutch pension funds due to the upcoming reforms, which could put upward pressure on 10s30s.

Structural drivers should help curves steepen more than forwards



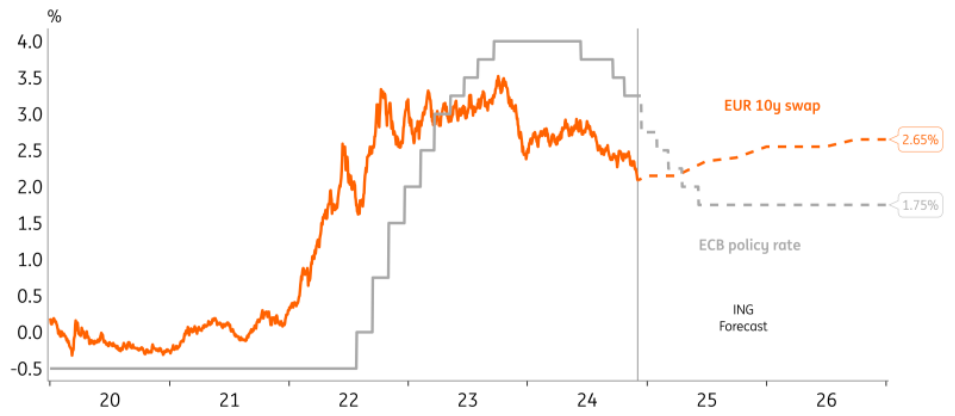
Source: ING, Macrobond

The risks to our baseline are tilted towards lower rates

Our baseline scenario sees the ECB settle at 1.75% and the 10Y Bund yield rise to 2.7% by year-end. We go into 2025 with fragile risk sentiment and the eurozone economy hasn't bottomed out yet. That combination may lead markets to increase the chance of a return to a secular stagnation regime. One in which the ECB may have to cut to 1% or beyond, whilst QT is put on hold or even replaced by QE. If markets decide this is the path of least resistance, then the whole yield curve would grind lower and the 10Y Bund yield would find itself below 2%. That's the downside risk case for rates.

On the other hand, the fight against inflation is not over and with wage growth still going strong, we could also imagine a scenario in which the ECB will not go into expansionary territory in 2025. Consumption-driven growth could pick up in mid-2025, as also predicted by the ECB, whilst trade tensions with the US may only materialise later in Trump's presidency. In this case, the terminal ECB rate could reprice somewhat higher limiting the downside to rates.

In our baseline, 10Y EUR swap rates are dragged higher by the US



Source: ING, Macrobond

Dutch pension funds are prepping for big reforms

Dutch pension funds are preparing for significant reforms, and given their sheer size, swap markets will be impacted. Structurally, we see less need for longer-dated (30Y+) fixed receiver swaps, but a reduction in risk appetite to ensure a smooth transition could lead to heightened demand for shorter-dated (e.g. 20Y) fixed receiver swaps in 2025



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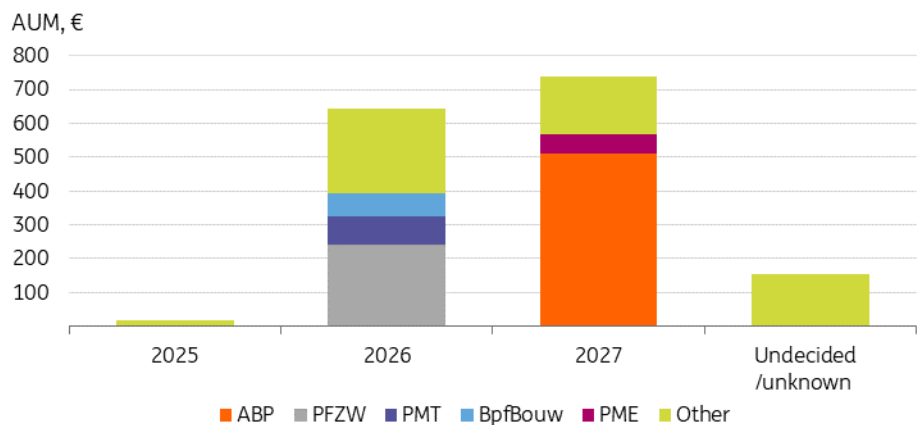


Going forward, we expect Dutch pension funds to remain risk-averse

Dutch pension reforms cannot be ignored by euro rates markets

Dutch pension funds are on the verge of significant reforms and 2025 will be all about preparing for that transition. The strong reliance on longer-dated fixed receiver swaps for managing interest rate risks means that swap markets will be impacted. In essence, the reforms are about shifting assets from Defined Benefits (DB) schemes to a Defined Contributions (DC) model. Around €600bn of assets are expected to transition in 2026, most on 1 January, making 2025 an important year.

