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What to watch: High stakes transatlantic (trade) poker, ECB back to neutral and the return of term premia

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In summary

- **Raise, call or fold: US tariffs put Europe's hand to the test.** The US has paused a proposed 50pps tariff hike on EU goods – originally set for 1 June – until 9 July amid tense trade talks. Such a hike would raise average US tariffs on EU imports from 9% to around 30%, risking EUR100bn in EU export losses equivalent to 0.5% of EU GDP, with machinery, automotive and agrifood particularly at risk, especially in Germany, Italy and France. But the US would also feel the pinch, with inflation rising by 0.4pp and growth slashed by -0.2pp. For now, the EU is putting up a fragmented front, with some member states advocating a firm response, while others are wary of aggravating the US or compromising their national economic interests. Concessions such as LNG and agricultural imports, digital tax adjustments and defense cooperation are also being considered, but the EU needs to find a consensus among member states to avoid a disjointed or diluted response that would prevent meaningful trade relief, and undermine credibility in transatlantic diplomacy.

- **ECB nearing neutral, but more cuts likely ahead.** At its next meeting on 5 June, we expect the ECB to lower the deposit rate to 2.00%, reaching the self-proclaimed neutral rate after one year of rate cuts. Recent data has painted a mixed picture: while inflation surprised on the upside, supposedly because of the late date of Easter, survey data and national accounts continue to signal lackluster growth in the Eurozone. The more pressing concern is elevated global uncertainty, particularly around US trade policy. Although we expect the latest salvo of tariff threats (+50pps) to be negotiated down, the lingering uncertainty is likely to dampen sentiment and cloud any near-term economic rebound. We maintain our terminal rate forecast of 1.5% for this year, with slight upside risk. Meanwhile, passive quantitative tightening should proceed at full speed as long as Eurozone spreads remain stable.

- **Term premia from Tokyo to Berlin are rising with underlying risks becoming global.** The global bond market has witnessed a significant bear steepening at the ultra-long end of the curve. 30y yields have surged by 30-80 bps year-to-date, while the 10y-30y steepness has increased by 20-30bps, driven by a synchronized repricing of term premia reacting to structural uncertainties, such as upside inflation risks, geopolitical tensions and rising fiscal risks. The dominance of US Treasuries in the ultra-long segment has amplified this trend. The acceleration is a warning signal for global duration stress. We expect central banks to prevent a full market meltdown. But the ultra-long end of global yield curves is likely to remain elevated and steep for longer as the dampening effect of quantitative easing (QE) fades and uncertainties prevail.

Raise, call or fold: US tariffs put Europe's hand to the test

A 50% tariff would be a lose-lose scenario in the short term. The US-EU trade relationship was thrown into fresh uncertainty following the US announcement on 23 May of a potential 50% tariff on EU goods, a dramatic escalation from the 20-point hike previously floated on Liberation Day. Originally scheduled to take effect on 1 June, the proposed tariffs have now been paused until 9 July, following diplomatic contact and a tentative agreement to pursue negotiations on more decisive footing. While more than 40% of US imports from the EU would avoid tariffs due to sectoral exemptions (i.e. pharmaceuticals, semiconductors and electronics), the average US tariff on European goods would still surge from approximately 9% to around 30%. That would lift global US import tariffs from 12% to around 16%, approaching levels considered recessionary. The EU is the US' largest import partner, with total imports reaching USD618bn in 2024, ahead of Mexico (USD510bn), China (USD463bn) and Canada (USD422bn). If enacted, we estimate the US tariffs on the EU would increase US inflation by 0.4pp and hit US GDP growth by -0.2pp, thus threatening to derail an already tepid growth outlook of +1.3–1.5% for 2025. On the European side, the higher tariffs could trigger over USD100bn in export losses, equivalent to roughly 0.5% of EU GDP – a hit similar in scale to what China is likely to experience following the recent deal with the US. More specifically, countries heavily reliant on US exports – such as Germany and Ireland – would face significant losses. Germany's GDP could fall by up to -0.6%, while Ireland may lose up to -3.4%, especially if pharmaceutical exports are affected. From a European sector perspective, machinery & equipment, chemicals, automotive and agrifood industries are particularly vulnerable. Export losses in the machinery & equipment sector alone could total USD6.7bn for Germany, USD2.6bn for Italy and USD1.5bn for France (see Figure 1). These developments reinforce our expectations of a dovish stance by the ECB, with forecasts for the terminal rate at 1.5%.

