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Allianz Research | 14 February 2025

What to watch: The yield curve sweet spot, France's better-late-than-never budget and the geopolitics of minerals

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In summary

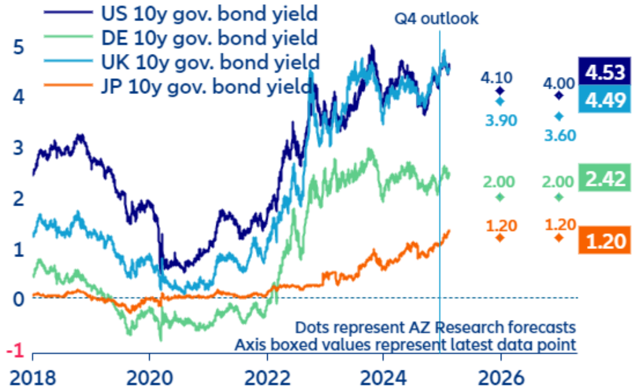
This week we look at three critical issues:

- Yield curve: The long duration sweet spot. Rising uncertainty due to back-and-forth tariff announcements sets the stage for lower economic growth, reinforcing our medium-term outlook for lower government bond yields. But the volatility presents attractive entry points for a long-duration strategy while the risk-return trade-off looks increasingly favorable. While US and German yields could rise modestly (+50bps) amid tariff-induced inflation fears, recession risks could drive them sharply lower (-200bps). Unlike the 2010s, investors benefit from high carry and a low equity risk premium, while bond-equity correlations are expected to become negative again, making bonds an attractive hedge. The optimal positioning lies in the 7-20Y segment for US Treasuries and 10Y for German Bunds, both from a carry and roll perspective as well as from an expected risk-return profile. A good entry point for a long duration position, given current volatility, would be 4.8% for the US 10y yield and 2.8% for Germany from today's perspective.
- Better late than never: France finally gets a budget. The Bayrou government managed to push through a watered down 2025 draft budget bill and escape a no-confidence motion. But the surviving budget leaves out several spending cuts and skews heavily towards tax hikes (EUR18bn) – including the surtax on domestic turnovers of companies (albeit only for 2025) and a minimum income tax rate of 20% for high-income households. The former should have a limited impact on traded French corporates (-2.1% median decline in income growth) as most large companies generate 70% of their turnover abroad. Volatility in French bond markets may rise in Q4 2025 as political deadlock may resurface during the preparation of the 2026 budget. New legislative elections are likely by then. To consolidate its finances while preserving medium-term growth, France should focus on targeted spending cuts and significantly lower taxation on labor, besides tackling excessive state pension spending.
- Rare earth and no peace? The new frontline of minerals. Minerals and resources have become a key battleground of war economics, as seen in President Trump's claim on mineral-rich Greenland and the rare earth deal with Ukraine, besides the intensification of conflict in the Democratic Republic of the Congo, home to the world's largest coltan, cobalt and tantalum reserves. Against this backdrop, speculation is creeping up for some metals (lithium, copper, gold). Meanwhile, record-high prices have not deterred investors from buying up gold. China recently allowed local insurance companies to invest up to 1% of their assets in gold, which could increase further upward pressures on gold prices by about 15%. Central banks have also been buying gold as countries try to build resilience against direct or indirect tariffs or sanctions from the US. We estimate that if China was to sell 10% of its US Treasuries holdings to pivot to gold, it could increase US yields by close to 10bps.

Yield curve: the long duration sweet spot

Increased economic uncertainty and weak consumer confidence reinforce our medium-term outlook for lower government bond yields. Since our last economic and capital market outlook published in December[1], government bond yields have been volatile but largely unchanged (Figurer 1). However, the news and data flow has confirmed our view of lower rates towards the end of the year, with asymmetric risks to the downside. The flood of executive orders signed by US president Trump on various aspects of the economy, including tariffs, and subsequent rollbacks have increased economic uncertainty. This hampers investment in the real economy, subsequently deteriorating the growth outlook, in turn leading to lower rates. At the same time, downside risks of a policy error have risen, especially in light of the aggressive cost-cutting announcements from the US administration. Economic data on both sides of the Atlantic are proof of this development. Consumer sentiment in the US fell to a six-month low in the latest reading, without any sign of a positive confidence shock since Trump's election. Meanwhile, the Eurozone fell back into stagnation in the last quarter of 2024, triggering the ECB to talk about cutting below its neutral rate of around 2% to combat a deteriorating growth outlook.