Almost half of pension fund assets are scheduled to transition on 1 January 2026

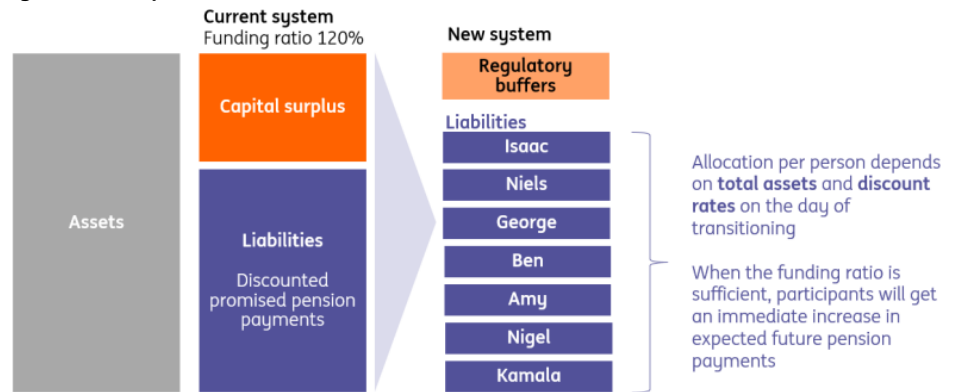


Source: ING estimates, PensioenPro, DNB

Even though [longer-dated swaps will be of less importance](#) under the new model, in 2025 we expect the demand for fixed receivers to remain elevated. To ensure a smooth transition process, pension funds have an incentive to reduce the volatility of their assets and liabilities.

On the day of transition (e.g. 1 January 2026), assets are allocated to the participants based on individual future liabilities and to fund-wide reserves. To prevent a situation where participants are forced to take pension cuts, funds are incentivised to [reduce market risk exposure](#) in the months leading to the date of transition.

Stylised example of the transition from a DB to DC model

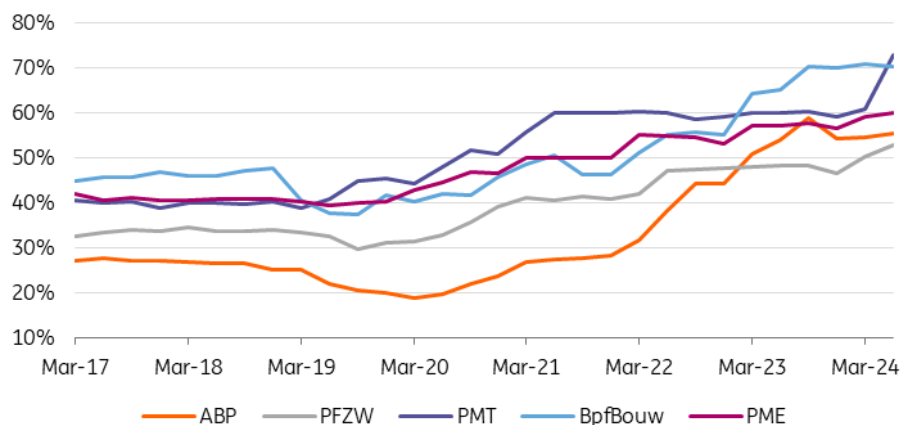


Source: ING Research

The uncertainty around Trump’s presidency in 2025 forms a key risk to the transition in our view, since a scenario with falling equity prices and lower EUR rates would hurt funding ratios significantly. A reduced risk appetite can be expressed through increased interest rate hedges, which have already increased over the past years. We will be watching the funding ratios of some of the larger funds, and if these show sharp drops, then we foresee further demand for fixed receivers.

Major funds may still continue to add interest hedges in 2025

Interest coverage ratio



Source: DNB, ING Research

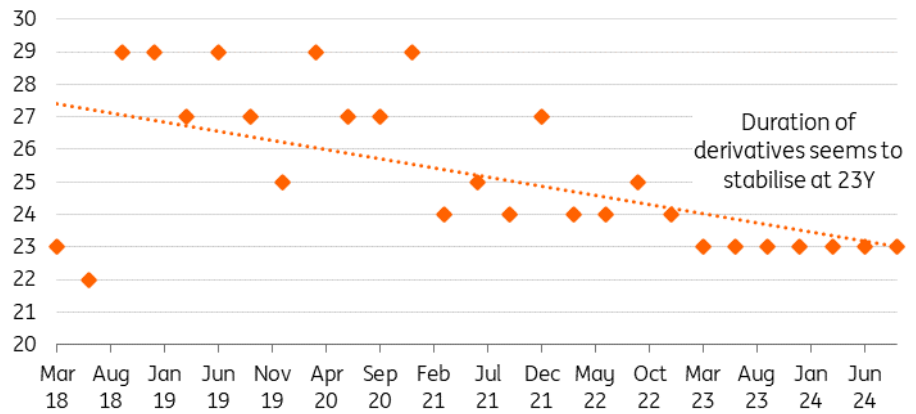
Most market impact expected on the long-end of the swap curve

The new Defined Contribution model reduces the need for fixed receiver swaps for 30 years and beyond. We, therefore, believe that [funds will already move to 20y tenors](#) to steer interest rate risks until the transition. Any shorter tenors will fail to cover the risks stemming from longer-dated liabilities, which will still need to be covered until the transition date. Longer tenors would fall obsolete after the transition date.

