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What to watch: US bond markets bracing for inauguration, UK's Reeves moment (the sequel) and China upgrades policy mix to counter potential tariffs

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In summary

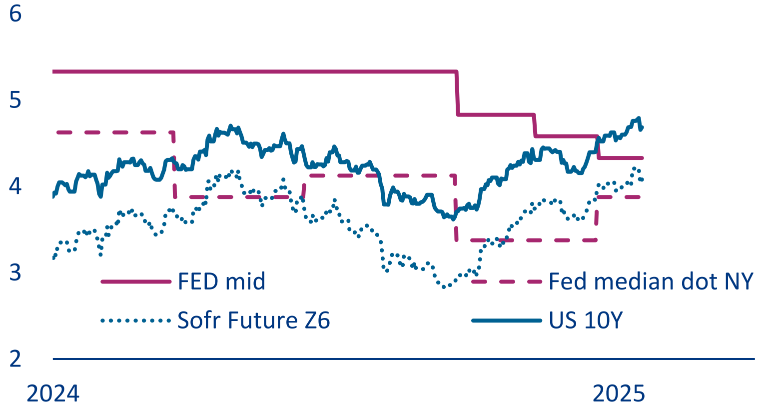
This week we look at three critical issues:

- US: bond m**arket bracing for Trump's inauguration.** US 10y yields climbed up to 60bps since their December lows (20bps ytd) before retreating after a weaker-than-expected inflation print this week. The previous sell-off was driven by a hawkish Fed stance, oil prices, bullish economic data and technical factors. We think markets are currently pricing in an overly high terminal rate for the Fed (around 4.0%) from a fundamental point of view and potentially underestimating the looming political pressure on the Fed to lower rates. We maintain our view that the Fed will deliver one more rate cut this year and two more in 2026, bringing the terminal rate to 3.5%. This should guide long-term yields down toward 4% over the year. However, volatility will persist with the news flow as the Trump administration is likely to quickly implement several of its campaign pledges soon after the inauguration next week.
- UK: not a repeat of the Truss moment. The UK's 10y government bond yield rose by up to 30bps this year to cross 4.9%, the highest level since 2008, before retreating on lower inflation numbers. Yet, the recent sell-off should not be confused with 2022's "Truss moment" as the magnitude is significantly smaller this time around and market functioning is not at stake. Instead, markets priced in a period of reflation and consequently only two more cuts by the Bank of England (BoE), compared to expectations of at least four just a month ago. We expect stagflationary forces to fade over the course of the year because of tighter financial conditions and more restrictive fiscal policy (at least GBP5bn additional savings). The BoE is likely to cut the bank rate by 25bps next month, and to cut in one of every two meetings until Q3 2025. With that, UK 10y yields should stabilize and even decline back towards 4% during 2025.
- China: trade in, trade out. Economic activity improved in Q4 and GDP growth in 2024 should meet the "around 5%" target. Frontloading ahead of a renewed trade war is boosting exports and should remain a tailwind until tariffs are hiked. With still low private confidence, the few positive signs in domestic demand are entirely the result of policy easing since September, which needs to continue this year to lift sentiment. Meanwhile, equity markets have had their worst start to the year in nine years. We expect more from the "very proactive" fiscal policy, with a further focus on consumers through expanding the trade-in scheme, supporting household income and strengthening the social safety net. But ultimately, the intensity and scale will be a response function to how much trade falls due to higher tariffs. The details will only be unveiled in early March. On the monetary side, in the very short term, the PBOC will likely focus more on smoothing the path of the USDCNY rate and sovereign yields. We expect the next policy rate cut only in Q2. Overall, we expect GDP growth at +4.6% in 2025.