Figure 1: Government bond 10y yields and Allianz Research December forecast, %

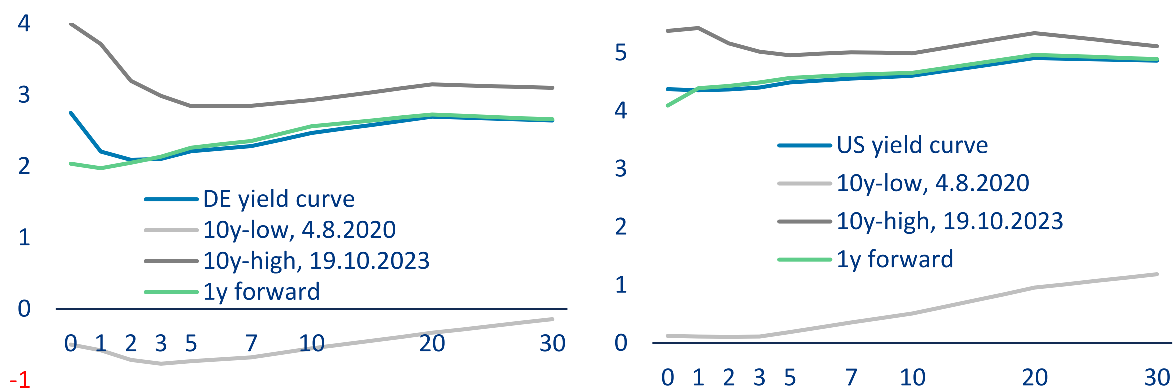


Sources: LSEG Datastream, Allianz Research

Volatility around ongoing headlines presents attractive entry points for a long-duration strategy while the risk-return trade-off looks favorable. With our fundamental view of yields approaching 4.1% in the US towards the end of the year and 2.0% in Germany, recent volatility in rates offers attractive entry points for a long duration position. The year-to-date range has been 40bps (4.4%-4.8%) in the US and 30bps in Germany (2.35%-2.65%). The upper range would allow for strong gains if our forecast materializes. A closer look at present and historic yield curves in Figure 2 highlights that risks are asymmetric. Both in the US and in Germany, we are only 50bps below the highs of the past 10 years – including the period when inflation was around 10% compared to the current 2-3% range. However, we are 400bps and 300bps above the lows in the US and Germany, respectively. While neither of these extremes is our baseline, they show where yields could go in case of unforeseen events (spike of inflation or a pandemic) and that gains are much larger than losses. A good entry point for a long duration position in the current volatility phase from today's perspective would be 4.8% for the US 10y yield and 2.8% for Germany.

[1] *See our report Global Economic Outlook 2025-26: Defying gravity?*

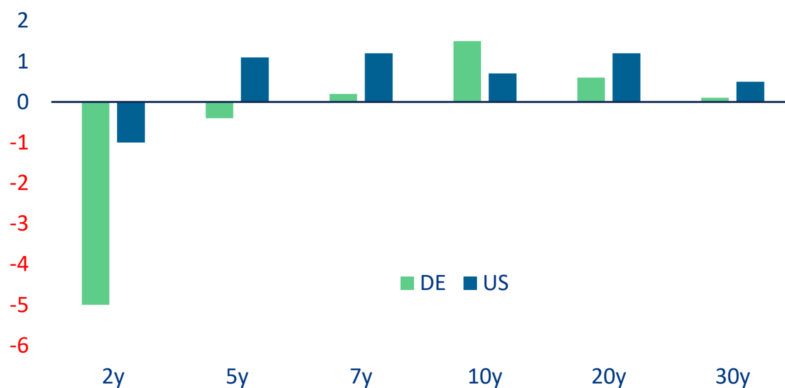
Figure 2: German and US yield curve, x-axis=years to maturity, y-axis=yield in %



Sources: Bloomberg, Allianz Research

Unlike in the 2010s, investors benefit from a high carry and a low equity risk premium, which makes bonds attractive, especially in the US, even if we do not see lower yields materializing. While in the pre-pandemic time span yields where very low or even negative in Europe, the situation now is very different. Bonds offer attractive carry even if yields are not falling. In fact, forward curves show that they can even rise by 10bps, still earning current one-year yields, given the forward curve lies above current levels (Figure 2). Bonds also look attractive as a hedge against an equity sell-off. In the US, the equity risk premium is extremely low. While bond-equity correlations are still positive, they almost certainly would become negative again in case of a demand-driven recession.