Our analysis suggests that funds have already reduced the duration of their derivatives portfolio from around 27 to 23 years, in line with our working hypothesis. After the reforms, Dutch pension funds will require fewer long-dated hedges, and thus we expect less demand for 30Y fixed receivers and more for 20Y swaps.

Hedging has already shifted to shorter durations

Highest correlated tenor with change in derivatives position (3Y rolling)



Source: DNB, ING Research

We stick to our view that the 20s30s EUR swap curve can steepen further. Our fair value model suggests the currently inverted slope should revert to a positive slope again, potentially already in 2025, and the Dutch pension fund dynamics should support the broader steepening trend.

Going forward, we expect Dutch pension funds to remain risk-averse and any market moves against them could further increase interest rate hedges. Increased hedging demand may have even already played a role in accelerating the recent swap spread moves and will continue to have an impact.

German Bunds still face pressure relative to risk-free rates

Bunds have underperformed versus risk-free rates at an accelerated pace amid structural headwinds from supply and the ECB's quantitative tightening. Further underperformance from the long end looks likely, but there are arguments for some stabilisation as Bunds still occupy a special place in the eurozone bond market



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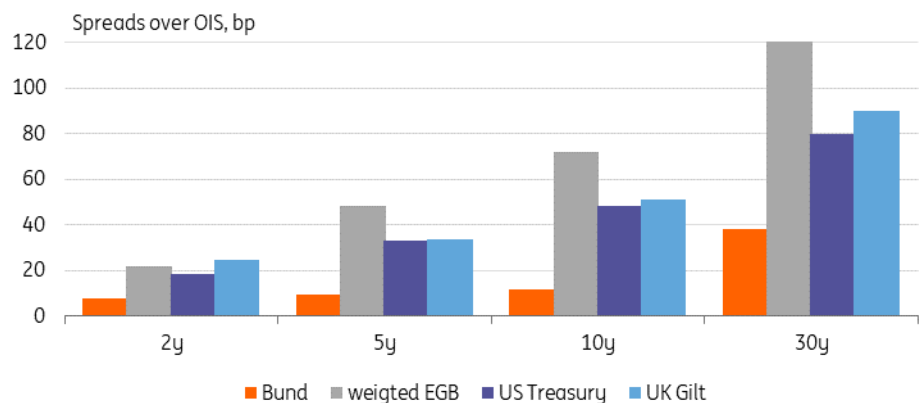
If any country has the capacity for more investment spending, it is Germany

The Bund spread remains under pressure, but we also see arguments for stabilisation

There had been a general sense that the central banks' quantitative tightening paired with ongoing high funding needs would require a reassessment of sovereign spreads – both relative to each other and versus “risk-free” rate expectations. This is a theme not exclusive to European government bonds but also observed in US Treasuries and Gilts.

However, what was a gradual underperformance of eurozone government bonds versus swaps led by Bunds suddenly accelerated early in October and turned into a vicious repricing that had repercussions across the wider EUR fixed-income market.

Treasuries and Gilts are much wider versus risk-free rates than Bunds



Source: Refinitiv, ING calculations

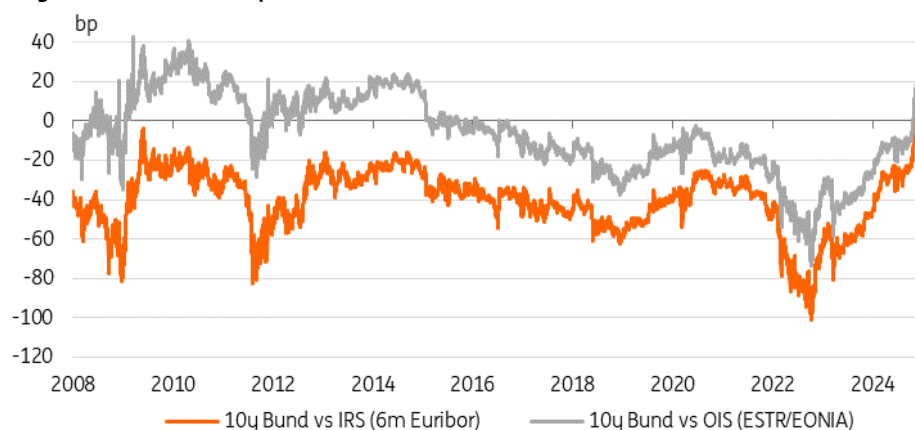
Bunds still hold a special position in the eurozone context...

