

INTEREST RATE OUTLOOK | EUROZONE, USA

# Markets under the spell of US trade policy

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## Monetary policy in times of uncertainty

Capital market participants expect further interest rate cuts in both the Eurozone and the US this year. We expect two interest rate cuts of 0.25% each by the US Federal Reserve and one interest rate cut by the ECB. In the US, the still strong labor market weakened somewhat over the course of last year and GDP growth in 1Q25 was negative at -0.3% q/q annualized, due to massively front-loaded imports before the introduction of the US tariff regime. The new US tariffs had cast their long shadow ahead and the preliminary escalation peak was reached after the announcement of reciprocal tariffs on "Liberation Day" at the beginning of April. Strong distortions on the global capital markets ultimately acted as a corrective for US President Trump's trade policy agenda, and so the enormously high reciprocal tariffs were suspended again for 90 days after a few days and reduced to a level of 10% grosso modo. During this period, the US administration intends to conclude trade agreements or at least framework agreements with its most important partners, such as with the UK and China. As in the US, the Eurozone economy can also tolerate a less restrictive monetary policy, as the new US tariff regime will take its toll on the economy and the German economic stimulus package and Eurozone-wide defense spending, including second-round effects, have yet to take effect. What both central banks have in common is that an annual inflation rate of two percent is the target, or one of them (the US also has full employment as a target). The latest inflation data on both sides of the Atlantic showed encouraging downward trends, which will gradually increase the central banks' future room for maneuver. In the US, however, a significant, tariff-induced rise in inflation is to be expected at the same time, which will make it more difficult for the Fed to lower key interest rates, as this could additionally fuel rising overall inflation. Consequently, the Fed must succeed in separating tariff-induced inflation from general inflation as precisely as possible in order to be able to argue for key interest rate cuts in a phase of rising overall inflation. In addition, the expected duration of the tariff-induced effect should be short and the underlying inflation rate should be close to the inflation target of 2%.

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As always, in this interest rate outlook, we present our expectations for both central banks, the ECB and the US Fed, as well as for the respective government bond markets. We also focus on the economic policy issue of government debt. This has returned to the spotlight, due to the tense fiscal situation, both in the US in the wake of the US tariff announcement on Liberation Day at the beginning of April and the associated turmoil on the capital markets, as well as in the Eurozone, due to rising defense spending and the German infrastructure program.

Note: Information on past performance is not a reliable indicator of future performance.

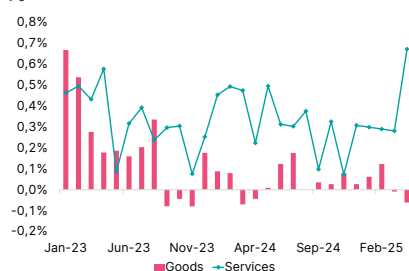
## Eurozone - ECB switches to crisis mode

The ECB is very likely to cut its key interest rates by a further 25 basis points (bp) in June. This should bring the deposit rate down to 2.0%. According to the ECB, the disinflationary process is still on track. Inflation has developed in line with the expectations of ECB economists and should therefore reach the target value of 2%. In contrast, the downside risks for the economy have also increased significantly from the ECB's perspective. The trade conflict is having a tightening effect on financial conditions and is dampening the confidence of households and companies. The ECB expects US tariffs to have a negative effect on export growth. Investment and consumption growth may also suffer from the trade conflict.

Furthermore, the ECB no longer announced any assessment of the degree of its monetary policy orientation. President Lagarde has pointed out that monitoring the direction of monetary policy in relation to the "neutral interest rate" would only be possible in a "shock-free" world. However, the shock of the US tariff conflict is currently having an impact on the global economy. The ECB is therefore focusing on two factors for its further course of action. Firstly, "readiness", in the sense of increased attention to all developments in order to arrive at an appropriate monetary policy assessment. Secondly, "agility", which is intended to emphasize that the ECB will react quickly to changing data. The ECB switched into "crisis mode", so to speak, in April. Against this backdrop, the uncertainty surrounding the outlook for the ECB's interest rate path has increased significantly.