US: bond market bracing for Trump's inauguration

The year-end sell-off in global bond markets has continued in 2025, with US 10y yields having climbed by up to 60bps since their December lows before retreating on a weaker inflation print this week. The initial sell-off was driven by a hawkish Fed stance, oil prices, bullish economic data and technical factors. A multitude of factors have driven the recent rise in yields, starting with a hawkish rate cut by the Federal Reserve in late December that reinforced its commitment to controlling inflation. Notably, the median dot of expectations for Fed cuts in 2025 had been revised up by two notches – the steepest reversal of the expected policy path since easing began (Figure 1). Meeting minutes released in January showed that Fed officials were concerned about inflationary policies from the incoming Trump administration. Confirming these worries, president-elect Trump brushed off reports that he might soften on campaign pledges regarding tariffs, which would be highly inflationary if fully implemented. But hard economic data has also surprised on the upside. A strong labor market report in January has further contributed to the yield surge as it indicates sustained economic strength even before the incoming US administration has delivered any business-friendly measures such as tax cuts or deregulation. At the same time, long-term consumer inflation expectations, measured by the University of Michigan survey, climbed to 3.3%, the highest level since 2008. Inflationary concerns can also be attributed to the 14% increase in oil prices, driven by tougher US sanctions against Russia, including blacklisting 183 oil tankers involved in Russian energy exports. Lastly, the rise in yields has also been influenced by technical market dynamics. In the US, data show that active investors have recently increased their bets against falling rates. This pressure has grown significantly in the past two weeks, with speculative positions doubling as traders anticipate further rate hikes or delays in easing monetary policy.

Figure 1: 10y government bond yields and central bank expectations, %



Sources: Bloomberg, Allianz Research

Notes: Fed median dot NY refers to the median projection of Fed governors for next year's (2025) policy rate. The SOFR Future Z6 is a proxy of where markets see the terminal rate of the Fed (overnight rate at the end of 2026).

However, these factors have largely reinforced expectations of a prolonged hawkish stance by the Fed, rather **than signaling an actual rise in inflation. This underscores market confidence in the Fed's independence and its** determination to bring inflation under control, whatever the cost. A closer look at the recent surge in long-term yields reveals that two-thirds can be attributed to a rise in real yields whereas only one-third came from a rise in the expected (break-even) inflation component (Table 1). This indicates that the recent inflationary drivers largely transmit into expectations of a more assertive Fed policy. Notably, the anticipated terminal rate in the current rate-cutting cycle has risen by a similar magnitude to the 10-year yield – approximately 60bps since mid-December – implying only one more rate cut and a terminal rate of 4.00-4.25%. This is an encouraging sign, suggesting that markets retain confidence in the Fed's independence and its commitment to counter inflationary pressures effectively.

Table 1: Capital market moves ytd and since December 2024, % and bps

	14/01/2025		Delta 2025 ytd	Delta since Dec 6 2024
S&P500	5843	%	-0.7%	-4.1%
STOXX600	508	%	0.1%	-2.3%
DAX	8202	%	0.3%	-1.3%
Oil Brent	80	%	7.1%	12.4%
EURUSD	1.03	%	-0.4%	-2.5%
GBPUSD	1.22	%	-2.4%	-4.2%
US 10Y	4.79	bps	22	64
DE 10Y	2.65	bps	29	54
UK 10Y	4.89	bps	32	61
Fed in Dec 2026 exp. (terminal rate)	4.20	bps	23	60
ECB in Dec 2026 exp. (terminal rate)	2.36	bps	29	47
BoE in Dec 2026 exp. (terminal rate)	4.21	bps	35	57
US 10Y inflation expectation (BE)	2.46	bps	12	21
DE 10Y inflation expectation (BE)	1.96	bps	19	22
UK 10Y inflation expectation (BE)	3.64	bps	13	18
US 2y inflation swap (infl. exp.)	2.70	bps	17	16
DE 2y inflation swap (infl. exp.)	2.17	bps	2	8
UK 2y inflation swap (infl. exp.)	4.41	bps	31	55
US swap spread 10y (fiscal austerity exp.)	-47	bps	3	1
DE swap spread 10y (fiscal austerity exp.)	-16	bps	-2	-4
UK swap spread 10y (fiscal austerity exp.)	-54	bps	-4	-7

Sources: Bloomberg, Allianz Research
Notes: This table does not include the partial reversal of interest rates on 15.01.2025 due to the publication of a weaker than expected inflation prints in the US and UK.