The poor performance of Bunds has raised concerns since they usually serve as a benchmark for the wider sovereign and sovereign-related bond market. Many have raised the spectre of valuations similar to those in the US or UK, where 10y government bonds trade around 50bp above OIS. We do not see such levels as a target for 10y Bunds anytime soon.

What sets Bunds apart is that they are just a small slice of the wider eurozone bond market, less than 20% of a €9.6tr market. But importantly they are still the highest rated slice with liquidity underpinned by a futures market. If we take the weighted average spread of 10Y eurozone government bonds versus OIS, we are already at cheaper levels compared to the US and UK.

Fan out the spectrum across the ratings and liquidity of the eurozone market and there is good reason for Bunds to trade at a premium. Bund valuations have stabilised and even recovered somewhat in recent weeks, mainly on the back of geopolitical risks in Eastern Europe flaring up again and also political tensions rising in France. But it is also worth pointing out that the 10Y Bund spread versus OIS peaked at levels last seen around 2014 just before the European Central Bank started buying government bonds.

10y Bunds are back at pre-QE levels versus the risk-free rate



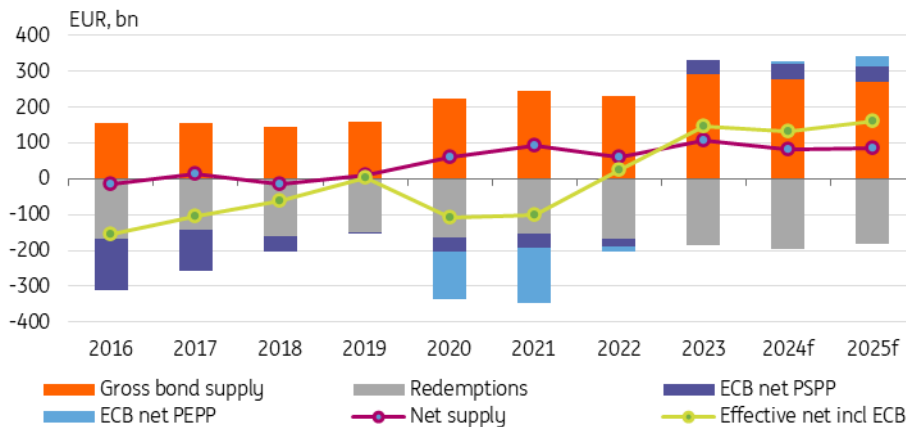
Source: Refinitiv

Pre-QE levels may serve as a first anchor point but the structural headwinds to sovereign valuations persist – foremost in the form of the large volumes that private investors will have to absorb going forward as issuance plans remain elevated and the ECB no longer reinvests redemptions from its bond portfolios.

Another cyclical factor also looks less likely to turn favourable anytime soon – the ECB will remain in a rate-cutting mode, which means that net flows on the swap leg of the spread should remain biased towards receiving. Additionally, at the long end of the curve, the prospect of receiving flows from Dutch pension funds looms large – on the back of indexations and going forward in preparation for transitioning to a new pension system.

The uncertainty around the German political backdrop could pose another headwind to Bund valuations versus swaps early in the year. Snap elections are scheduled for February after the current governing coalition broke apart over the budget and the handling of Germany’s constitutional debt brake. We doubt there will be big impacts on near-term spending solely from this. Reforming the debt brake will take time, but if the increased spending is ultimately directed towards investment, it could positively impact the long-term outlook of the German economy. If any country has the capacity for more investment spending, it is Germany.

Effective Bund supply remains elevated as the ECB runs down its bond portfolio



Source: ECB, Deutsche Finanzagentur, ING calculations

... and amid persistent headwinds the front end provides an anchor, too

The very front-end provides the most important anchor though, where the 2y Schatz has been more range bound since November at 7-12bp above OIS. In money markets, the pricing of German collateral in repo markets seems to have stabilised at levels around 5bp above the overnight ESTR rate, having already come off a peak at around 10bp in late September through early October. Some of the accelerated underperformance versus swaps further out the curve was indeed triggered by the repo market’s term-premium adjusting to these spot levels as the pricing over the year-end failed to repeat the rich valuations of past years.

For spreads further out the curve such as the 10Y Bund, we think this argues for some stabilisation at levels around 10-20bp above OIS (5 to -5bp around IRS) with risk-on/off episodes mainly driving the deviations towards flat and below swaps again. Bunds should always have a place as a portfolio diversifier to hedge against unforeseen events and recent events have shown that the reflexes still work in the right direction.

