Flash Economics

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Bond markets overreacted to the risk of recession in the United States and the risk of a public deficit in the euro zone

The recent fall in long-term interest rates in the United States (from 4.80% on 14 January 2025 to 4.19% on 7 April 2025) is linked to the expectation that the United States could fall into recession. But while most of the leading economic indicators point to weaker growth in the US in 2025 than in 2024, they do not yet point to a recession. Moreover, inflation remains fairly high and the public deficit is very high: we therefore expect long-term interest rates in the US to correct upwards from their low point at the beginning of April 2025 (4.00%).

In the eurozone, the recent rise in long-term interest rates (for Germany's 10-year rate from 2.08% at the end of November 2024 to 2.37% at the beginning of February 2025 and to 2.64 on 7 April 2025) is linked to the prospect of a rising public deficit, mainly due to increased military spending. In 2024, Germany spent 2.1% of GDP on defence, France 2% of GDP, Italy 1.5% of GDP and Spain 1.3% of GDP. Germany had a public deficit of 2.5% of GDP in 2024, France 5.8% of GDP, Italy 3.4% of GDP and Spain 3% of GDP. The new budgetary rules allow Germany to have a public deficit of 1.5 points of GDP, if it is due to military spending, above the deficit authorised (by the debt brake) of 0.35% of GDP. France must continue to reduce its public deficit (target for 2025, 5.4% of GDP); Spain plans to increase its military spending significantly (from 1.3% of GDP in 2024 to 2% of GDP before 2029); Italy has a target of increasing its military spending to 2% of GDP in 2028, but all the indications are that this target will be missed. All in all, the eurozone's public deficit will be only marginally affected by the new budgetary rules on military spending.

Furthermore, the ECB will continue to cut interest rates, and growth will remain weak: a downward correction in long-term interest rates in Germany (and the eurozone) from the high point of 2.89% in mid-March 2025 (12 March) is highly likely.

Following Donald Trump's announcement of the introduction of tariffs, there was a downward correction in all long-term interest rates. The fact remains that the risk of recession in the United States and the risk of a public deficit in Europe are still overvalued by the bond markets.

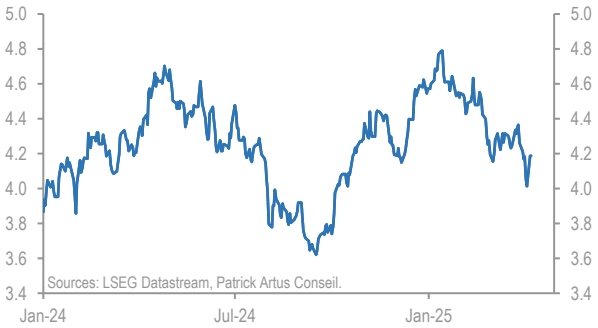
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In the United States, an exaggerated fall in long-term interest rates

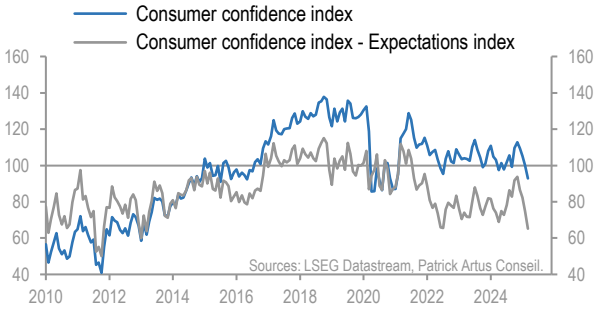
The 10-year interest rate on government debt fell from 4.80% on 14 January 2025 to 4.16% on 3 March 2025. Since then, it has risen slightly (to 4.32% on 9 March 2025) and fallen again after Donald Trump announced tariffs (to 4.00% on 4 April 2025) and rose to 4.19% on 7 April 2025, **Chart 1**.

Chart 1
United States: Interest rate on 10-year government bonds (as %)



This fall in the long-term interest rate in the United States is due to **the expectation that the policies pursued by the Trump administration** (tariffs, deportation of immigrants, cuts in the resources of federal agencies and universities) **will plunge the United States into recession**. It is true that consumer confidence and its Expectation Index measured by the Conference Board have fallen (**Chart 2**).