Figure 1: Top 10 most impacted European export sectors

Country	Sector	Exports (USD bn)	Max export loss (USD bn)
Germany	Machinery & Equipment	35.5	6.7
Germany	Automotive manufacturers	29.7	5.6
Italy	Machinery & Equipment	13.7	2.6
Ireland	Chemicals - Industrial & Other	10.7	2.0
France	Transport Equipment	8.1	1.5
France	Machinery & Equipment	7.8	1.5
Ireland	Chemicals - Plastics & Rubber	7.4	1.4
Italy	Agrifood - Food & Beverages manufacturing	7.1	1.3
Italy	Textiles - Apparel & Footwear	6.7	1.3
Slovakia	Automotive manufacturers	6.6	1.2

Sources: UNCTAD, Allianz Research

The EU is putting up a fragmented front, yet to reach a consensus. Despite a shared interest in avoiding a damaging tariff war, the EU has struggled to present a fully unified position. While institutions in Brussels favor a quick resolution, internal divisions remain over the scope and content of the EU's countermeasures and concessions. Some member states advocate a firm response, pushing for a calibrated retaliation targeting sensitive US exports. A draft EU list includes up to EUR95bn in retaliatory tariffs on US goods, including EUR10.5bn in aerospace, EUR10.3bn in auto parts, EUR6.4bn in agricultural goods and EUR7.2bn in electrical equipment, among others. However, others are more cautious, wary of aggravating the US or compromising their national economic interests. Differences also arise over how much the EU should offer to the US in return for tariff relief. Earlier this year, the EU proposed EUR50bn in additional imports from the US, primarily focused on LNG and agricultural products such as soybeans. But this amount may come short expectations for the US, from which the EU imported roughly EUR370bn worth of goods in 2024, compared with nearly EUR590bn from China or nearly EUR530bn of EU exports to the US. The US administration likely expects Europe to increase imports from the US by EUR100bn or more. Additionally, further concessions, especially on politically sensitive issues like digital taxation or climate-related levies, have sparked internal disagreements. This intra-EU friction has complicated Brussels' negotiation posture, even as the European Commission aims to fast-track discussions before the 9 July deadline. The risk is a disjointed or diluted response that fails to secure meaningful trade relief while undermining the EU's credibility in transatlantic diplomacy.

The EU has bargaining chips under its sleeve. In the face of US pressure, the EU has begun to outline a broader trade package aimed at defusing tensions while preserving key economic interests. These options, varying in ambition and feasibility, are aimed at creating a mutually beneficial path forward (see Figure 2). Key proposals include already floated ideas such as ramping up LNG and agricultural imports, but also reviving a zero-for-zero tariff framework for industrial goods and softening or adjusting digital taxes and the Carbon Border Adjustment Mechanism (CBAM) to reduce friction with US exporters. Some EU members are also exploring whether defense and security cooperation – including purchases of US military equipment and joint initiatives – could help sweeten the broader deal. Since Europe aims to ramp up defense spending and has a 50% European-sourced procurement target, this could allow up to EUR75bn for US firms (i.e. 50% of SAFE funds). While some of these options offer clear mutual benefit, others face domestic resistance within Europe. As shown by the disagreement around the Mercosur deal, agricultural liberalization raises concerns in southern member states, while digital tax adjustments are politically sensitive in several capitals (i.e. Dublin, Luxembourg, etc.). Nonetheless, Brussels sees these trade-offs as potentially necessary to avoid far costlier economic consequences if tariffs proceed. With less than six weeks to find a resolution, negotiations will likely intensify. Whether this standoff results in a durable agreement or devolves into a full-blown trade war remains contingent on both sides' willingness to make difficult compromises. The pause is temporary and the stakes are high.