We assume that the US tariffs will have a dampening effect on the Eurozone economy in 2025 and 2026. The ECB economists' current forecasts do not yet take into account the negative consequences of the escalated tariff conflict. We therefore expect the growth forecasts for 2025 (currently 1.1%) and 2026 (currently 1.4%) to be lowered with the updated forecasts in June. However, the likely dampening effects of the tariff conflict will be offset by measures to strengthen the economy, such as the German special fund of EUR 500bn and the "Readiness 2030" package at the EU level. The economy is also benefiting from the fact that the restrictive effect of monetary policy has eased noticeably following the ECB's significant interest rate cuts. As a result, financing costs for companies and households have fallen and credit growth has already accelerated.

Inflation services and goods, m/m in %



Source: ECB, Erste Group Research

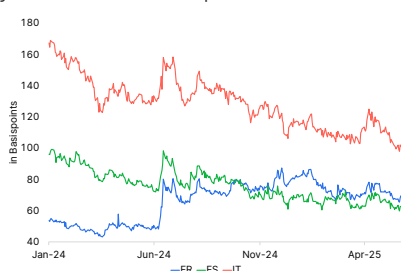
The latest inflation data was mixed. After a strong downward trend in March, service provider inflation rose sharply to 3.9% y/y in April. An unusually strong acceleration in service provider inflation was also observed on a monthly basis. According to our analysis of the data, this acceleration is due to the shift in the Easter vacations between March and April. As a result, a noticeable decline in inflation momentum for services is likely in May. However, overall inflation stabilized at 2.2% y/y, thanks to strong downward pressure from energy prices. Persistently low energy prices should continue to have a dampening effect on inflation in the coming months. Important leading indicators for services inflation, such as wage growth, continue to decline. As a result, we and the ECB are confident that the rate of increase in service prices will continue to fall over the rest of the year. Specifically, wage growth declined further in 4Q24 to 4.1% y/y. The ECB is currently forecasting a

further slowdown in momentum to 3.8% and 3.7% in 1Q25 and 2Q25, respectively. Based on current developments, this expected path appears to be realistic or rather conservative.

We believe that the ECB Governing Council should have put a temporary end to interest rate cuts at a deposit rate of 2%. Now that the situation in the customs conflict has eased, we believe that the downside risks to the economic outlook have receded. The focus will now be on reliable economic data over the coming months. Only on the basis of this will it be possible to assess the extent to which the customs dispute is actually weighing on the economy. In this highly uncertain environment, the downside risks for the interest rate outlook have increased noticeably. If economic data deteriorates unexpectedly sharply due to the customs dispute, the ECB could lower the deposit rate to below 2%.

The special fund of EUR 500bn adopted in Germany in March and the massive increase in military spending at the EU level due to the Ukraine-Russia conflict and NATO realignment led to a peak rise in 10-year Bund yields to almost 3%. This is because higher economic expectations could also cause inflation to rise somewhat in the medium term and rising debt also means a greater supply of German government bonds. German government bonds, however, are currently caught between weaker US forecasts and expectations, which will also be felt in the global economy, and positive expectations from the planned fiscal stimulus in the Eurozone. At 2.6%, the yield on the 10-year German government bond is now in the middle of this year's yield range. We expect a period of consolidation close to current levels in the coming months. The US tariff conflict with the EU and other trading partners and the break-up of the transatlantic alliance will continue to dominate the risk landscape and could make for a volatile market.

Risk premiums to Germany, 10-year term in basis points



Source: refinitiv, Erste Group Research

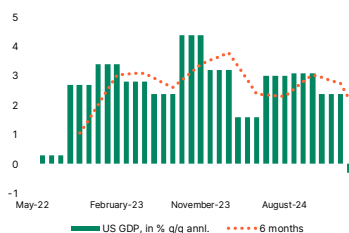
Spreads on Eurozone government bond markets have been falling since the beginning of the year. The rapid formation of a government in Germany following the elections in February, the breakdown in transatlantic relations with the US and escalation in the customs dispute have changed investors' political concerns. In addition, calm has returned to the French political scene for the time being under Prime Minister Bayrou, as a result of which France's spreads have narrowed noticeably over the course of the year. The risk premiums on Spanish and Italian government bonds have also narrowed slightly since the beginning of the year.

