5 December 2024

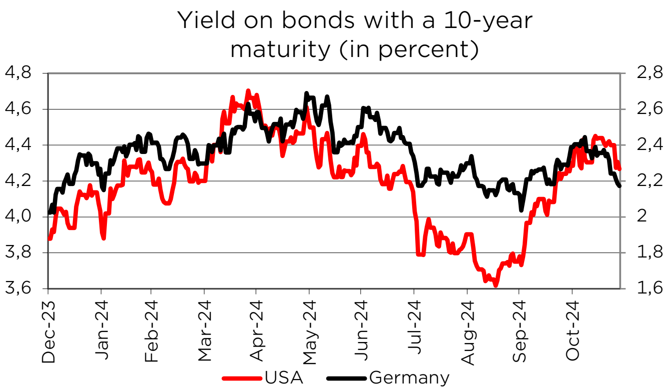
Outlook 2025 (II): Diverging monetary policy developments

In 2024, the bond markets were largely dominated by falling inflation, the start of the cycle of interest rate cuts, high volatility and the presidential election in the United States. Whether and which of these factors will continue to play a significant role on the bond markets in the coming year and how this will affect the development of the euro against the US dollar, among other things, can be read today in the second part of our annual outlook. You are also welcome to visit our YouTube channel, where you will find our annual outlook series in sound and vision.

https://www.youtube.com/mmwarburgco

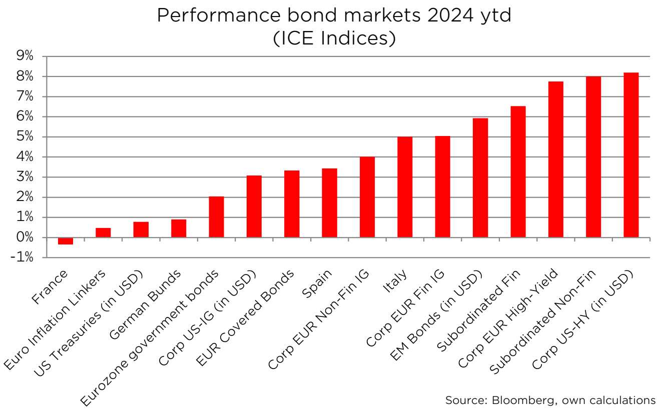
Looking back to 2024: falling key interest rates and Donald Trump

On the bond markets, 2024 was characterized by declining inflation, the start of the cycle of interest rate cuts, persistently high volatility and the presidential elections in the USA. Yields on 10-year German government bonds fluctuated within a range of around 70 basis points between 2.0% at the beginning of January and just under 2.7% at the end of May. The volatility of US Treasuries was even higher at over 100 basis points between 3.6% in mid-September and 4.7% at the end of April. However, there were also movements of 20 basis points and more on individual days. The reasons for these large movements can be quickly identified. On the one hand, capital market participants were wrong in their monetary policy assessments on several occasions, while on the other, the election campaign and the election of Donald Trump as president in the USA led to a significant rise in interest rates. In Germany, on the other hand, yields fell at the current margin due to the weak economic situation and the end of the traffic light coalition.



Source: Bloomberg, own calculations

In addition to the influencing factors already mentioned, the fact that yields actually rose slightly at the long end despite falling key interest rates and that the very good corporate results also led to a positive performance on the stock markets was also decisive for the performance on the bond markets. It is therefore not surprising that the performance of government bonds, which are dominated by interest rate risk, lagged significantly behind corporate bonds, which benefited from higher carry and spread developments. The good economic development in the USA and the absence of a noticeable recession in Europe meant that, as in the previous year, the riskier segments of the bond market such as high-yield and subordinated bonds performed best. Overall, money was made in all segments of the bond market with the exception of French government bonds.



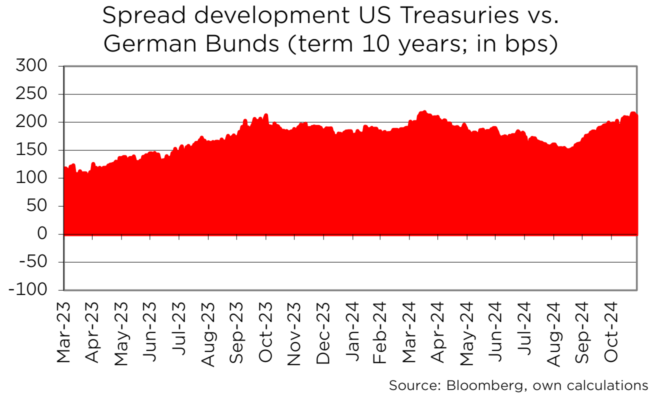
Outlook 2025: diverging developments

The coming year is likely to be characterized by diverging developments between the US and Europe in terms of the economy, monetary policy and bond yields. With the introduction of tariffs, tax cuts and infrastructure programs, Donald Trump will probably ensure that the US economy continues to grow significantly. Our growth forecast for 2025 is +2.6%, with Europe and especially Germany, the growth underperformer, struggling to achieve positive growth. However, there are no signs of a severe recession in Europe either.

