Funcas Intelligence

GLOBAL INSTABILITY AND EUROPE'S STRATEGIC RESPONSE

May 2025

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Funcas Intelligence (FI) is a publication directed towards a broad base of international and Spanish readers. Funcas Intelligence´s focus is to identify and assess the game changers and relevant events of the global economy and the financial sector with potential impact for Spain.

FI is produced by the staff of Funcas under the direction and supervision of Managing Editors Ms. Alice Faibishenko and Mr. Juan Núñez-Gallego. We would like to especially thank Santiago Carbó Valverde for providing the views expressed in the article titled, *Yield Curves and Crosswinds.*

Contents

Yield Curves and Crosswinds

Navigating divergent monetary policies, bond market volatility and tariffs

→ The divergence between the Federal Reserve's cautious stance and the ECB's ongoing rate cuts is reshaping yield curves and driving volatility across global bond markets.

→ Investors face a complex environment shaped by persistent inflation, trade tensions, and uncertain tariff outcomes, requiring active management and geographic diversification in fixed-income strategies.

As we progress through the second quarter of 2025, global financial markets are contending with a complex interplay of monetary policy decisions, inflationary pressures, and geopolitical tensions. In the United States, the announcements of new tariffs on the majority of countries on April 2nd, particularly China, has caused a great deal of financial turbulence. Indeed, financial tensions drove the U.S. government to moderate its stance and open a 90-day negotiation period with more than 100 countries. However, investor uncertainty remains as the final outcome of the tariff negotiations is very difficult to foresee.

Financial tensions drove the U.S. government to moderate its stance on tariffs and open a 90-day negotiation period with more than 100 countries

In the United States, the Federal Reserve maintains a cautious stance, holding the federal funds rate steady at 4.25%–4.50%, despite strong calls from the administration for rate cuts amid slowing economic growth and persistent inflation. Conversely, the European Central Bank (ECB) has adopted a more accommodative approach, implementing its seventh consecutive rate cut, bringing the deposit facility rate down to 2.25%. This divergence in monetary policy paths has significant implications for bond markets, yield curves, and investor strategies across both regions.

U.S. monetary policy: A balancing act amidst inflation and growth concerns

The Federal Reserve faces a delicate balancing act as it strives to achieve its dual mandate of price stability and maximum employment. Despite a contraction in first quarter GDP and increasing pressure from the administration to cut rates, the Fed remains steadfast, citing concerns over inflation, which remains above the 2% target. Treasury Secretary Scott Bessent has pointed to the inversion of the yield curve, with the two-year Treasury yield falling below the federal funds rate, as a market signal for potential rate cuts. However, so far the Fed appears poised to maintain its current policy stance until clearer signs of economic slowdown emerge.

The Federal Reserve is holding rates steady despite a Q1 GDP contraction and mounting political pressure to cut

In contrast to the Fed, the ECB continues its easing cycle, reducing key interest rates by 25 basis points in April, despite a rise in core inflation to 2.7%

Eurozone: ECB's easing cycle amidst persistent inflation

In contrast, the ECB continues its easing cycle, reducing key interest rates by 25 basis points in April, despite a rise in core inflation to 2.7% .ECB officials, including Vice President Luis de Guindos, express optimism about the disinflation process, suggesting that inflation is nearing the 2% target. The ECB's dovish stance reflects concerns over deteriorating growth prospects, exacerbated by global trade tensions and their impact on the Eurozone's export-driven economy.

10-year Treasuries surged in early April amid trade tensions and inflation concerns, prompting a reevaluation of the U.S. Treasury market's safe-haven status, while EU bond markets have remained relatively stable

Bond market dynamics: Volatility and shifting investor sentiment

Bond markets have experienced heightened volatility in recent months. In the U.S., the 10-year Treasury yield surged to approximately 4.5% in early April, driven by concerns over inflation and the sell-off in response to escalating trade tensions. This spike in yields prompted a reevaluation of the bond market's role as a safe haven, with some investors expressing concerns over the long-term stability of U.S. Treasuries. In the Eurozone, bond yields have remained relatively stable, supported by the ECB's accommodative policies and a more favorable inflation outlook.