Figure 3: Carry & roll over a three-month period with repo rate funding, bps



Sources: Bloomberg, Allianz Research

A long-duration position should be added in the 7-20Y segment for US Treasuries and 10Y for German Bunds. As a rule of thumb fixed income investors prefer the part of the curve which is steepest to profit both from the carry (interest rate) but also from the roll-down on the curve, as lower yields increase the price of a bond. Looking at the steepness of the curve, the 10y point in Germany looks most attractive to add duration. In the US, the range is wider, lasting from about 7y to 20y maturities. This is also supported from a carry & roll perspective, which shows that this part currently offers the highest return if the curve was to stay put (Figure 3). The 30y point should be avoided as the very long end of the curve (20y30y) is inverted both in Germany and in the US. Also, in terms of hedging opportunity against a stock market correction, i.e. should yields and stocks come down more strongly, the 10y point looks best in terms of risk-return profile. Since bond prices move inversely to yields, lower yields result in price gains. The magnitude of these gains depends on both the yield shift and bond duration. In a recessionary scenario, 10y

yields would likely decline less than the short end, but higher duration ensures stronger price gains. Meanwhile, the very long end typically reacts less to falling yields but still delivers substantial returns due to its extended duration.

France finally gets a budget

Prime Minster Bayrou has finally managed to push through a watered down 2025 draft budget bill. The government resorted to using Article 49.3 of the French Constitution, which allows a budget bill to be approved without a formal vote in parliament. Unlike its predecessor, the Bayrou government managed to escape a no-confidence vote as both the Socialist Party (part of the left-wing NFP alliance) and the right-wing Rassemblement National (RN) recognized the risks of creating a major political crisis and significantly damaging the economy. However, the result is a budget bill without several of the spending cuts that featured in former Prime Minister Michel Barnier's budget, including a temporary freezing of state pensions, cuts to healthcare spending and a reduction of teacher headcounts. Moreover, it also excludes some unpopular ideas, such as increasing stamp duties or restricting the waiting periods for civil servants. On the receipt side, the current government maintained the two measures expected to yield the largest revenues: the surtax on large companies and the minimum income tax rate of 20% for high-income households. The surtax on large companies is set to only apply in 2025, through, compared to two years in the Barnier budget.

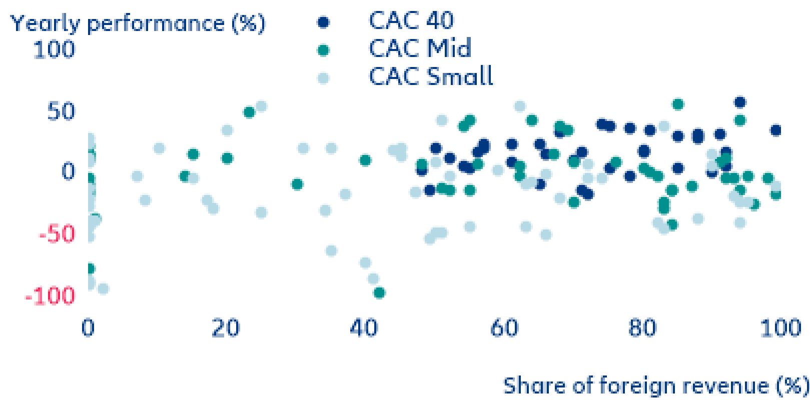
Table 1: 2025 Bayrou Budget: main measures

Receipts	EUR bn	%GDP	Spending	EUR bn	%GDP
Budget measures			Budget measures		
Lowering of the VAT exemption threshold	0.4	0.0	Cuts in transfers to local governments	2.2	0.1
Surtax on large companies	7.8	0.3	Reduction in ecological transition expenditure	1.4	0.0
Share buyback tax	0.4	0.0	Reductions in my MaPrimeRénov' program	1.0	0.0
Increase in financial transaction tax rate	0.6	0.0	Research budget cuts	1.0	0.0
CVAE maintained	4.2	0.1	Culture budget cuts	0.2	0.0
Minimum income tax rate of 20%	1.9	0.1	Foreign aid cuts	1.2	0.0
Increase in airline ticket tax	1.0	0.0	Other budgets	0.2	0.0
Tightening of tax credit for R&D investment	0.5	0.0			
Reductions in social security contributions relief	1.6	0.1			
Total 2025	18.4	0.6	Total 2025	7.1	**0.2**