The US yield sell-off has pushed global rates higher, but additional factors have played a role in Germany and the UK. As US yields serve as an anchor for global interest rates, much of Europe's upward movement reflects US dynamics. However, local drivers have also contributed. In Germany, prospects of a CDU-led government have boosted hopes for a stronger growth outlook, with parties pledging tax cuts for households, potential corporate tax reductions and reduced bureaucracy. Additionally, discussions around relaxing the debt brake to allow more fiscal easing have gained traction, reflected in a further decline in swap spreads.

We maintain our view that the Fed will deliver one more rate cut this year and two more in 2026, bringing the terminal rate to 3.5%. This should guide long-term yields down toward 4% over the year, though volatility will persist amid the news flow from the incoming US administration. Markets are currently pricing in an overly high terminal rate for the Fed. Given the substantial fiscal deficits, such elevated yields – especially real yields – are unsustainable for the debt trajectory. Additionally, the market is underestimating the political pressure on the Fed to lower rates or at least avoid further hikes. Once expectations align with our projected terminal rate, government bond yields are likely to adjust downward accordingly. However, a flurry of announcements from incoming President Trump is expected to keep markets busy and volatile as they digest the news flow.

President Trump is expected to deliver quickly, with executive orders on immigration, federal spending and deregulation policy soon after the inauguration. President Trump has signaled his intention to enact core policy pledges swiftly after taking office next Monday. Policies that do not require Congress approval are likely to be enacted first. We expect President Trump to sign executive orders on immigration to deploy the National Guard and/or the military at the US-Mexico border and to order the detention and deportation of unauthorized immigrants caught at the border. The President could also trigger the Alien Enemies Act of 1798 to act forcefully, but he would likely face legal challenges. However, to proceed to deportation on a large scale, the President will need to ask Congress to provide financial resources. Congressional Republicans will likely approve new funding swiftly in the next couple of weeks, although the amount that will be approved remains uncertain as Republican deficit hawks will want to see offsetting saving measures elsewhere. A possible figure would be around USD30-40bn of funding approved for 2025. On federal spending, President Trump and the Department of Government Efficiency run by Elon Musk and Vivek Ramaswamy will likely move quickly to reduce funding to some federal agencies (such as the Consumer Financial Protection Bureau or the United States Environmental Protection Agency) and cut back "unauthorized" spending (i.e. spending not authorized by Congress to items such as foreign aid). However, these measures will take at least a few months to be effectively implemented.

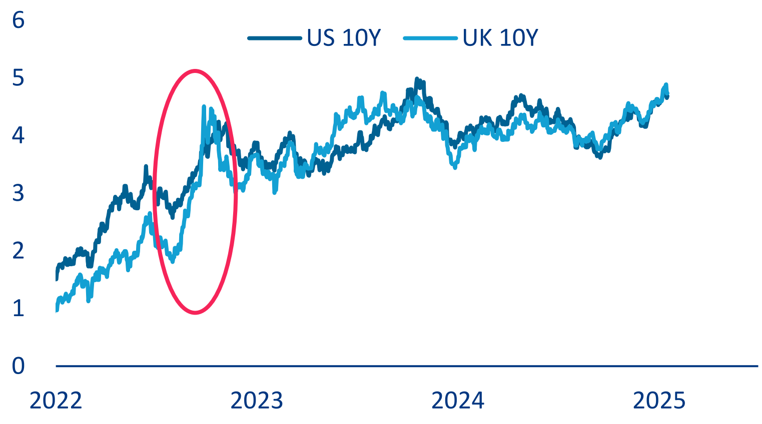
Tariff hikes could also come swiftly, but more likely with incremental steps. Some decisions could also be made quickly on industrial policy. President Trump could potentially move very quickly on industrial subsidies. While it will take time (and tough negotiations in Congress) to repeal Biden's flagship policies such as the Inflation Reduction Act, the President could invoke his authority to direct industrial subsidies to strategic sectors without waiting for Congressional approval. For instance, the President can use authority within existing programs or laws (e.g., the Defence Production Act) to direct subsidies or incentivize industrial production in critical sectors like semiconductors or steel. In terms of deregulation, the President will likely act very swiftly after the inauguration to reverse Biden-era limits on energy projects and exit the Paris Climate Accords. More generally, he could mimic what he did during his first term by issuing an executive order that requires two regulations to be deleted for every new one added. Through executive orders, the President will potentially pause enforcement of new regulations and initiate a full review process for rescission. When it comes to tariffs, uncertainty is very high. President Trump' top economic advisers are reportedly mulling a slow ramp-up in tariffs to avoid economic disruption and to keep tariffs as a bargaining chip in future negotiations with trading partners. In the short term, the most likely scenario is that President Trump announces targeted tariff hikes on some strategic sectors such as steel, aluminium and automotive, but steep tariff hikes on a larger basket of products cannot be ruled out. Canada, Mexico, China and the EU (the latter on automotive) could be the prime targets.