## USA - Back to mercantilism

At the meeting of the Federal Open Market Committee (FOMC), the body of the US Federal Reserve that decides on interest rates, which ended at the beginning of May, key interest rates were not changed. The upper limit of the federal funds target rate therefore remains at 4.50%. The FOMC noted that the economic outlook was solid despite strong movements in net exports (a massive increase in imports prior to the US tariff imposition, which had a strong negative impact on the 1Q25 US gross domestic product data of an annualized -0.3% q/q). However, the uncertainty of the economic outlook has

increased further. The inflation rate is still characterized as somewhat elevated. The risks of achieving the dual mandate of the inflation target and the full employment target will be closely monitored by the FOMC and it was explicitly stated that the risks of higher unemployment and rising inflation have increased. Fed Chairman Powell generally sees inflation developing well and, above all, stable longer-term expectations, which are also consistent with the 2% inflation target. On the subject of tariffs, Chairman Powell said that they are higher than expected and their final form is highly uncertain, making it impossible to say at present what the appropriate monetary policy response would be. Powell sees the current monetary policy status as still restrictive and the FOMC not in a hurry to change its monetary policy stance immediately under the current economic conditions.

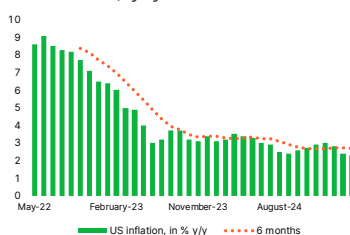
US GDP, q/q in % annualized



Source: U.S. Bureau of Economic Analysis, Erste Group Research

We believe that the US Federal Reserve will be able to separate general inflation from tariff-induced inflation well, especially with lower tariffs, and will adopt a somewhat less restrictive monetary policy stance in the second half of 2025, which should lead to two key interest rate cuts in September and December. On the growth side, we expect the US to escape a recession, i.e. two consecutive quarters of negative growth, as private consumption and corporate investment will remain weak, but will not come to a complete standstill. We expect GDP growth of 1.4% for the full years 2025 and 2026. Although both headline and core inflation have moved towards 2% in recent months, we believe that the import tariffs implemented at the beginning of April will provide significant additional upward pressure on prices, so that, even given the declining price increases in housing costs, which are so important for the basket of goods, we expect inflation to reach 3.3% this year and 2.6% in the following year. US yields have risen sharply in connection with the reciprocal US tariffs. Investors did not feel adequately compensated for the potential risks arising from the trade war. Trump added fuel to the fire with his attacks on Fed Chair Powell. A prolonged crisis of confidence in the US affecting all US investments, including US government bonds, cannot be ruled out, but is not our base case scenario. In our view, US government bonds could be in greater demand again after the current consolidation in the upper third of this year's trading range, although Trump's erratic policies and rising issue volumes could form a counterbalance.

US inflation, y/y in %



Source: U.S. Bureau of Labor Statistics, Erste Group Research

As Donald Trump's second term in office as US president continues, it is becoming increasingly clear that the course towards a modern form of mercantilism from Trump's first term is intensifying. Traditional mercantilism is a 16th to 18th century economic doctrine that focused on the accumulation of wealth through export surpluses, protective tariffs and colonial control. Its modern version manifests itself in the form of economic nationalism, strategic protectionism and a reassertion of state power in the control of trade and industry.

The US government argues that it will revitalize American industry, reduce strategic vulnerabilities and protect jobs that have been eroded by decades of globalization. By protecting domestic production from foreign competition, the US government continues, the US could rebuild its manufacturing base and regain its economic independence.

However, the chronic trade deficits of the US are linked to the dollar as the world's reserve currency. This meant that there was a constant demand for

## Conceptual weaknesses of modern mercantilism

the dollar, which prevented the exchange rate from adjusting to the deterioration in the trade balance. As a result, exports remained relatively expensive and imports relatively cheap. This also enabled the US to live beyond its means for decades, as evidenced by the constant rise in foreign debt. In order to balance the trade and current accounts, the US would either have to reduce its imports or increase its exports. With a fully utilized labor market, this can only be achieved at the expense of domestic demand. Furthermore, it is by no means trivial to convert a considerable part of an economy from services to industry. This is made even more difficult by a still strong labor market and the increasingly dynamic deportations and entry controls. Less immigration and a falling birth rate will in themselves result in lower economic growth.

Other conceptual weaknesses of US economic policy include rising prices due to tariffs for consumers and companies that rely on foreign inputs. Trade wars can provoke retaliatory measures by other countries that harm American exporters. Economic nationalism can reduce the efficiency of global supply chains, slow innovation and discourage foreign investment, while protectionism in itself keeps uncompetitive producers alive. Moreover, a weakened commitment to international institutions could undermine the US' ability to shape global economic rules, ceding influence to competitors like China.