Sources: Ministry of Finance, Allianz Research

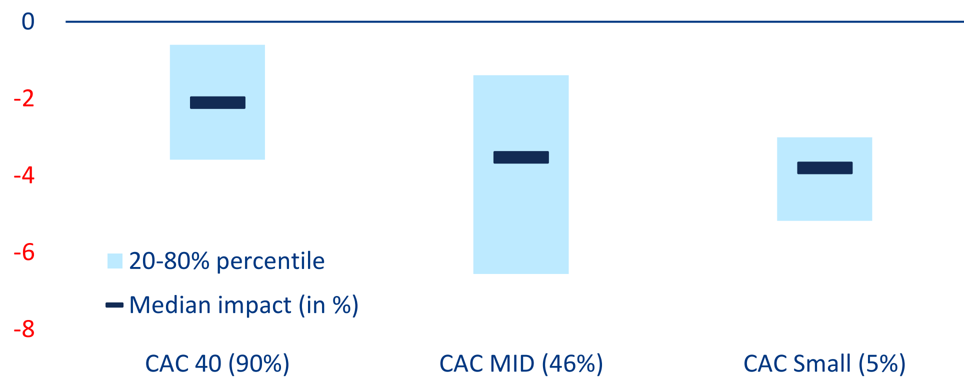
The one-time hike impacts taxable revenues in France, so it will have a limited impact on traded French corporates. According to the official budget, the surcharge will be calculated based on the average revenues from 2024 and 2025 and must be settled by the end of 2025. For firms with revenues between EUR1bn and EUR3bn, the tax rate on French earnings will rise from 25% to 30.2%. Companies with revenues exceeding EUR3bn will see their tax rate increase from 25% to 35.3%. Our analysis suggests that the impact on French corporate balance sheets will be limited as it will only target upper-mid and large companies, which generate only 30% of their revenues in France (Figure 4). We expect a relatively modest -2.1% median decline in corporate income growth. Mid-sized companies are expected to face a slightly greater impact of -3.5%, despite only 46% of firms in this category being affected. The most impacted group will be small-cap companies, experiencing a -3.8% decline in income growth, as their revenues are primarily domestically driven. However, the broader effect remains limited as just 5% of companies fall into this category (Figure 5). Overall, markets are expected to absorb this impact smoothly as the projected earnings recovery for 2025 and 2026 (~10%) should more than offset this temporary setback.

Figure 4: Share of foreign revenue of French traded companies (in %)



Sources: LSEG Workspace, Allianz Research

Figure 5: **Expected impact on companies' net income growth due to the tax increase (in %)**



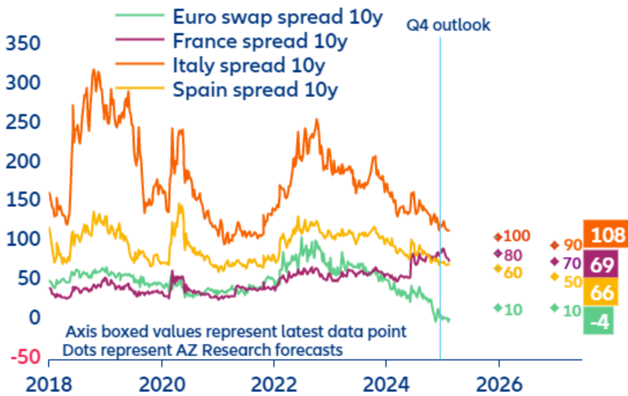
Sources: LSEG Workspace, Allianz Research
Note: In parentheses the share of companies within the indices affected by the measure

Overall, the 2025 budget appears to be based on relatively optimistic growth and tax collection assumptions, leading to high risks of fiscal slippage. The budget contains more than EUR18bn of tax hikes or new levies, including the abandonment/postponement of the CVAE cut (a production tax). Spending cuts will be limited to around EUR7bn and concentrated on central government ministries. Overall spending will keep increasing because of the absence of constraints on pensions and healthcare spending, which make up over half of total public spending in France. In all, the structural fiscal adjustment is expected at 0.7% GDP in 2025. The government targets a headline deficit of 5.4% of GDP (from an estimated 6% in 2024). Our forecast is more pessimistic at 5.7% of GDP because i) we expect slower GDP growth (+0.7% vs +0.9% expected by the government), ii) we suspect that receipts will once again undershoot because tax hikes will likely increase the incentives for corporates to find ways to shrink their taxable profits (such as increasing deductible expenses or through financial and accounting strategies) and iii) the government's assumptions regarding the sharp slowdown of healthcare and local government spending appear optimistic[2].