Figure 2: Summary table of EU negotiation options

Bargaining Chip	Description	Upside for US	Upside for EU	Favorable Countries
Increased LNG imports	Boost EU imports of US LNG	Reduces trade deficit, boosts US energy exports	Secures stable energy supply, diversifies sources	Germany, Netherlands, Poland
Agricultural product purchases	Commitment to buy more US soybeans and beef	Supports US farm sector, politically important	Maintains agricultural access to US market	France, Spain, Italy
Zero-for-Zero tariff deal (autos & industrials)	Mutual elimination of tariffs on key industrial goods	Improves US access to EU market, symbolic win	Avoids major auto tariffs, boosts industrial exports	Germany, Slovakia, Italy
Digital tax adjustments	Delay or rework digital services taxes targeting US firms	Protects US tech giants from higher tax bills	Creates space for broader deal, avoids legal disputes	Ireland, France, Sweden
Carbon Border Adjustment Mechanism (CBAM) flexibility	Adjust implementation of CBAM to ease US concerns	Minimizes US exporters' costs	Preserves trade diplomacy, shows climate leadership	Germany, Denmark, France
Defense & security cooperation	Increase EU spending on US defense equipment by up to EUR75bn	Signals allied unity, potential economic boost for defense sector	Reinforces strategic autonomy, builds goodwill	Poland, Baltics, France

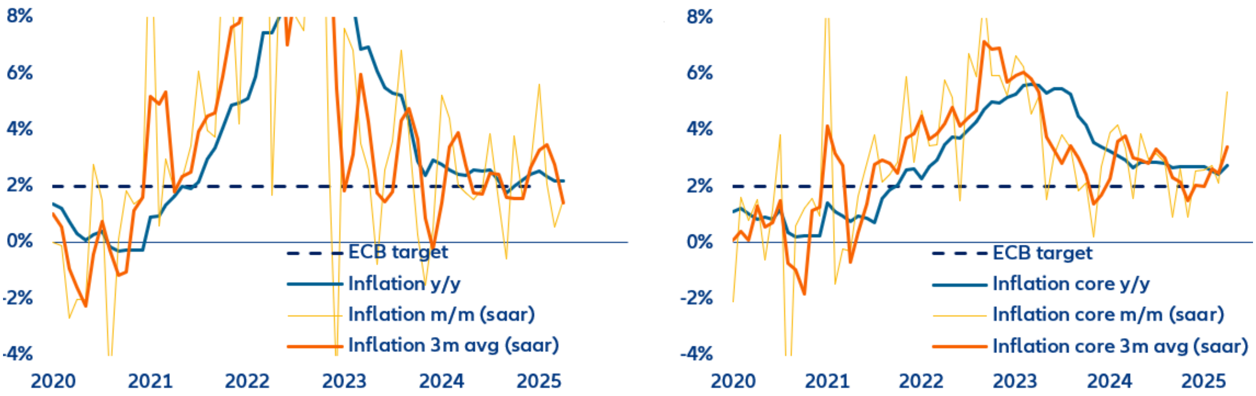
Source: Allianz Research

ECB nearing neutral, but more cuts likely ahead

The ECB is set to deliver another rate cut, pushing the policy rate to neutral. At its next meeting on 5 June, the ECB is expected to lower the deposit rate again by 25bps to 2.0%. This brings the total amount of easing to 200bps since it started lowering rates one year ago. Easing the monetary policy stance one more time is widely expected by markets but the big question remains what's next? We maintain our call of two more rate cuts to 1.5% to move the ECB to a slightly accommodative stance.[1] Elevated uncertainty stemming from the ongoing trade dispute with the US is dampening investment and consumption in the Eurozone. A weaker US economy, stronger euro and imported deflation from China, which is also grappling with oversupplies, is setting the stage for lower inflation and weaker growth, thus calling for more monetary easing.