UK: not another Truss moment just yet

The UK has led the global yield surge in 2025, fueled by fears of reflation, a more hawkish central bank stance and fiscal deficits, although they have retreated somewhat on a lower-than-expected inflation print. Within the first two weeks of the year, the UK's 10y government bond yield had risen by more than 30bps to reach 4.9%, the highest level since 2008. Part of this move was reversed with weaker inflation prints in the US and UK this week. Markets were initially pricing in a significant rise in short-term inflation expectations, driven by fiscal policy announcements and consequently less central bank easing than previously expected – down to around two cuts by the Bank of England (BoE), compared to expectations of at least cuts four just a month ago. Long-term yields had mostly been driven up by the real yield component, demonstrating market confidence in the central bank's ability to manage inflation risks in the long run. But concerns of a hawkish central bank had been exacerbated by looming fiscal deficits. Worried about more bond supply down the road, swap spreads fell significantly more than in the US or Germany over the past weeks (Table 1). This dynamic suggests that despite broader global trends, the UK remains vulnerable to fiscal pressures, reinforcing the importance of disciplined policy management to stabilize the bond market and alleviate investor concerns.

But this is not a repeat of the "Truss moment" of 2022. At that time, yields surged by 100bps within just three days, compelling the Bank of England to intervene to prevent market dysfunction (Figure 2). In contrast, the current rise in yields is much less severe, and there is no indication of immediate risks to market stability. Moreover, the latest increase in yields is partly driven by global factors, including a sharp rise in US yields and oil prices. This means that a substantial portion of the recent sell-off in the UK stems from developments outside the government's control.

Figure 2: 10 government bond yields in the UK and US, highlighting the "Truss moment" in 2022, %



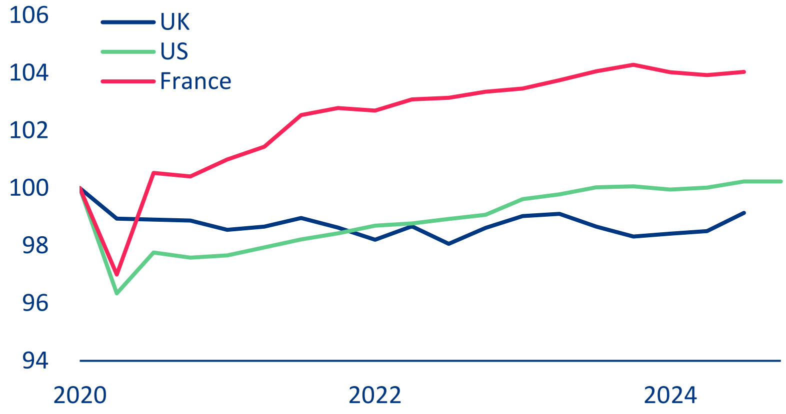
Sources: Bloomberg, Allianz Research

Meanwhile, the Bank of England has to contend with stagflation: the nasty combination of sticky inflation and a weak economy. At 4.75%, the BoE's bank rate is now the highest of all major developed economies: the US Fed's policy rate stands at 4.5% (the upper bound of the Federal Fed Funds), the ECB's is at 3% (deposit rate) and Australia's RBA's is at 4.35% (cash rate). The BoE began a shallow easing cycle in August 2024 but has cut the bank rate by only 25bps twice since then, despite a weak economy – UK GDP grew by a meagre +0.1% q/q in Q3 2024 and is likely to have flatlined in Q4 2024. Nevertheless, the stickiness of inflation has markets expecting the bank rate to decrease to only 4.25% by early 2026 – i.e. only 50bps of additional rate cuts are priced in on a 12-month horizon.