[2] *This risk is highlighted by France's fiscal watchdog (Avis n°2025 – 1 Amendement aux lois de finances 2025 | Haut Conseil des Finances Publiques)*

While the risk of another general election after July has reduced, French spreads may widen again if uncertainty rises in September during the preparation of the 2026 budget. President Macron may call for new elections in Q4 2025. President Macron has, for now, no incentive to dissolve the National Assembly, which the Constitution allows him to do from July 2025 (i.e. 12 months after the last dissolution) as polls indicate that the chamber would remain fractured into the three main blocks, with political deadlock persisting. Lower uncertainty amid the new budget has already supported French spreads, but financial markets could react negatively to fiscal slippages, should political deadlock recur through the year. We expect volatility to rise in Q4 2025 when the Bayrou government will have to start preparing the 2026 budget and find substantial new savings to reduce the deficit further. In fact, by then, France's fiscal situation may look even more precarious relative to its Eurozone peers and President Macron may be forced to call for new general elections. Our outlook for French 10y government bond spreads therefore remains at 80bps at the end of this year, slightly above current levels (Figure 6).

Figure 6: Eurozone government bond spreads versus Germany, bps



Sources: LSEG Datastream, Allianz Research

To consolidate its finances while preserving medium-term growth, France should focus on targeted spending cuts and significantly lower taxation on labor. France has a notoriously high tax burden, which dents its competitiveness: In the industrial sector, employers' social contributions and production taxes (net of subsidies) make up 18% of the sector's gross value added –much higher than that of most peer countries in Europe (Figure 7). In this context, pursuing deficit-reduction based on tax hikes (particularly on corporates) runs the risks of being self-defeating, denting competitiveness and incentives to invest and hire further, pressuring growth and ultimately making the reduction of the deficit even more challenging. The French economy would benefit from a significant reducing of taxation on labor (employers' and employees' social contributions particularly). This would improve companies' competitiveness and support household purchasing power at the same time. Others benefits include the stimulation of labor demand (corporates have more incentives to hire) and labor supply (households are more incentivized to look for a job and/or work longer hours), in turn boosting France's relatively low employment rate and supporting public finances. To finance this, increasing the VAT would have its merits, but it would be politically difficult to sell. France could also tackle excessive state pension spending (e.g. de-indexing state pensions for the wealthiest 20% of the population and introducing more capitalization), reduce the number of civil servants[3], reduce the number of local government layers, launch a comprehensive review of local governments' public finances to promote stricter accounting rules and transparency[4] and remove some tax rebates.

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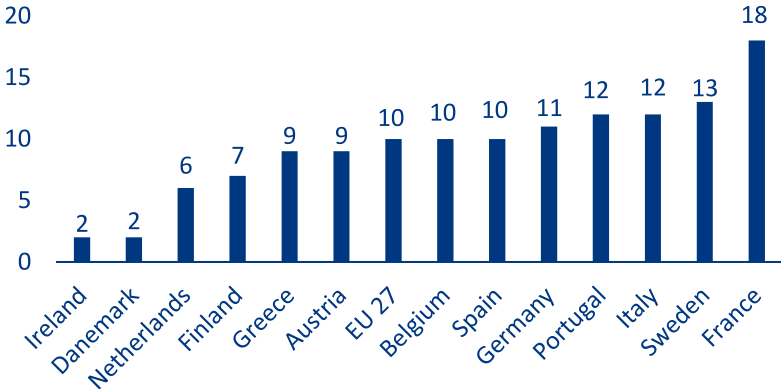
[3] *This would allow a slowdown in compensation payments and, in the medium term, generate substantial savings on pensions spending since the bulk of the state pension deficit in France is accounted for payments to retired civil servants rather than to the pensioners of the private sector.*

[4] *The re-introduction of the housing tax (removed by President Macron for primary properties) would also be a sensible option. Local governments' source of funding should be at their discretion (local taxation) rather than receiving transfers from the central government, which de-incentive them to manage their finances soundly.*

Figure 7: Employers' social contributions and production taxes (net of subsidies) in the industrial sector, in % of gross value added



Sources: Eurostat, Rexecode, Allianz Research

Rare earth and no peace? The new frontline of minerals.