Headline inflation is hovering above target but a recent spike in core inflation has raised concerns. Headline inflation stayed put in April at 2.2% y/y but core inflation shot up to 2.7% y/y, a nine-month high. Even more concerning was the sequential price development that strips out base effects. Seasonally adjusted core prices rose by an annualized 5.4% m/m, the highest jump in more than two years (Figure 3). The price increases in April largely came from service inflation. However, most of that was related to travel components, suggesting that the late Easter holiday lead to an anomaly with higher base effects and seasonal adjustment issues. We therefore see this as a one-off and expect ongoing disinflation going forward. In fact, we see inflation significantly dropping below the 2% mark in the second half of this year, paving the way for further rate cuts. This comes amid lower oil prices and a stronger euro, which is not only hampering growth via the export channel but also lowering import costs. To add to this, wage growth has dropped strongly recently, both in official indicators (negotiated wages, hourly wages all down to 2021 or 2022 levels) or the more recent and monthly Indeed Wage Tracker.

Figure 3: Eurozone headline and core inflation, y/y and sequentially in %



Sources: LSEG Datastream, Allianz Research

Meanwhile, economic headwinds are increasing amid uncertainty surrounding US tariffs. The latest batch of purchasing manager indices (PMI) shows a deterioration of the service sector back into contractionary territory with a reading of 48.9 (values below 50 indicate contraction). The manufacturing PMI also remained in the red zone at 49.4 despite the recent recovery (Figure 4). At the same time, consumer confidence is falling. Both are no surprise given that global economic uncertainty has surpassed the highs seen during the Covid-19 pandemic. On the positive side, the labor market is still strong, with the unemployment rate staying at a record low of 6.2%. However, the labor market looks less strong when comparing the unemployment rate with the non-accelerating inflation rate of unemployment (NAIRU), which has drifted lower over the past decade, or with the recent fall in the vacancy rate. How all this is reflected in the updated staff expectations to be published at this meeting will be closely watched.

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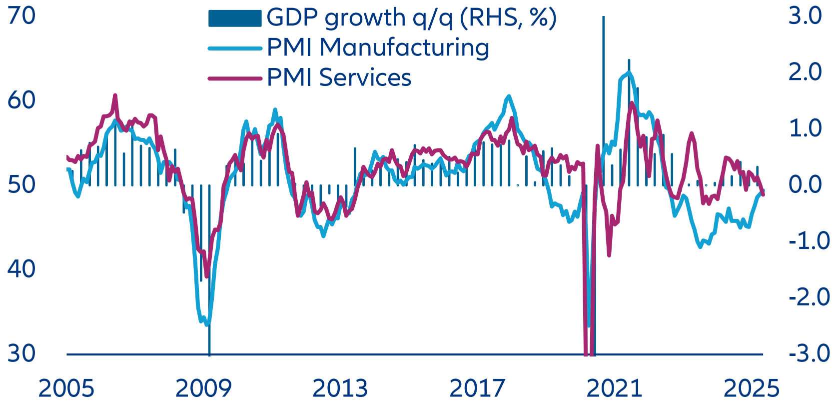
[1] *The ECB has previously stated that the nominal neutral rate currently is around 1.75% to 2.25% (see [Natural rate estimates for the euro area: insights, uncertainties and shortcomings](#))*