The UK is more at risk of supply-side damage than its peers, making it vulnerable to stagflation and higher rates. Several factors can fuel inflation, including oil (and commodity) prices, non-commodity import prices, supply-chain disruptions, inflation expectations and the balance between supply and demand in the economy (measured by the output gap or the vacancy to unemployed ratio on the labor market). On the positive side in the UK, inflation expectations[1] have come down rapidly over the past two years, settling around their long-term average in Q4 2024. This means that the BoE did not lose credibility during and in the aftermath of the inflation surge of 2022-23: the private sector still expects inflation to return to its long-term average in the relatively near term. However, the UK is still suffering more than its peers from two large supply shocks – the sharp rise in energy prices and lower labor participation. Between Q2 2020 and Q3 2024, energy prices (as measured by the producer price index[2]) have been multiplied by 2.6 in the UK, against 2 in France and 1.6 in the US. At the same time, the participation rate in the labor market has come down compared to pre-pandemic levels, while it has slightly increased in the US and has surged in France (Figure 3). The combination of elevated energy prices and few people in the labor market in the UK have contributed to maintaining elevated price and wage pressures. Services inflation was running at +4.4% y/y in December 2024 (from +5% in November) while average earnings growth (three-month moving average) picked up to +5.1% in October (from +4.4%).

[1] *We look at the BoE's business survey of 12-month ahead inflation expectations.*
[2] *For the UK we calculate a proxy of the headline energy PPI (not available) using a mix of gas, electricity, and fuel prices.*

Figure 3: Labour participation rate (2020-Q1 = 100)



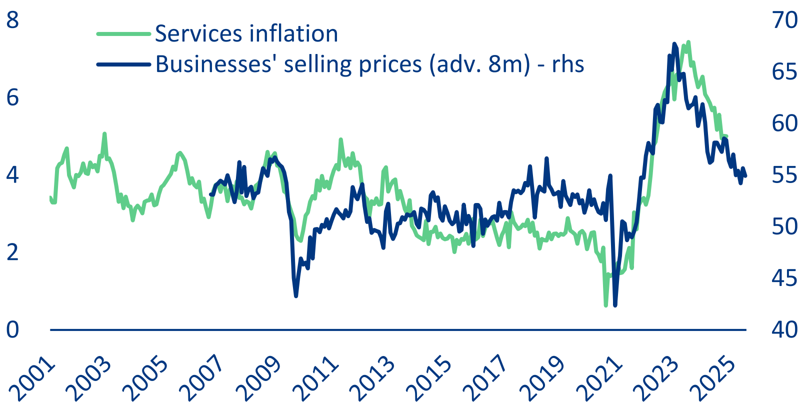
Sources: LSEG Workspace, Allianz Research

Note: participation rate = number of people of working-age working or actively seeking a job as a percentage of the total of working-age people.

However, we think stagflationary forces will fade by Q3 2025 because of tighter financial conditions and fiscal policy (at least GBP5bn of additional savings). We expect inflation to pick up and remain elevated in the first half of 2025. Ofwat announced last month that the average water bill will rise by +23.5% m/m in April. Moreover, in response to the recent rises in wholesale gas prices, it is likely that the Ofgem utility price cap will rise in April by +3.5% (+2% previously) and will fall by -1% in July (-2% previously). However, against this backdrop, tighter financial conditions and tighter fiscal policy in 2025 will keep GDP growth weak. The UK economy has barely grown on a sequential basis since mid-2024, the result of weakening confidence following the budget in October and, externally, because of the weakening of the European industrial sector. The elevated level in Gilt yields will likely keep residential construction activity and turnover weak in the first half of 2025. Besides, high financing costs for the government, but more importantly lower growth than expected by the OBR, put the Chancellor on course to break her fiscal rule this year. This means that she will likely be forced to unveil more tax rises and/or spending restraint in the OBR March fiscal update – or potentially even before. Letting borrowing increase too much would be a recipe for more rises in the Gilt yield, and the Chancellor has reiterated that she is "absolutely committed to meeting the fiscal rules". We expect her to scale back some of her ambitions to step up spending on overseas aid and defense and to further reduce unprotected department spending, but to keep higher funding for the NHS and infrastructure, which are core pledges in the government's platform (reneging on this would not be politically palatable). Further tax rises cannot be ruled out. In all, fiscal policy could swing from being mildly restrictive (0.2pp of GDP) in 2025 to restrictive (0.4/0.5pp of GDP, i.e. GBP5bn of additional savings may be announced).