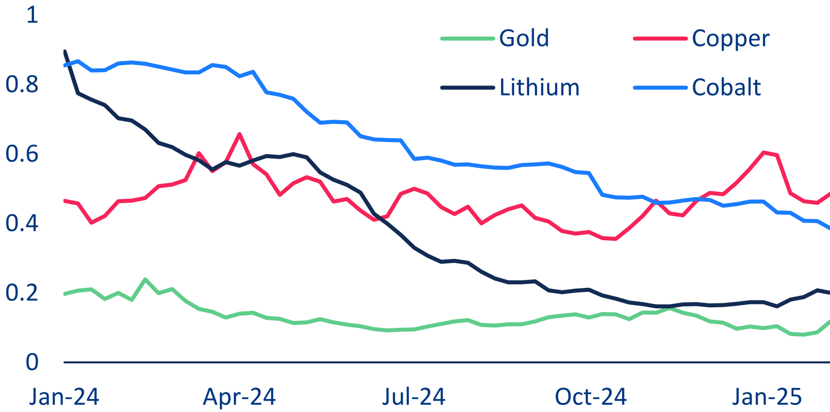
What do Greenland and Goma have in common? Minerals and resources have become a key battleground of war economics. China has been spearheading the race for quite some time, investing in regions such as Latin America and Africa to secure key inputs for its manufacturing industries. But now the US is also turning its attention to critical minerals, as seen in President Trump's claim on Greenland. The Danish territory is not only rich in potential oil & gas resources but also 1.5mn metric tons of rare earth minerals (the 8th largest reserves in the world), as well as large amounts of uranium and other minerals[5]. While Greenland is unlikely to become a US territory, US firms are likely to ramp up mining projects and the Danish government has showed willingness to open the island to more American influence both in mining extraction and via an increased presence of the US military. At the same time, in return for continuing American support in war efforts against Russia, the Trump Administration has requested USD500bn worth of rare earths from Ukraine, which has the largest reserve of rare earths and critical minerals in the European continent outside of Russia. This includes around 500,000 metric tons of lithium (10% of world reserves), 137mn tons of graphite (20% of world's reserves) and around 2% of the world's uranium reserves. However, many of the mines and deposits are currently in territory under Russian control, which would complicate a potential deal. Africa is another battleground in the global mineral race. Rich in untapped resources, the continent has attracted major players. China dominates thanks to its first mover advantage and now controls entire supply chains, while the US has expanded its influence, notably through the Lobito Corridor to access Zambia and Angola's copper belt. France previously controlled Niger's uranium supply, and Morocco's hold on Western Sahara is tied to mineral resources. The EU has also signed agreements with several African nations to secure minerals, though some, like Rwanda's, remain controversial. Indeed, since 2022, Rwanda's proxy group M23 has fueled conflict in the mineral-rich Democratic Republic of the Congo (DRC), officially citing security concerns but coinciding with a surge in Rwanda's mineral exports. The DRC holds the world's largest coltan, cobalt and tantalum reserves, vital for the energy transition.

Speculation is creeping up for some metals. Against this backdrop, one could expect metal prices to increase as supply tensions could be exacerbated in the next few quarters. Since early November 2024, aluminum prices are up +1%; Lithium prices are up by +6% but far below the historical highs of late 2022 while nickel is down -1% and cobalt prices decreased by -11%. This tends to suggest that traders in metals markets have been pricing in lower demand for industrial goods such as automobiles and windmills, and disregarding any geopolitical risk premium. However, we observe that speculative positioning is slowly building, as measured by Working's T index, which assesses the balance between commercial and financial interests in the futures market (a high index means an

[5] *See our report What to watch | 6 February 2025*

excess of financial positioning vs. hedging needs). The speculative index is ticking up for lithium, copper and gold but not so for cobalt (Figure 8).

