ODDO BHF

MARKET *view*

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European investors' attention increasingly turns to bond markets

> *Based on recently released corporate financial reports, we seen no reason to worry about widespread debt, and default rates remain moderate*

European government bonds experience unusual volatility in the start of the year. Over the past 12 months, the yield on 10-year German Bunds fluctuated within a range of 2.08% to 2.66%. The past week saw a sharp surge, however, with the 10-year yield jumping from 2.38% on 28 February to 2.93% on 12 March.

Following snap elections on 23 February 2025, the CDU and CSU entered exploratory talks with the SPD, resulting at short notice in the announcement of a public spending programme that includes a EUR 500 billion special fund for infrastructure and an increased defence budget. This plan would require a suspension of Germany's debt brake for all military spending above 1% of GDP. Increasing the defence budget to 3.5% of GDP would translate to an additional EUR 110 billion in government borrowing per year. Friedrich Heinemann, an economist at the Centre for European Economic Research (ZEW) in Mannheim, estimates that Germany's public debt could exceed 100% of GDP by 2034.

At time of writing, on 14 March 2025, whether this spending package will be implemented as proposed by the negotiators of the three parties remains uncertain. The main hurdle is that the debt brake has been enshrined in Germany's constitution since 2011. To bypass this rule, the CDU and SPD need a two-thirds majority in the Bundestag, which they can only achieve in the outgoing parliament with support from the Greens and the FDP. In the newly elected Bundestag, the CDU, SPD, and Greens will control only 65.5% of the seats. However, as of 14 March, neither the Greens nor the FDP have committed to supporting the proposed constitutional amendment. Additionally, both the AfD and Die Linke have filed lawsuits with the Federal Constitutional Court, questioning – for different reasons – the legality of this attempt to secure a parliamentary vote on the debt brake before the new parliament convenes for its first session.

Constitutional issues aside, the CDU and CSU are also facing backlash from their voter base over plans to increase government debt, in contradiction to CDU leader Friedrich Merz's pledge during the campaign. **If coalition negotiators proceed with the planned spending package, it is unclear whether the next government will be able to obtain the required two-thirds majority in the Bundestag.**

Nevertheless, a change of path seems unavoidable. For years, successive German governments have scrupulously adhered to both the constitutional debt brake and the Maastricht criteria, which requires European Monetary Union members to maintain public deficits below 3% of GDP and public debt below 60% of GDP. In 2024, Germany's public deficit totalled approximately EUR 119 billion, or 2.8% of GDP, while its public debt stood at around 63% of GDP, or EUR 2,489 trillion (including federal, state, municipal, and social security debt) at the end of the third quarter of 2024.

Germany is not alone in ramping up public spending. The EU is also planning major stimulus programs, such as the Invest AI initiative, which aims to mobilize EUR 200 billion for artificial intelligence, EUR 50 billion of which would be provided by EU funds and EUR 150 billion by the private sector. Further spending programs are planned for the decarbonization of the European economy, the defence industry, and Ukraine.

France is closely watching Germany's fiscal expansion. Unlike his predecessor Michel Barnier, French Prime Minister François Bayrou managed to pass a 2025 budget in February with relatively little pushback from Parliament. The budget aims to cut the deficit by EUR 139 billion versus 2023 to 5.4% of GDP. However, there is ongoing debate in France about the need to invest more in national defence. The government plans to double the annual defence budget from EUR 50.5 billion in 2025 to EUR 100 billion by 2030. Given France's public debt-to-GDP ratio of 109.5% at the end of 2024, there is limited scope to expand government borrowing. Instead, Finance Minister Eric Lombard is hoping to tap into life insurance plans and private retirement savings for investment in the defence industry. This would be achieved by creating dedicated investment buckets within life insurance and pension funds for investment in French defence companies.

Bond markets, especially in Germany, reacted immediately to the CDU/CSU and SPD proposal. Following the announcement, yields on longer-term German government bonds surged. Consequently, the yield curve for German Bunds has steepened: the spread between 2- and 10-year Bunds has widened from roughly 30 basis points (bps) at the start of 2025 to nearly 70 bps by early March.

We would not rule out the possibility of a further steepening of the yield curve. The **European Central Bank (ECB)** could contribute at the short end by further cutting interest rates, in light of the sharp decline in Eurozone inflation last year and weak economic growth. Market participants anticipate that the ECB could lower interest rates by another **50 bps to 2% by the end of the year.** However, the extent of the ECB's rate cuts will depend on actual inflation and growth data. At the long end of the curve, higher government borrowing – particularly in Germany – could drive long-term yields even higher.

Investors seeking higher returns than the 3% yielded by German Bunds will find opportunities in **euro-denominated corporate bonds.** In the portfolios managed by **ODDO BHF TRUST**, we focus on **investment-grade** corporate bonds, i.e. bonds issued by reputable companies with a credit rating of at least **BBB- (S&P, Fitch) or Baa (Moody's)**. Over the past two years, the corporate bond risk premium (the additional return that investors can expect to earn from higher-risk corporate bonds versus comparable duration government bonds) has declined steadily, leaving limited room for further narrowing. However, there is also little indication that this trend will reverse. Based on recently released corporate financial reports, we seen no reason to worry about widespread debt, and default rates remain moderate. Therefore, we still consider corporate bonds more attractive than government bonds and will continue to **capture the existing yield premium** in our portfolios.

Past performance, simulations, and forecasts are not indicative of future results.

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