We expect the BoE to cut the bank rate by 25bps next month, and to cut in one of every two meetings until Q3 2025. With that, UK 10y yields should stabilize and even decline over the course of the year towards 4%. Data already suggest that core inflation and wage growth will pull back in the next six to 12 months. For instance, a survey of businesses' selling prices indicates fading services inflation ahead (Figure 4) while businesses expect median pay settlement for the next 12 months to have come down substantially. In this environment, while we have pushed out some BoE rate cuts to later in the year, we still anticipate a lower bank rate than the market by end-2025. We still expect the BoE to cut the bank rate by 25bps at its next meeting in February, and then to cut in one of every two meetings through Q3. We then expect back-to-back 25bps rate cuts in the November and December meetings. In all, the bank rate should reach 3.5% by December 2025, in line with our expectations for headline inflation to remain elevated (between 2.5% and 3%) through the end of the summer, but core inflation will weaken substantially from the spring. That will give the BoE confidence that underlying inflationary pressures are abating and that more needs to be done to offset the drag on the economy from tight financial conditions and fiscal policy. In this environment, we expect 10y government bond yields to fall back from currently elevated levels towards the 4.0-4.5% range as soon as markets will price in a more dovish central bank stance amid easing inflation expectations.

Figure 4: Services inflation and businesses' selling prices.

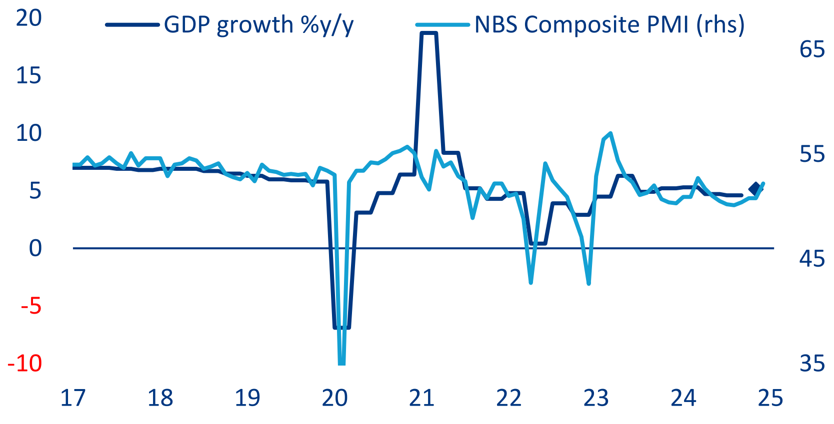


Sources: LSEG Workspace, Allianz Research

China: trade in, trade out

China's policy shift since late-September has led to an improvement in economic activity in Q4 and the likely **achievement of the "around 5%" growth target for 2024.** GDP is likely to have grown by +5.1% y/y in Q4 last year (after +4.6% in the previous quarter), allowing full-year growth to reach +4.9%. Recent data releases suggest that the Chinese economy ended 2024 on a relatively good note (Figure 5), with PMI surveys in the services and construction sectors shooting up in December and the manufacturing PMIs remaining in expansion territory. The latter were probably supported by exports, which rose by a strong +10.7% y/y in December (after +6.7% the previous month). Frontloading ahead of a probable renewed trade war later this year is likely at play and should remain a tailwind in the coming few months, before higher tariff rates are implemented. Domestically, the performance of demand in China is still patchy, with uneven retail sales, very early green shoots in housing sales, housing construction still in a downturn and private investment overall still slowing. With still low confidence in the private sector, the few positive developments in domestic demand are likely entirely the result of policy support since late-September, which needs to be extended further this year to lift sentiment.