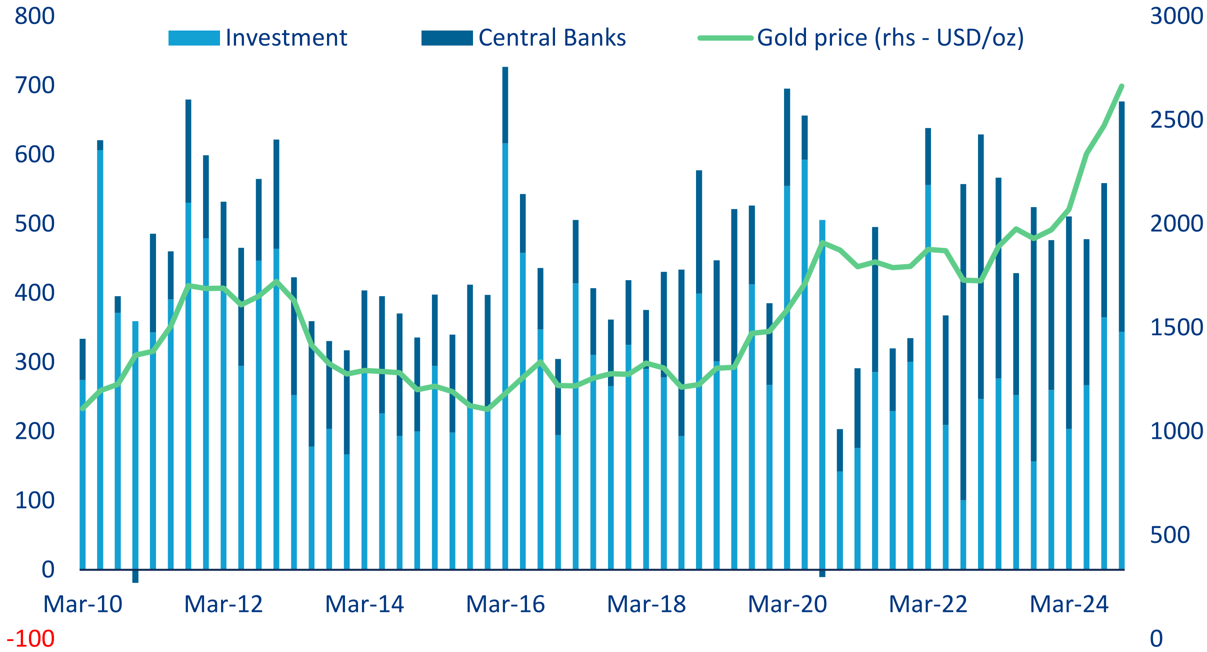
Figure 8: Working's T index for selected metals



Sources: CFTC, Allianz Research

All that glitters is gold: Amid uncertainty and the risk of a more protectionist US administration, both investors and central banks have been buying a record-high amount. While the USD remains on top of the financing system, gold is gaining traction as a safe haven despite record-high prices, not only for investors but also for countries facing tariffs or sanctions. Gold purchases by investors and central banks peaked in Q4 2024 (Figure 9). Over the last 15 years, purchase volumes were only higher during the market sell-off and recession fears of early 2016 and during the pandemic. The interest for gold is likely to remain strong in the near future as a number of emerging countries, with China leading the pack, will try to build resilience against direct or indirect policy in the US that could hurt them. The PBoC purchased 5 tons of gold in November 2024 and added another 10 tons in December 2024. China has also recently allowed its domestic insurance companies to invest up to 1% of their assets in gold, channeling up to USD27bn. At current prices, this would represent about 290 tons of gold and could increase further upward pressures on gold prices by about 15%. Over the next 5 years, the coming online of new gold mines is projected to increase global supply by 3 to 4%, around 3mn to 4mn ounces annually by 2030, with major projects in Australia, West Africa, Pakistan and Canada. While exploration budgets for gold have decreased in 2024, they are poised to increase by over 5% in 2025 against the current backdrop. China has already been diversifying away from US treasuries over the last 10 years, with holdings accounting for 23% of outstanding UST in March 2013 to about 9% in late 2024. However, we do not believe China would fully switch from UST holdings to gold as it would be quite challenging from on operational standpoint. Furthermore, it could also lead the PBoC to sell UST at a discount while purchasing gold at inflated prices. Based on recent market episodes, we estimate that if China was to sell 10% of its holdings (about USD70bn) to pivot to gold, it could push US yields about 10bps higher.

Figure 9: Purchase of gold by investors and central banks (in tons)



Sources: World Gold Council, Allianz Research

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