Going forward, we see three main sources of such risks – geopolitical risks, eurozone political and sovereign risks and macro outlook risks – although the episode around Silicon Valley Bank of early 2023 also shows how other events can quickly lead to a larger outperformance of Bunds.

Eurozone bond spreads: a reordering in progress

Quantitative tightening and a still elevated supply are headwinds for the overall eurozone sovereign bond space. But that does not mean individual countries can't outperform further while others remain under more pressure. All eyes are on French deficit concerns, while the periphery continues on a positive footing



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This time around all eyes are of course on France

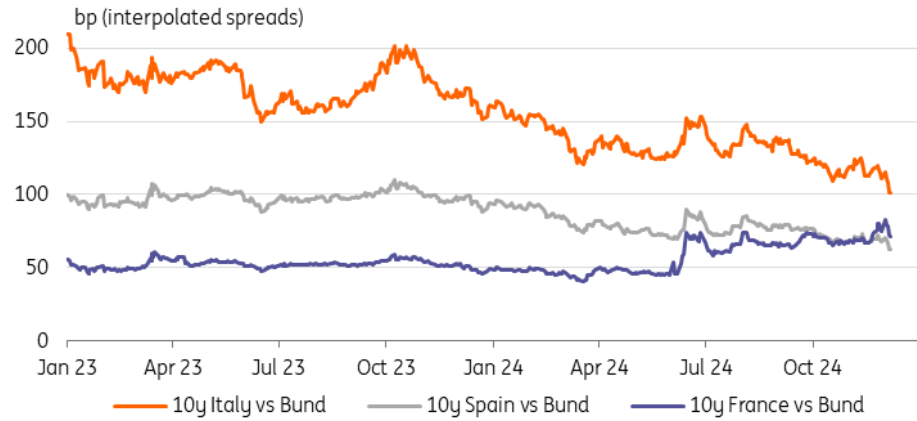
Spread risks look more contained and idiosyncratic

The market seems to sense that eurozone risks are by now largely contained and we are looking more at idiosyncratic country stories. The reaction of Bund swap spreads to episodes of eurozone political turmoil had become smaller in scope and more short-lived. Notably, periphery bond spreads have remained on a tightening trend despite French political unrest. In fact, markets are challenging the hierarchy of spreads from the past years as the conventional high-risk countries, e.g. Italy, Spain and Portugal are doing relatively well compared to say France and Belgium.

The market has internalised the European Central Bank's reaction function to signs of market dysfunction and the ECB's suite of instruments has also evolved including the Transmission Protection Mechanism (TPI). Add to this that the EU has moved closer together with each of the past crises, culminating in the common debt issuance through the NGEU.

The counterargument is that one cannot expect any further progress as long as political uncertainty hampers leadership in both France and Germany. With debt levels overall still elevated, deficits high and the macro outlook fragile, even the ECB warned recently that 'fiscal slippage' could reignite market concerns over sovereign debt sustainability. The political situation could leave the ECB picking up the pieces again.

Towards a new hierarchy within eurozone bonds



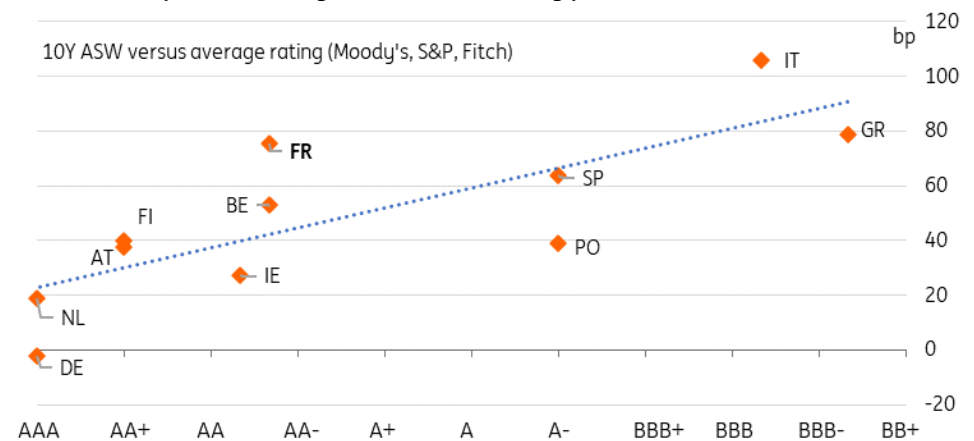
Source: Refinitiv, ING

Eyes will remain on France, but a lot of pessimism is already priced...

This time around all eyes are of course on France. The 10y yield spread of French government bonds over their German peers widened to 88bp in December before retreating to previously already elevated ranges. Further widening looks possible as politics enter a new phase of heightened uncertainty and new parliamentary elections now loom large in summer 2025. But markets had been wary about the prospects of quickly solving French fiscal problems to begin with, as pricing already reflects an expectation of rating downgrades. With the latest widening, French 10y spreads over swaps were more in line with an 'A-' rating rather than its current 'AA-' – three notches lower.