Chart 2
United States: Consumer confidence index and consumer confidence index - Expectations index (Conference Board, 1985 = 100)



But we can see:

- **That the Conference Board's leading indicator** is lower than in 2018-2019, 2022-2024 but is still higher than in any year between 2000 and 2016 (**Chart 3**).

Chart 3
United States : Conference Board leading economic indicators index (2016 = 100)



- That the **PMI and ISM still show an upward outlook for production in manufacturing** in the services sector. The manufacturing data are fairly consistent with stable activity in industry. (**Charts 4A/B**).

Chart 4A
United States: Manufacturing and services PMI (indices)

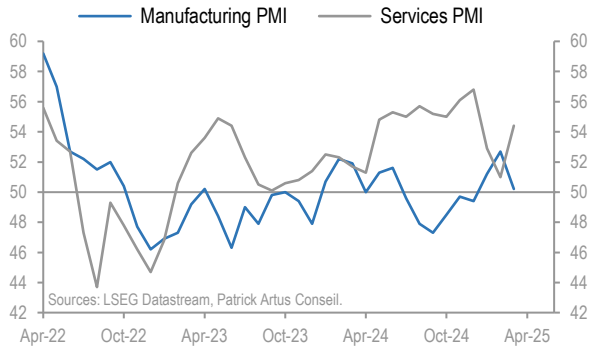
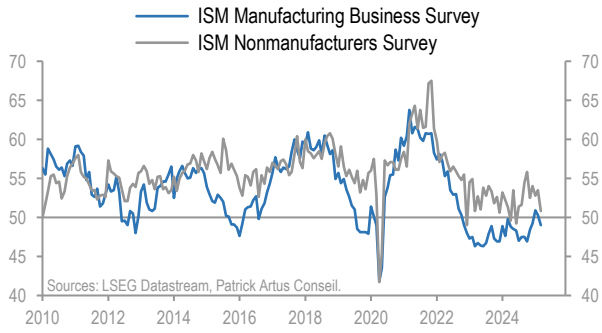


Chart 4B
United States: Manufacturing and Nonmanufacturers PMI (indices)



The most likely outcome is that there will be no recession in the United States, but simply a slowdown in activity. Moreover, **inflation remains high** (3.1% for inflation excluding energy and food in February 2025) **and will most likely be increased by tariffs. The trend in the public deficit is very high** ($1.1 trillion between October 2024 and February 2025) and is well above the level measured for fiscal year 2024, which had resulted in a public deficit of 6.4% of GDP.

There is therefore every indication that the fall in US long-term interest rates between January and the beginning of April 2025 was exaggerated and will therefore be corrected.

In the eurozone, the exaggerated rise in long-term interest rates

The 10-year interest rate on German public debt rose from 2.08% at the end of November 2024 to 2.37% at the beginning of February 2025 and to 2.64% on 7 April 2025, after peaking at 2.89% on 12 March 2025.

This rise in long-term interest rates (which applies to all countries in the eurozone (**Chart 5**)) is linked to the **expectation of a higher public deficit in the eurozone** (the ECB forecast a deficit of 3% of GDP in 2025, identical to that of 2024, and 3.1% of GDP in 2026), **Chart 6**.

Chart 5
Interest rate on 10-year government bonds (as %)

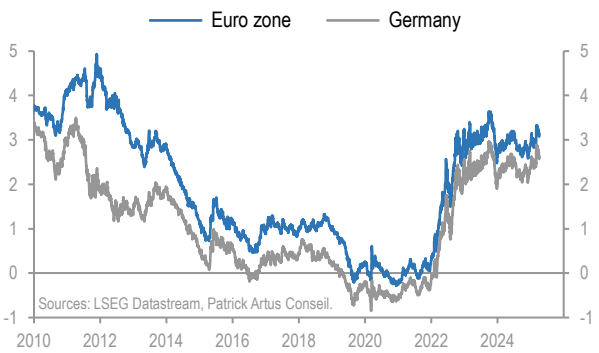
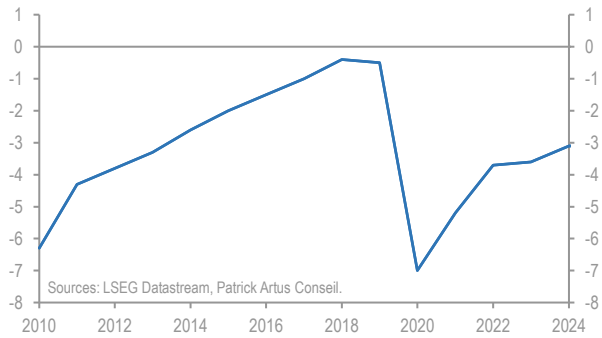