Trump's second term in office has so far been characterized by the United States' shift towards modern mercantilism, which may lead to short-term gains for individual sectors in the US. Overall, however, US economic policy means higher prices, lower growth, loss of confidence, tense alliances and a weakened global leadership role.

## Focus - Sustainability of US and Eurozone government debt

The recent turmoil on the capital markets following the US tariff hammer on Liberation Day declared by US President Trump was testimony to the fact that the markets intervene as a corrective in the event of massively damaging fiscal policy. This has recently been accompanied by a loss of market confidence in the United States. While the usual market reaction to crises was to buy US government bonds (and the US dollar), which drove yields down, there was the exact opposite, very strong market reaction on and after Liberation Day. It became clear that there is not endless confidence in the US, which was also confirmed by the downgrading of the US credit rating by rating agency Moody's in mid-May this year. We shed light on the trend towards constantly growing government debt in the Eurozone and US and conclude with our assessment of debt sustainability.

### Eurozone - France in focus with regard to long-term debt sustainability

#### France in focus of financial markets

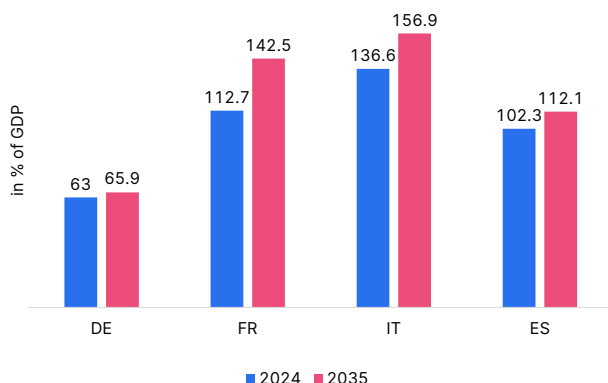
In terms of debt sustainability, France is particularly in focus among the large Eurozone countries due to a combination of a high government debt ratio (113% of GDP) and an unexpectedly high deficit in 2024 (around 6% of GDP). This is compounded by unstable political conditions, which make it difficult to

credibly consolidate the national budget. The French government plans to reduce the deficit slightly to just under 6% of GDP in the current year. In order to consolidate the national budget quickly, France would have to cut its generous social benefits compared to other countries, but this does not appear to be politically feasible. Against this backdrop, France would need an increase in growth momentum in the coming years in order to be able to significantly reduce its deficit and debt ratio. Rating agencies have already reacted to France's budgetary problems in recent months by downgrading its ratings. However, thanks to its significantly better demographic profile, France has a not inconsiderable advantage in terms of long-term growth prospects compared to Germany, Italy and Spain.

No increased risks to fiscal stability in short term

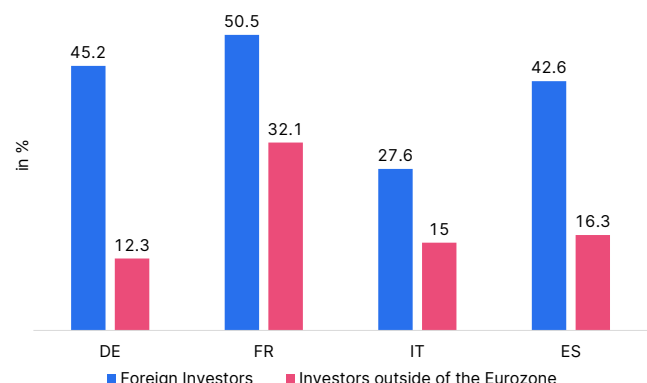
Based on data up to 2024, the European Commission does not see any increased risks to the sustainability of fiscal stability in the short term for Germany, France, Italy or Spain. However, the situation is viewed much more critically in relative terms for France and Italy than for Spain and Germany. The fiscal stability of some countries (including France, Italy, Spain and Austria) has also deteriorated somewhat compared to 2023, due to current deficits that are still too high and government debt that is too high. France (22% of GDP) and Italy (25% of GDP) continue to have excessive gross financing requirements, which inevitably results from a relatively high government debt ratio. The countries' gross financing requirements should fall to 16% of GDP in the medium term.