Government fragility was always part of the picture, even if not expected to come to a head quite so soon. The focus is now on the implications for a longer-run debt trajectory and where France finds its place relative to its peers. French spreads are already well above Spain's and are now close to par with those of Greece.

French bond spreads already reflect a lot of rating pessimism



Source: Rating agencies, Refinitiv, ING calculations

... and wider spillover has been muted, which should allow further selective tightening elsewhere

Importantly, the rekindled concerns surrounding France have not prevented, for instance, Italian government bond spreads versus Bunds trading close to the tightest level since 2021. What we are still seeing with regard to the wider eurozone periphery is an increased market optimism on the back of relative political stability and macro resilience leading to hopes for further rating upgrades. With spreads also supported by

the general ECB rate-cutting environment for now, this more than counterbalances the impact of the ECB's gradual quantitative tightening.

This setup may hold in the early part of 2025. But it could become more and more challenging as ECB reinvestments now come to a complete stop. Our central scenario also sees the ECB reaching the trough in policy rates at just below neutral levels by mid-year and longer rates beginning to trend higher, thus steepening the curve from the back end. But the outlook comes with a great degree of uncertainty, not least because of the unpredictability of US politics. Volatility is never a friend of spread products.

For eurozone spreads, that may mean a modest potential for more selective tightening in the early part of the year – if political tensions do not escalate further. But further spread performance in the latter part of the year looks more challenging. A downside risk scenario that would see the ECB cut rates more substantially and also contemplate deploying its balance sheet gains would likely have the most profound impact on spreads, starting with Bunds.

SSA spreads pushed wider as underlying sovereign levels get reassessed

Sovereign-related and supranational issuers are not just caught up in the reassessment of sovereign risk. If longer rates start drifting higher, credit curves should remain steeper with the sector also facing elevated funding levels. The EU bond market evolves further but faces challenges as key states are under pressure and supply risks loom



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We await the detailed plans for the next six months from the EU

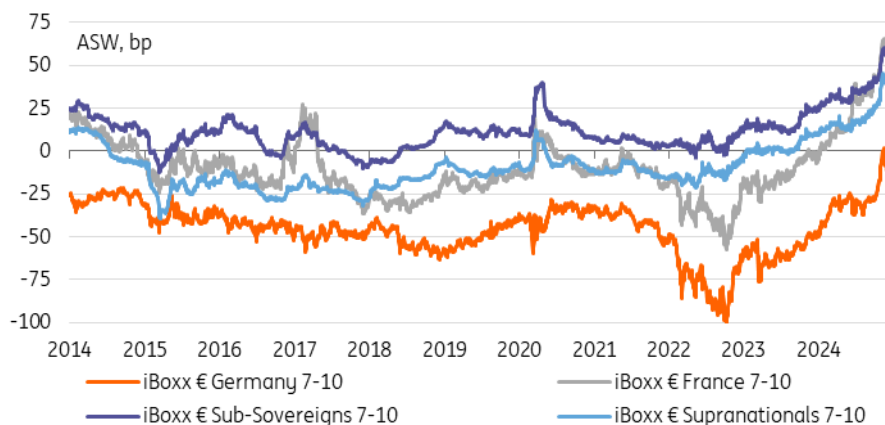
SSAs face ongoing pressure from the underlying reassessment of sovereign risk

For supranational, sub-sovereign and agency (SSA) bonds, 2024 was, for a large part, a year of gradually widening spreads over swaps. This was mainly the effect of the European Central Bank continuing to normalise its policy implementation amid an overall elevated supply flow. This pushed the entire credit spectrum wider starting from the government bonds space, and Bunds specifically. Some issuers have lagged in the last widening move more than others. Especially for less liquid names, screen prices may not reflect prices where bonds would actually change hands – in many cases, price discovery typically runs through the primary market.

The start of the next year will be key when primary markets reopen and issuers usually frontload a good part of their funding for the year. This can put pressure on spreads. The larger issuers coming early in the year will particularly set the tone for other issuers – all eyes will be on KfW, EIB and of course the EU.

For the time being, the recovery of Bunds may provide some relief as relative valuations now look less stretched – i.e. versus the sovereign, but also less liquid relative to liquid names (think for instance German Laender versus KfW). But to the degree that French political turmoil is the underlying reason this could be a double-edged sword with only core and more liquid names to really benefit. On the positive side, even the latest escalation has had muted spillover into other jurisdictions, save Belgium to some extent.

SSA spreads were pressured wider by Bunds



Source: Markit, ING

The start of the year will set the tone

One question will be whether there is a reason to frontload funding or whether there is room to postpone some of it amid current political uncertainty in France and Germany.