Chart 6
Euro zone: Fiscal deficit (as % of nominal GDP)



The bond market's reaction is linked to:

- **The new European budgetary rules**, which authorise a public deficit in excess of 3% of GDP if it is due to a level of military spending in excess of 1% of GDP;
- **The new German budgetary rules**, which authorise a federal public deficit of up to 1.5 points of GDP above the previously authorised level (0.35% of GDP) if this is due to higher military spending, and which allow the Länder to have a small public deficit (0.35% of GDP);

- **The announcement of a plan to invest €500 billion over 10 years in infrastructure** (transport, energy) and in the energy transition in Germany;
- The European Commission's announcement of a €150 billion plan to finance the rearmament of Europe.

Investors in European public debt concluded that the eurozone's public deficit was set to rise sharply.

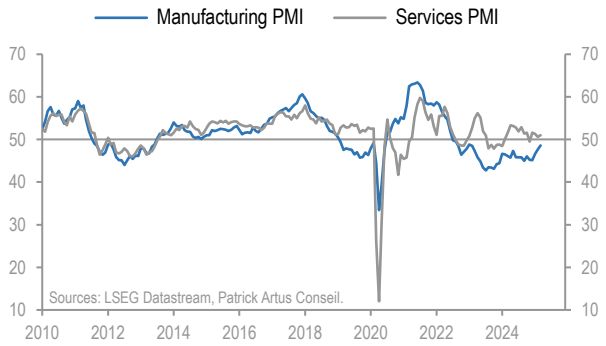
But this is not the case:

- Germany had a public deficit of 2.5% of GDP in 2024, and the maximum allowed under the new rules is 1.85% of GDP;
- France had a public deficit of 5.8% of GDP in 2024, and aims to reduce it to 5.4% of GDP in 2025 and to continue to reduce it beyond 2025;
- Spain and Italy have low military spending (1.3% of GDP in Spain, 1.5% of GDP in Italy); these two countries plan to increase their military budget to 2% of GDP, but only in the long term (by 2028 or 2029); moreover, all observers believe that this will be difficult.

All in all, although military spending in the eurozone countries will increase, it will be a slow process, and will only slightly increase their public deficits.

Furthermore, the ECB is likely to continue cutting interest rates (towards 2% at the end of 2025 or 2026) and growth in the eurozone will remain weak (**Chart 7**).

Chart 7
Euro zone: Manufacturing and services PMI (indices)



We can therefore see that long-term interest rates have very probably overreacted to the rise since the end of 2024 in the eurozone, and that this overreaction will be corrected.

Summary: overreaction to the fall in US long-term interest rates, and overreaction to the rise in eurozone long-term interest rates

The sharp fall in US long-term interest rates (from 4.80% on 14 January 2025 to 4.00% on 4 April 2025) is linked to expectations of a sharp slowdown in activity. But in reality, the United States is far from a recession at the moment, so this sharp fall in long-term interest rates will correct itself.

The sharp rise in long-term interest rates in the eurozone (from 2.08% at the end of November 2024 for Germany's 10-year rate to 2.64% on 7 April 2025) is linked to the relaxation of budgetary rules in Germany and the eurozone, in particular to authorise additional military spending.

But in reality, the induced rise in the total public deficit of the eurozone countries will be very small, as the ECB continues to lower its interest rates, and growth is forecast to be weak (around 1% on average per year in 2025). As a result, the rise in long-term interest rates will correct itself; Germany's 10-year interest rate has already fallen from 2.89% on12 March 2025 to 2.64% on 7 April 2025.

Following Donald Trump's announcement on 2 April 2025 of the introduction of tariffs on US imports, there has been a downward correction in long-term interest rates. However, the risk of recession in the United States and the risk of a public deficit in Europe are still overvalued by the bond markets.

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