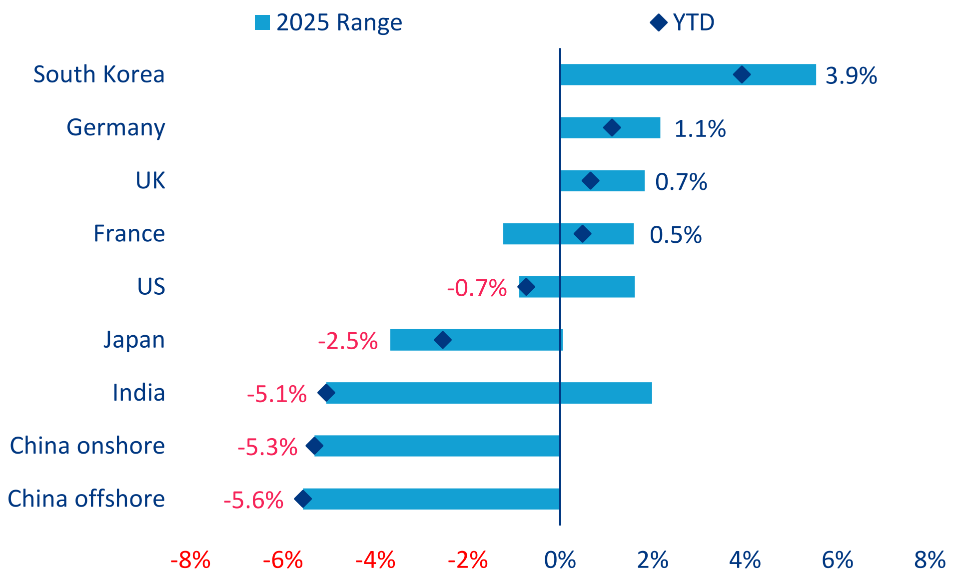
Figure 5: China GDP growth (%y/y) and National Bureau of Statistics' Composite PMI



Sources: national sources, LSEG Datastream, Allianz Research

Amidst low confidence and low price pressures, equity markets have had their worst start to the year in nine years. The onshore and offshore benchmarks dropped by -5.3% and -5.6% in the first nine trading days of 2025, underperforming global peers (Figure 6). The downward trend has persisted since early October last year as investors' piled-up expectations were undermined by constant delays and a lack of details about government stimulus. We expect another year of low earnings growth amid persistent domestic deflationary pressures. While the government has pledged increased support for consumers, the property market, which constitutes a significant portion of Chinese household assets, shows limited signs of recovery (with overall prices continuing to decline and housing stock levels remaining high) – thus weighing on household consumption. Depreciation pressures on the RMB, with a new wave of US tariffs looming, could further dent consumer confidence. Meanwhile, oversupply issues are likely to persist, owing to intense domestic competition, the drag from geopolitical tensions on exports and the government's continued focus on manufacturing investment. We expect a very moderate increase in inflation to 1% in 2025 after 0.2% in the two previous years. Despite relatively attractive valuations compared to historical averages and global peers, weak fundamentals remain a key concern for Chinese equity performance.

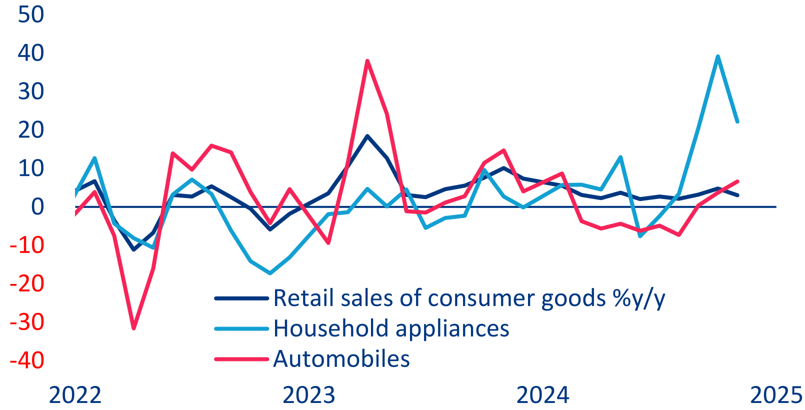
Figure 6: Global equity performance in the first nine trading days of 2025



Sources: LSEG Datastream, Allianz Research
Notes: Data as of 13 January 2025; The market performance is proxied by the total returns of following benchmarks: S&P 500 for the US, FTSE 100 for the UK, DAX for Germany, CAC 40 for France, CSI 300 for China onshore, Hang Seng Index for China offshore, TOPIX for Japan, Nifty 50 for India and KOSPI for South Korea.