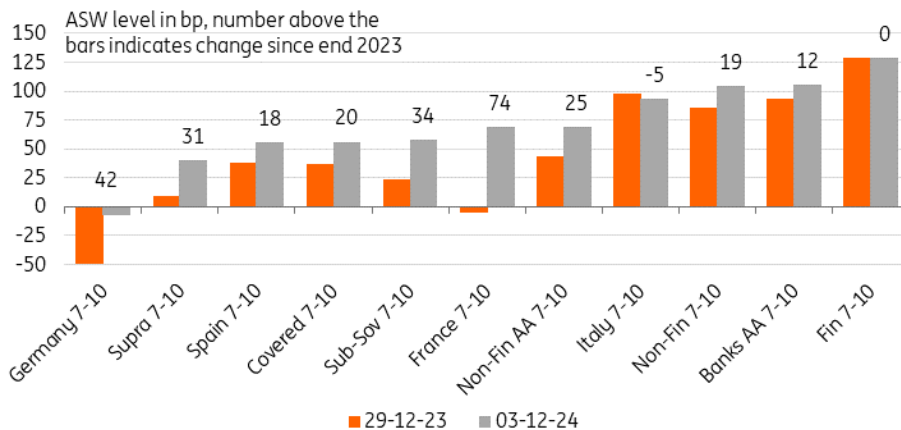
Funding of SSAs via EUR in 2024 had seen a pronounced frontloading with an issuance volume of €80bn in total in January setting a new record. Reasons were many, with the ECB slowing reinvestments, the EU elections in summer and the US presidential race looming later; there was plenty to get ahead of. But it was also due to the overall high funding volume. In the end, January accounted for just below 20% of funding for the entire year, a similar share as in 2023.

The wiggle room now appears limited as overall funding volumes should stay high in 2025. In terms of timing, French politics will remain an ongoing concern and could see another round of legislative elections in the summer. French-related spreads are likely to remain elevated, but it appears that other jurisdictions remain shielded for now.

If potential French elections do not trigger wider spread turmoil and another outperformance leg of Bunds, we think there is a chance that their gradual underperformance trend versus swaps continues amid persistent supply headwinds. This would likely feed through to SSAs again. At the same time, the ECB could signal by mid-year that it is close to being done with easing, while we see long-end rates continuing to drift higher. We think credit curves will likely remain steeper in such an environment.

However, there is still room for SSAs to perform relative to sovereigns, even if that does not translate to tighter spreads versus swaps. More importantly, any underperformance versus swaps might also be moderated by valuations of the SSA sector now being more attractive relative to other asset classes, from covered to (non-)financial corporates.

SSAs are wider, but also relatively more attractive



Source: Markit, ING calculations

High net supply remains a headwind

High grade € SSA issuance from the regions we track – Western Europe, North America, Japan, Australia and New Zealand plus global suprationals – has reached more than €412bn in 2024, well surpassing the €360bn of 2023 and setting a new record. Western Europe typically accounts to more than 90% of the €-denominated issuance, more than a third of which again is solely down to one single issuer – the European Union. For 2025 we expect only a slightly higher gross issuance level closer to €420bn with minor shifts below the surface.

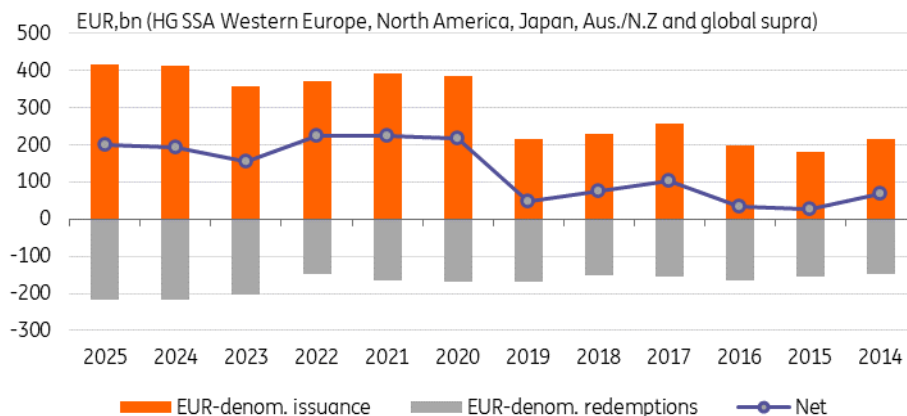
While we await the detailed plans for the next six months from the EU, it has already flagged that gross issuance could increase to €150-160bn in 2025. This comes amid rising refinancing needs with larger bond maturities due next year – €28bn compared to €3bn in 2024. This also means that net issuance could actually decline from €135bn to €122-132bn.

ESM and EFSF will issue €28.5bn in 2025, up from €26bn in 2024, which includes the one USD dollar bond per year from the ESM. For the EIB, we again pencil in around €30bn in €-denominated funding out of roughly €60bn in total. Taking the E-Names and EU together we already arrive at 45% of the total €-issuance we forecast for 2025.