Unlike in the past two years, inflation should no longer play the main role in 2025. We assume that overall inflation in both the USA and Europe will settle at around two percent. The only risk of an upward deviation is in the USA, where measures such as import tariffs could have a price-driving effect.

In our view, these developments will also mean that the US Federal Reserve, unlike the European Central Bank, will turn the key interest rate screw significantly less. We expect three key interest rate cuts of 25 basis points each in the US by the end of 2025, including one this year. In the eurozone, on the other hand, we expect at least five key interest rate cuts, one of which is likely to be decided in December.

The key interest rate cuts should be reflected above all in falling yields at the short end of the yield curves for US Treasuries and Bunds. This will lead to the yield curves “normalizing” again from the short end, i.e. becoming steeper. In the case of 10-year US Treasuries, risks such as import tariffs and debt expansion are likely to cause yields to move sideways at the current level with volatility in the coming year. We expect a value of 4.35% as at December 31, 2025. Ten-year German government bonds will benefit at least to a small extent from the greater extent of the key interest rate cuts, which is reflected in our expectation of a slight decline in yields to a year-end value of 1.85%. However, a complete decoupling from US yields is unlikely due to the high correlation. As a result of this forecast, the transatlantic spread will widen significantly, which should also have an impact on the US dollar. More on this later.

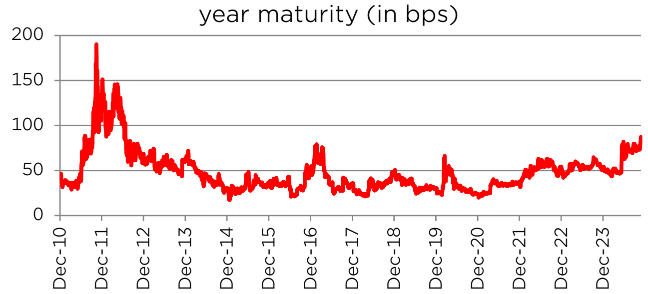


In terms of duration, at least a neutral position should be taken compared to the respective benchmark. We continue to recommend mapping duration via high-quality bonds. In both the US and the eurozone, we expect government bonds to achieve a positive performance in 2025. For 10-year US Treasuries and 10-year Bunds, this should be between 3.5% and 4.5% in local currency.

Government bonds: quality with long maturities and Southern Europe as an admixture

In the European government bond segment, we will continue to focus primarily on long maturities with high quality in 2025, as in the current year. In addition to pure government bonds, supranationals and national development banks or government financing vehicles are also suitable here. In this way, a yield premium can be achieved over government bonds with almost the same quality. Covered bonds from core Europe can also be used as a substitute with a yield premium. In duration management, these quality securities with long maturities and yields as well as current yields of 2.5 to 3.0% play a key role. As a further important component of a European government bond portfolio, we recommend including issues from Southern Europe in addition to those from core Europe. We expect government bonds from Italy and Croatia, among others, to continue their relative outperformance compared to core Europe in 2025.

Yield difference government bonds France vs. German government bonds with 10-year maturity (in bps)



Source: Bloomberg, own calculations

French government bonds are very attractive from a yield perspective, as the credit spread against German government bonds has widened to its highest level since August 2012 at over 85 basis points. However, due to the political uncertainties in France, the pressure on credit spreads is currently continuing. Until there are signs of political easing in Paris, we advise caution.

Corporate bonds: falling inflation, falling key interest rates ¬ rising yields

Having already advised an overweighting of credit risks in the current year, we are sticking to this recommendation for the coming year. Above all, the further decline in inflation, the noticeable cuts in key interest rates, but also the good corporate results and the absence of a recession should lead to a positive development in corporate bonds. We will continue to focus our bond allocation on investment-grade corporate bonds in the coming year. In contrast to the current year, however, we are somewhat bolder and recommend slightly increasing the allocation to riskier segments such as high yield and subordinated bonds. In the subordinated bond segment, we are focusing on strong issuers from the investment grade universe. Due to the complexity of the bond terms and conditions, we mainly use fund vehicles in this segment rather than individual securities. Due to Donald Trump's election victory, we also recommend an allocation to the US high-yield segment. The measures planned by Trump (including deregulation, expansion of oil production) should have a positive impact here in particular. Due to the size of the US high-yield market, we also recommend focusing on fund solutions here.