Figure 4: Eurozone GDP growth and PMIs, index, %

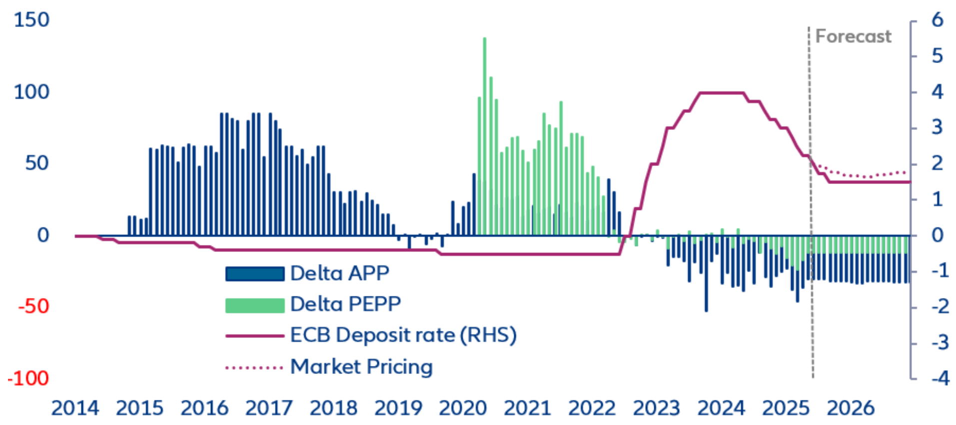


Sources: LSEG Datastream, S&P Global, Allianz Research

Going forward, we expect a continuous meeting-by-meeting cutting cycle, with a terminal rate of 1.5% to be reached by September 2025. But both upside and downside risks remain. Given the economic headwinds, and inflation dropping below the 2% target, we keep our previous terminal rate target of 1.5% to be reached after two more rate cuts in July and September. Risks are symmetric. A tariff increase by 50pps as threatened by US President Trump would likely cause the ECB to set rates even lower. On the flip side, if inflation was to surprise again on the upside in May, further rate cuts are certainly off the table for the time being.

Quantitative tightening (QT) should proceed at full speed as the European government bond market is not showing any signs of stress. Eurozone spreads and long-end government bond yields are comparatively stable in Europe. This supports the ECB's confidence to stick to their ongoing QT process. Since the latest adjustment in January to let both PEPP and APP bonds run off the balance sheet, an average of EUR55bn has rolled off the ECB's balance sheet per month – somewhat above the EUR40bn on average expected this year (Figure 5). Given the costs surrounding the still very large balance sheet[2], the ECB has an incentive to stick to ongoing QT and ease on the interest rate side – as long as government bond spreads remain stable (Figure 6).

Figure 5: ECB quantitative easing and tightening, billion EUR per month and policy rate, %



Sources: LSEG Datastream, Bloomberg, Allianz Research

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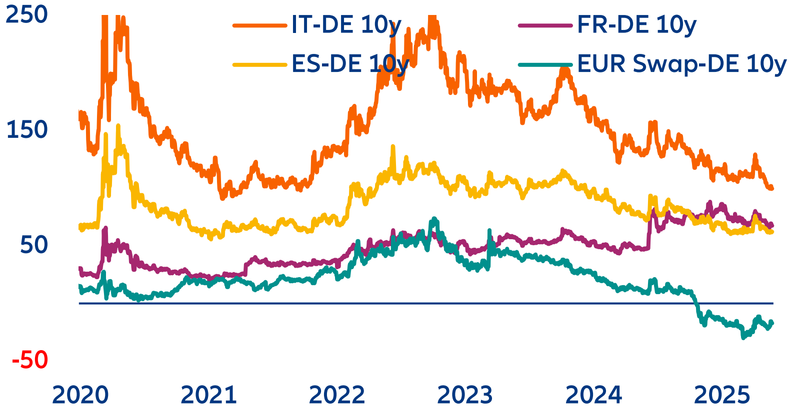
[2] See 2024_02_29_what_to_watch.pdf