Another 25% of overall issuance will come from the German agencies and Lander. We assume an issuance volume of again close to €105bn, with KfW likely to account for €45bn alone – its €-denominated funding share. Filling in the rest, we look to French and Dutch agencies – slightly lower to similar in magnitude compared to last year, of €18bn and €15bn, respectively – and as the next largest block to suprationals other than the E-names as well as Canadian agencies and provinces – for both we look for slightly lower volumes as especially the latter tend to fund more opportunistically in EURs.

The overall EUR net funding volume could come in at €200bn, up from €195bn in 2024, but still below the peak levels of 2020 through 2022. However, this does not account for the ECB no longer reinvesting any maturing bonds from its portfolio holdings.

SSA supply will remain at elevated levels



Source: BondRadar, issuer websites, ING

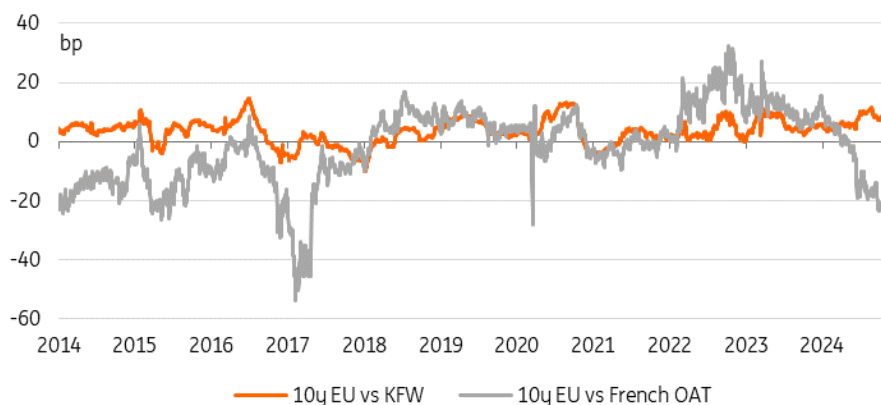
EU bonds' role within SSAs: challenges and opportunities

The EU remains a focus: for one it dominates the SSA space with its high issuance levels. Paired with its high rating AAA/Aaa/AA+, it also serves as a benchmark to a degree.

The further evolution of that benchmark role was dented this year when MSCI and ICE decided against incorporating the EU into sovereign debt indices. It is not the end of the Figstory, as other index providers iboxx and S&P/Barclays still have to report back on their consultations where feedback rounds just closed in November. It would be surprising if the feedback resulted in materially different conclusions from the earlier two exercises. Still, this topic could be revisited, especially if there were more indications that the NGEU would not remain a one-off. Funding a common defence strategy amid a changing geopolitical landscape for instance could have significant supply implications for the future, although recent headlines suggest that options via a separate financing vehicle are being explored.

Further development was made on other fronts, though. ICE has just launched a Long EU bond futures contract, although it is cash-settled and based on an 8-13Y bond index rather than a basket of deliverable bonds as markets are accustomed to in the eurozone government bonds space. That might hinder it from gaining wider traction. But Eurex – the name behind the government bond contracts – has indicated that the EU is meeting the conditions for a launch of its own contract, especially since the EU has established a repo facility and also joined the Eurex repo platform for clearing and trading.

EU bonds have so far managed to stay aloof of French political



Source: Markit, ING calculations

Those are the more technical underpinnings, but the EU will be closely watched for the impact that France may have on its credit perceptions. Fitch bases its AAA rating for the

EU mainly on the capacity of AAA-rated member states to provide financial support if needed. Moody's, meanwhile, highlights that the rating is more sensitive "to changes in the ratings of the three countries rated Aaa to Aa2 that make large contributions to the EU budget, i.e. Germany, France, and the Netherlands," though notes a degree of resilience if downgrades are limited in extent and focussed on one member state. S&P seems to follow a GDP-weighted average rating approach more mechanically than currently results in its AA+ assessment.

The market has at its peak placed French swap spreads on levels implying a rating up to three notches lower from its current AA- rating. With two negative outlooks, a one-notch downgrade looks possible over the next year. This alone would unlikely already impact the average calculations underpinning the EU, even as France has an almost 17% weight in the EU. But the market might well see this as the beginning of a cycle if French politics do not show signs of turning the corner on budget issues. An offsetting factor could remain the positive sentiment with regards to Italy and Spain in particular – together with a weight of just over 20%.

EU bonds do look rich versus the French sovereign as the widening of the latter has had a modest spillover effect, but they tended to correlate more with German SSAs in the long run. On this measure, the EU currently is at the wider end of a spread dynamic that has typically stuck to a relatively narrow band.

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