Based on our expectation of falling key interest rates and a slight narrowing of spreads over the course of the year, we anticipate a performance of around 5% for investment-grade corporate bonds. Performance in the subordinated and high-yield segment should reach 6.0% to 7.5%. Current income should be the main performance component in all segments.

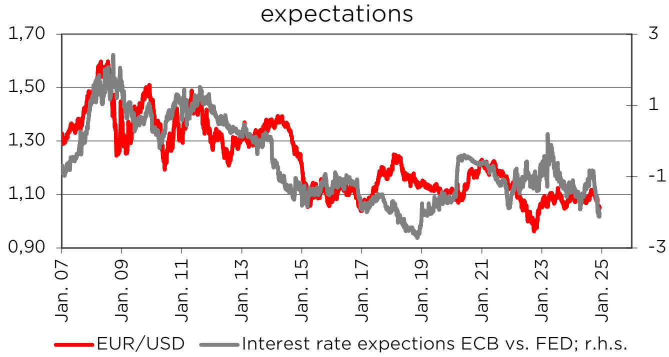
Alternative investment idea: Cat bonds

As in the previous year, we recommend adding alternatives to the traditional bond segments in this outlook. For us, these will once again be catastrophe bonds (cat bonds) in the coming year. The charm of cat bonds lies above all in the fact that they develop largely uncorrelated to the traditional bond market. In the current year, cat bonds benefited above all from the fact that the damage caused by the hurricanes was significantly lower than forecast. At around eleven percent, the performance in this segment was well above that of all traditional bond segments. Experts are also forecasting double-digit percentage growth in value for the coming year. Due to its complexity, this segment should also be covered by a fund solution.

Currencies: (Interest rate) advantage US dollar

The US dollar should be able to benefit from an increasing interest rate advantage over the euro in the coming year. We expect at least five interest rate cuts by the European Central Bank, but only three by the US Federal Reserve. The stronger US economy should also support the greenback in 2025. Under the Trump administration, we expect a volatile appreciation up to parity. The risk to this forecast is on the upside if Trump's economic policy does not boost inflation in the US as much as expected. In this case, the US dollar could appreciate less strongly against the euro.

EUR/USD exchange rate and interest rate expectations

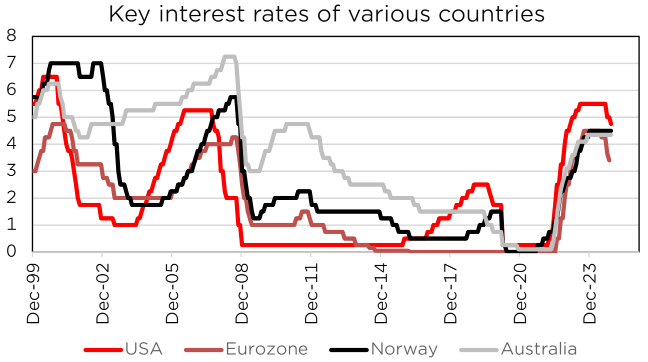


Source: Refinitiv Datastream

In addition to the US dollar, there are other currencies that appear interesting with a view to 2025. Again, the reason is the interest rate advantage and the different central bank policies. The Norwegian central bank has left its key interest rate unchanged this year and is only expected to cut interest rates by a total of 50 basis points in the coming year. Together with a stable oil price, this interest rate advantage should support the krona next year, so that the short-term yields of around 4.5% appear comparatively attractive compared to 2.0% to 2.5% for German government bonds.

The Australian central bank also raised its key interest rate to 4.35% in November 2023 and has paused since then. Although the inflation rate has fallen significantly since peaking at over seven percent in 2022, at 3.4 percent it is still well above the target value of 2.5 percent. Even though the labor market has shown initial signs of cooling in recent months (which tends to lead to falling inflation rates), wage growth remains so high at 4.1% that the upward pressure on the inflation rate is likely to continue. This should also prevent a significantly more expansive course by the central bank and thus interest rate cuts. The yield curve for Australian government bonds is inverted in the short term and rises from the second year to maturity. Again, an investment in the short term is recommended.