**Strongest increase expected in France**  
Public debt as % of GDP 2024 vs. 2035



Source: European Commission, Erste Group Research

**Highest share in France**  
Debt to foreign investors, 2024



Source: European Commission, Erste Group Research

Over a medium-term horizon, however, the European Commission sees considerable risks to the sustainability of public finances in France, Italy and Spain. Based on underlying assumptions regarding growth and financing costs, the Commission assumes a significant increase in the public debt ratio for all three countries by 2035. The most significant increase is forecast for France from the current 113% to 143%, for Italy from 137% to 157% and for Spain the smallest change from 102% to 112%. The main drivers for the forecast increases are a rising share of interest costs and the costs of an ageing population. The Commission expects interest costs as a percentage of GDP to double on average in the EU countries by 2035.

The main reason for the expected sharp rise in France's debt ratio in the coming years is the problematic starting point of a high deficit of 6% of GDP. In contrast, Italy and Spain's problems lie in increased social spending due to an ageing population. However, from a demographic perspective, the ratio of working-age to retired population should not deteriorate any further in many European countries from 2035 onwards.

In the short term, France, Spain and Italy perform differently on risk parameters such as the proportion of short-term debt (the lower the better), the average maturity of bonds issued (the longer the better) and the proportion of bonds held by foreign investors (the lower the better). France, for example, is highly short-term financed and vulnerable, as 51% of government bonds are held by foreign investors. This in turn is a strength of Italy, where the proportion is only 28%. However, Italy performs poorly due to a comparatively high proportion of short-term debt at 13%.

However, political conditions also play a key role in assessing the debt sustainability of Eurozone countries. Unstable political conditions and governments that deliberately refuse to consolidate public finances can cause a significant widening of risk premiums in individual countries at any time. Against this backdrop, France poses the greatest risks in 2025. New elections may be held as early as the summer. This could cause uncertainty on the financial markets, which could cause risk premiums on French government bonds to rise again. In contrast, the political situation in Spain and Italy is currently comparatively stable.

## **US - Long-term debt development forecast not sustainable ceteris paribus**

At the press conference following the Fed meeting in May, Fed Chairman Powell put it in a nutshell: the development of the US national debt is not sustainable in the long term, but the level is. The trajectory of US government debt as set out in the Congressional Budget Office's (CBO) Budget and Economic Outlook of January 2025, which assumes that current laws will apply for the next 30 years, is unsustainable in the long term. This is due to persistent structural budget deficits, rising interest costs and demographically driven increases in social benefits. These factors are likely to outstrip economic growth and tax revenues and lead to a steady increase in debt in relation to GDP.

The CBO's projections show that, according to the US report (~net debt), which we will follow in this article, the national debt will rise from 98% of GDP in 2025 to 118% in 2035 and climb further to 156% by 2055. The standard international measure, gross public debt, is 123% of GDP for the US in 2025, rising to 169% of GDP by 2055. The forecasts are based on fundamental trends that show no signs of reversal. Debt growth, measured by US convention, exceeds the post-World War II peak of 106% in 2029 and continues without stabilization. Debt growing faster than the economy is the core definition of an unsustainable fiscal path. Such a level of debt, especially if not caused by one-off emergencies such as wars or financial crises, poses a

Increase in US net debt to 156% of GDP over 30 years

long-term risk to economic stability, investor confidence and fiscal sovereignty.

A federal deficit of over 6% of GDP is expected for the 2025 financial year. Over the next ten years (2025-35), annual deficits are never expected to fall below 5% of GDP. These are not temporary deficits, but chronic gaps between revenue and expenditure. The main causes of this imbalance include projected growth in social programs (Social Security and Medicare), rising interest costs and tax revenues that are insufficient to keep pace with spending trends, especially if the tax cuts from the Tax Cuts and Jobs Act (TCJA) of 2017 are extended without offsetting measures. The rating agency Moody's, which lowered the US credit rating to Aa1 from Aaa in mid-May of this year, assumes in its simulation that, taking into account the extension of the TCJA for 2035, the deficit will be 9% and the debt-to-GDP ratio 134%. According to Moody's, the latter would rise almost twice as fast as in the CBO's baseline scenario. Perhaps the most alarming fiscal trend, however, is the projected growth in interest payments. In 2025, the US government is expected to spend USD 952bn on net interest payments. By 2035, this amount will double and account for 4.1% of GDP. Interest costs are projected to reach 5.4% of GDP by 2055, due to higher debt and increased interest rates. This rapidly growing category of government spending limits the flexibility to invest in infrastructure and education and to respond to economic shocks. The danger here lies in a debt spiral in which growing debt leads to rising interest payments, which in turn contribute to even higher deficits and further borrowing. This compound interest effect restricts fiscal policy options and harbors the risk of a crisis of confidence.