Further fiscal easing will be delivered, hopefully centered on consumers, but the scale will be a response function to external shocks. Chinese authorities have been active in delivering policy support since last September, though it has fallen short of market expectations. The latest announcements in January provide hints on how fiscal easing will take shape this year. In 2025, fiscal policy will be "very proactive" (as per official language, vs. "proactive" previously), through an enlarged official deficit target (likely close to 4% of GDP vs. 3% in 2024) and quotas for government bond issuance (e.g. RMB2-3trn of ultra-long-term central government special bonds, vs. RMB1trn in 2024). The precise numbers will only be unveiled at the "Two Sessions" in early March. High on the watchlist will be how fiscal easing will support domestic private consumption. Authorities have already announced that last year's consumer trade-in scheme will be extended and expanded into 2025. The scheme had been successful in supporting retail sales of household appliances and automobiles but did not manage to fully overturn consumer sentiment for the better (Figure 7). Further measures to support household income and strengthen the social safety net are necessary. Ultimately, the intensity and scale of fiscal easing will depend on how large upcoming hits to growth will be, in particular coming from the renewed trade war with the US.

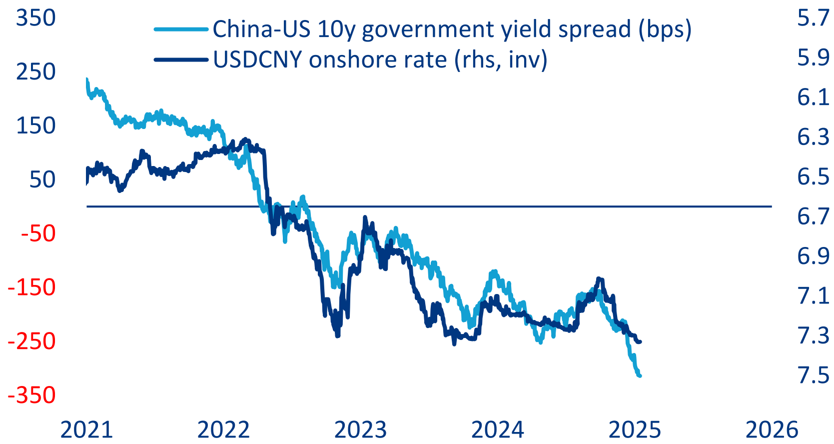
Figure 7: China retail sales (%y/y) – total consumer goods and categories targeted by the consumer trade-in scheme in 2024



Sources: national sources, LSEG Datastream, Allianz Research

Monetary policy: balancing between easing and FX stability. The expected changes in US policies (both domestic and external) are already having an impact on China through the currency channel: the CNY depreciated by 3% vs. the USD in October-November last year, and the USDCNY onshore rate breached the level of 7.3 at the beginning of 2025 after two weeks of resistance. The ongoing bout of currency weakness is also the result of China's domestic policies. Indeed, the stance of the monetary policy was shifted from "prudent" to "moderately loose" on 9 December 2024 (the last time this happened was in November 2008), fanning market expectations of imminent large policy rate cuts. The spread between China and US 10-year government bond yields broke through -300bps in January, reaching record low levels (see Figure 8). While a weaker currency is in theory supportive for exports, Chinese policymakers will be careful about the impact on financial flows and domestic confidence. At a press conference this week, while reiterating that monetary policy is "moderately loose", the PBOC also brought attention to the importance of FX stability. This suggests that in the very near term, policymakers may be more focused on smoothing the path of the USDCNY rate rather than delivering policy rate cuts – we expect the next such move only in Q2 this year (-10bps to the seven-day reverse repo rate).

Figure 8: China-US 10-year government yield spread (bps) and USDCNY onshore rate



Sources: LSEG Datastream, Allianz Research

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