Key interest rates of various countries



Source: Refinitiv Datastream

Market data

Stock marktes	As of 06.12.2024 09:47	Change versus 29.11.2024 -1 week	05.11.2024 -1 month	05.09.2024 -3 months	05.12.2023 -1 year	29.12.2023 YTD
Dow Jones	44766	-0,3%	6,0%	9,8%	23,9%	18,8%
S&P 500	6088	0,9%	5,3%	10,6%	33,3%	27,6%
Nasdaq	19701	2,5%	6,8%	15,0%	38,4%	31,2%
DAX	20361	3,7%	5,7%	9,6%	23,2%	21,5%
MDAX	27250	3,5%	2,6%	7,5%	2,9%	0,4%
TecDAX	3514	2,5%	5,3%	7,5%	9,8%	5,3%
EuroStoxx 50	4952	3,1%	1,7%	2,8%	11,2%	9,5%
Stoxx 50	4403	1,7%	1,6%	-0,2%	9,1%	7,6%
SMI (Swiss Market Index)	11765	0,0%	-0,9%	-2,2%	7,3%	5,6%
Nikkei 225	39091	2,3%	1,6%	6,6%	19,3%	16,8%
Brasilien BOVESPA	127858	1,7%	-2,1%	-6,3%	0,8%	-4,7%
Indien BSE 30	81701	2,4%	2,8%	-0,6%	17,9%	13,1%
China CSI 300	3973	1,4%	-1,8%	22,0%	17,1%	15,8%
MSCI Welt	3848	1,0%	4,2%	7,9%	27,3%	21,4%
MSCI Emerging Markets	1102	2,2%	-3,2%	2,4%	13,4%	7,7%
Bond markets						
Bund-Future	134,47	-31	302	-5	-6	-275
Bobl-Future	119,51	-34	150	151	93	23
Schatz-Future	106,92	-15	41	58	119	38
3 Monats Euribor	2,88	-6	-18	-59	-108	-103
3M Euribor Future, Dec 2024	2,83	3	-2	-19	28	53
3 Monats $ Libor	4,46	-12	-18	-69	-99	-94
Fed Funds Future, Dec 2024	4,51	0	0	5	39	67
10 year US Treasuries	4,19	-1	-10	46	1	32
10 year Bunds	2,11	2	-33	-4	-10	11
10 year JGB	1,05	1	12	17	37	43
10 year Swiss Government	0,23	-1	-21	-24	-49	-47
US Treas 10Y Performance	608,14	0,2%	1,2%	-2,5%	4,0%	1,2%
Bund 10Y Performance	576,15	-0,1%	3,0%	1,5%	3,8%	1,9%
REX Performance Index	458,23	0,3%	2,1%	1,3%	3,6%	2,3%
IBOXX AA, €	2,84	-2	-30	-28	-50	-23
IBOXX BBB, €	3,29	-3	-32	-35	-82	-47
ML US High Yield	7,30	-6	-22	-20	-111	-49
Commodities						
MG Base Metal Index	420,04	1,3%	-3,5%	4,2%	12,6%	7,5%
Crude oil Brent	72,09	-1,5%	-5,3%	-1,6%	-6,7%	-7,2%
Gold	2643,23	-0,6%	-3,6%	5,4%	31,1%	28,0%
Silver	31,20	3,8%	-4,4%	8,6%	29,8%	28,7%
Aluminium	2610,73	1,3%	-0,5%	10,6%	23,1%	11,3%
Copper	8961,83	0,8%	-6,6%	-0,2%	8,6%	5,9%
Iron ore	106,29	3,8%	1,1%	16,4%	-18,7%	-22,1%
Freight rates Baltic Dry Index	1160	-14,3%	-17,4%	-39,6%	-63,1%	-44,6%
Currencies						
EUR/ USD	1,0578	0,2%	-2,9%	-4,7%	-2,2%	-4,3%
EUR/ GBP	0,8287	-0,3%	-1,2%	-1,6%	-3,3%	-4,4%
EUR/ JPY	159,03	0,2%	-4,2%	-0,1%	-0,1%	1,7%
EUR/ CHF	0,9297	-0,1%	-1,1%	-1,0%	-1,7%	0,4%
USD/ CNY	7,2635	0,2%	2,1%	2,4%	1,6%	2,2%
USD/ JPY	150,11	0,2%	-1,0%	4,6%	2,0%	6,4%
USD/ GBP	0,78	-0,4%	1,9%	3,1%	-1,1%	-0,1%

Source: Refinitiv Datastream

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