Social Security and Medicare are main drivers of spending growth

Social Security and Medicare spending is the main driver of long-term spending growth and will account for more than half of all non-interest spending in 10 years. This reflects the ageing of the Baby Boomer generation and rising healthcare costs. By 2035, the number of Americans aged 65 and older will rise significantly, increasing the number of beneficiaries of social programs. At the same time, the number of working-age contributors is growing more slowly, reducing the tax base per beneficiary. Reforms to social programs, such as raising the retirement age, changing benefit formulas or increasing Medicare cost-sharing, will most likely be necessary to stabilize long-term debt. The projections assume that many tax provisions of the TCJA will expire as scheduled in 2025, which will increase projected revenues. However, should these provisions be extended, which is currently on US President Trump's policy agenda, revenues would fall by around 1% of GDP annually.

Fiscal adjustments necessary to avoid an era of limited scope for action

If the US continues its current fiscal policy course, several risks could materialize. If the capital markets doubt the US government's confidence in its fiscal commitments, borrowing costs could soar and debt dynamics could tighten, which in turn would curb private investment and slow economic growth. Rising debt service obligations would reduce the government's ability to respond to recessions, pandemics, or military conflicts. Younger Americans could face higher taxes and fewer public services in the future to pay for today's debt. The Budget and Economic Outlook makes clear that the US is on a debt path that is growing faster than the economy, failing to stabilize and crowding out national priorities. Fiscal measures in the form of a combination of revenue increases, benefit reforms and fiscal discipline are needed to



correct the unsustainable long-term debt trajectory of the US. Without credible policy changes, of which there is currently no sign, the government risks entering an era of limited options and increased economic vulnerability, especially if interest payments begin to strain the budget and the accumulation of debt undermines US economic strength.

Market confidence could also be shaken if the suspicion were to arise that the debt problem was to be solved by means of inflation. This would manifest itself in constantly and significantly rising yields on US government bonds, as would doubts about the independence of the US Federal Reserve - its chairman or the Federal Open Market Committee (FOMC), which decides on interest rates.

## Forecasts<sup>1</sup>

GDP	2023	2024	2025	2026
<b>Eurozone</b>	0.4	0.9	0.5	0.9
<b>US</b>	2.9	2.8	1.4	1.4

Inflation	2023	2024	2025	2026
<b>Eurozone</b>	5.5	2.4	2.0	2.1
<b>US</b>	4.1	3.0	3.3	2.6

Interest rates	current	Sep.25	Dec.25	Mar.26	Jun.26
<b>ECB MRR</b>	2.40	2.15	2.15	2.15	2.15
<b>ECB Deposit Rate</b>	2.25	2.00	2.00	2.00	2.00
<b>3M Euribor</b>	2.01	1.98	1.99	2.01	2.02
<b>Germany Govt. 2Y</b>	1.80	2.00	2.00	2.00	2.00
<b>Germany Govt. 5Y</b>	2.10	2.10	2.10	2.10	2.10
<b>Germany Govt. 10Y</b>	2.54	2.50	2.50	2.50	2.50
<b>Swap 10Y</b>	2.51	2.60	2.70	2.70	2.70

Interest rates	current	Sep.25	Dec.25	Mar.26	Jun.26
<b>Fed Funds Target Rate*</b>	4.33	4.13	3.88	3.63	3.38
<b>3M SOFR</b>	4.33	4.08	3.83	3.58	3.33
<b>US Govt. 2Y</b>	3.96	3.90	3.70	3.50	3.30
<b>US Govt. 5Y</b>	4.04	3.94	3.75	3.63	3.60
<b>US Govt. 10Y</b>	4.45	4.30	4.20	4.20	4.20
<b>EURUSD</b>	1.13	1.15	1.16	1.17	1.17

\*Mid of target range

Prices from May 28, 2025

Source: Market data provider, Erste Group Research

<sup>1</sup> Regulatory requirements oblige us to point out the following: Forecasts are not a reliable indicator of future performance.

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Published by:

Erste Group Bank AG  
Group Research  
1100 Vienna, Austria, Am Belvedere 1  
Head Office: Wien  
Commercial Register No: FN 33209m  
Commercial Court of Vienna

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