Figure 6: Eurozone government bond and swap spread against Germany, bps



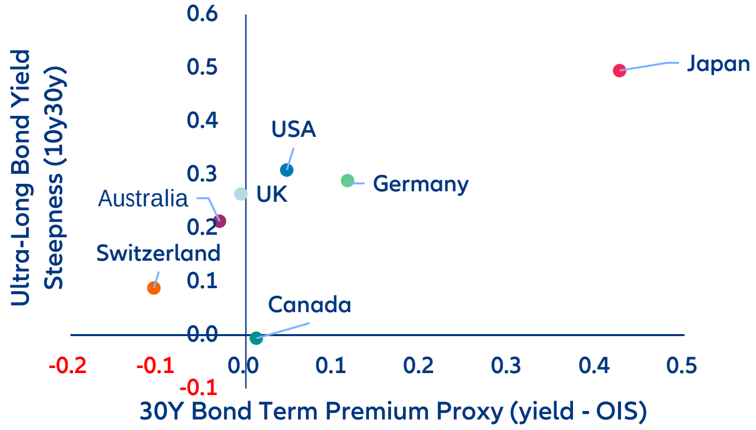
Sources: Bloomberg, Allianz Research

Term premia from Tokyo to Berlin are rising with underlying risks becoming global

After many years of stability and flatness, the ultra-long end of global yield curves (30y and beyond) has increased substantially, with yields shifting 30 to 80 bps upwards and the 10-30y segment steepening by 20-30bps year-to-date (Figure 7). Two factors explain this global phenomenon: 1) the synchronized repricing of the term premia and 2) the dominance of US Treasuries in the ultra-long segment. Term premia have been on a steady rise for three years as the dampening effect of Quantitative Easing (QE) phases out. The recent repricing of term premia is a result of the macro narrative shifting from deflationary secular stagnation to structural uncertainty (Figure 8). These uncertainties include: *upside inflation risk* – fluctuations around inflation targets have increased and are now skewed to the upside even in the very long term, as evidenced by the US 30y breakeven inflation rate stabilizing in a 2.4%-2.6% range, and Japan and China are drifting away as global deflationary anchors; g*eopolitical tensions* – markets are pricing in a more fragile global monetary system where bond holdings can be weaponized even between trading partners and allies and finally *rising fiscal risks:* markets are starting to price a scenario where public debt steadily outpaces economic growth and debt supply, and demand will therefore balance at a higher equilibrium rate that could ultimately challenge fiscal sustainability.

While term premia are the driving force behind the general upward trend of ultra-long yields, the recent acceleration is primarily a US story. When extracting common factors from global 30y yield movements, the principal factor – the global duration drift – explains over 75% of the year-to-date change. This factor closely aligns with the US 30y yield, stressing the dominance of US Treasury securities in this maturity segment. Only in Japan and Switzerland do specific factors explain a significant share of recent yield changes. Japan has a risk premium of 50bps due to the recent sell-off from domestic insurers while Switzerland has a -20bps attributable to safe-haven flows (Figure 9).

Figure 7: Steepness vs term premium proxy (YTD Change in pp)

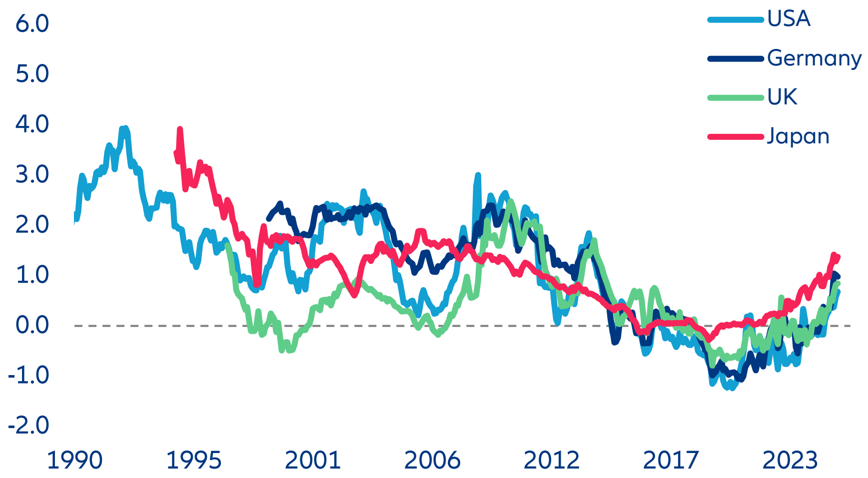


Sources: LSEG Workspace, Allianz Research

Central banks will prevent a meltdown but the ultra-long end of the curve will remain elevated and steep. Monetary authorities may have been taken aback by the extent of the surge in ultra-long yields. However, should the situation deteriorate, they will not hesitate in providing liquidity and alleviating pressure on the bond market. If possible, they will likely steer clear of outright intervention to avoid panic, opting instead for “stealth” measures such as regulatory changes (i.e. lighter supplementary leverage ratio (SLR) for US banks, money market fund regulation), adjustments in quantitative easing reinvestments, swap line support or repo tweaks. We could already see some jawboning at the central bank symposium in Japan this week where several Fed and BoJ members will be speaking. From the Treasury side, shifting bond issuances to the shorter end could also lift some pressure from the ultra-long end (as already announced by the Japanese Treasury). In our view, ultra-long yields are now entering a consolidation phase. Investors will reassess their sovereign bond exposure, with selective duration positioning and eventual long-term duration hedging. In this phase, the risk for US ultra-long yields remains on the upside as the “beautiful bill” may potentially turn out more irresponsible than anticipated. Conversely, European and Japanese long-term yields may have some downside potential due to fundamentals and new demand from capital repatriation flows. In the longer term, the ultra-long end of global yield curves is poised to remain elevated and the 10y30y segment will remain steep. As central banks' QE portfolios mature, the dampening impact will roll down the curve, adding steepening pressure. We estimate that in the US, the ultra-long end could see a 20 bps steepening for the 10y30y segment from this effect alone.

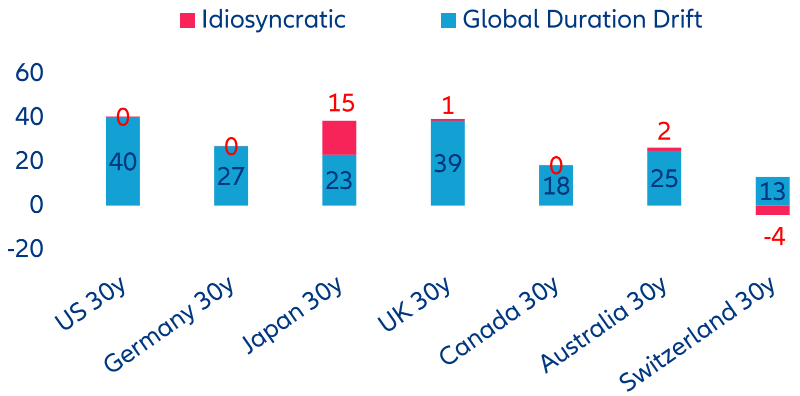
Government bonds become cheaper compared to private assets, with crowding-out risk for corporates. Government bonds have generally become relatively cheaper compared to corporate bonds. This is particularly true for the ultra-long end where asset swap spreads are largely negative for major sovereign issuers and futures being unusually rich against their basis cash bonds. Some high-quality US corporates, such as Microsoft and Apple, are even trading below the sovereign curve now. While these issuers have benefited from a safe asset substitution effect, other US corporates might face a crowding-out risk as the supply of US public debt is likely to clear at a lower price (higher yield) in a market with decreasing foreign demand. This dynamic may put pressure on US corporate spreads and rate-sensitive equities. In contrast, Europe and Japan are less exposed to such crowding out risks as rising government bonds issuance can be compensated by repatriation flows.

Figure 8: Global term premia converge as QE effects fade*



Sources: LSEG Workspace, Allianz Research
*Notes: *term premia estimates for 10y government bonds using ACM Model*

Figure 9: Factor decomposition of recent change in 30y yields, in bps*



Sources: LSEG Workspace, Allianz Research
*Notes: *data as of May 26 2025*

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