Geographic diversification and active management are becoming critical in navigating fixed-income portfolios

Investor strategies: Navigating a complex landscape

Investors are recalibrating their strategies in response to the evolving macroeconomic environment. In the U.S., the flat yield curve and persistent inflation have led to increased interest in shorter-duration bonds and inflation-protected securities. In the Eurozone, the ECB's rate cuts have spurred demand for higher-yielding assets, with investors seeking opportunities in corporate bonds and emerging market debt. The divergence in monetary policies between the U.S. and Eurozone underscores the importance of geographic diversification and active management in fixed-income portfolios.

The final tariff structure in the U.S. and (the reaction from the rest of the world) will also shape the U.S. and global economy

Outlook: Monitoring central bank policies and economic indicators

Looking ahead, the trajectory of interest rates and bond markets will affect central bank policies and key economic indicators. In the U.S., the Federal Reserve's decisions will depend on the interplay between inflation trends and economic growth. The final tariff structure in the U.S. and (the reaction from the rest of the world) will also shape the U.S. and global economy. In the Eurozone, the ECB's commitment to supporting the economy through monetary easing will be tested by inflation dynamics and external shocks. Investors still seem nervous and will remain vigilant, closely monitoring policy developments and macroeconomic data to deal with the complexities of the current financial landscape.

Critical Minerals, Rare Earths and Escalating Geopolitical Tensions

Assessing U.S., Chinese, and EU strategies

→ The global race for rare earths and critical minerals is intensifying as China maintains dominance and uses its leverage to exert influence, and the United States pursues an aggressive approach to increase access to resources overseas.

→ The EU has developed a strategy, but this is not a top priority for Europe for now, making the bloc more vulnerable to supply chain disruptions.

Introduction
Critical materials and rare earth elements have become central to 21st-century industrial competitiveness and geopolitical strategy. Once niche commodities, the global market has surged, doubling to $320 billion in the past five years, with demand expected to double again by 2030.[1]

Critical materials and rare earth elements have become central to 21st-century industrial competitiveness and geopolitical strategy

These materials are essential for clean energy, defense technologies, electric vehicles (EVs), and AI systems, sectors that will determine economic and military power.[2] China dominates mining, processing, and refining, leveraging its control to advance its strategic interests. The United States is racing to secure supply chains, reshape industrial policy, and bolster economic sovereignty, while the EU is struggling to keep up.

Critical and rare earths and why they matter
The United States has deemed 50 minerals essential to the economy and national security, while the EU lists 34 critical raw materials that are important for its economy and are at risk of supply disruptions.[3,4]

The United States and the EU recognize 17 rare earth elements (REEs), a group of chemically similar metallic elements. REEs have narrower supply chains and are often more difficult to extract, requiring more work to separate them from other minerals.

Aluminum and steel are key for solar panels and wind turbines. Lithium, cobalt, nickel, manganese, and graphite support rechargeable batteries. Copper and various rare earths are essential in solar panels, electronics, and AI technologies. Silicon is needed for photovoltaic panels, and graphite is used in lithium-ion batteries.

Rising demand and global supply concentration

Demand is surging for these resources. Global demand for copper may double by 2035 to meet net-zero carbon emissions by 2050.[5] U.S. data centers that support AI could require as much as 200,000 tons of copper per year.[6] The EU demand for lithium batteries, which power electric and energy storage vehicles, will increase 12-fold by 2030.[7]

China has one-third of global rare earth reserves, produces 70 percent, processes nearly 90 percent, and refines over 91 percent of the worldwide supply.[8]

The United States, by contrast, has just one percent of global rare earth reserves and produces 11 percent of rare earths. It is either fully or 50 percent import-reliant for 41 of the 50 critical minerals. China is the top producer of 29 of these critical minerals.[9]

The EU's Green Deal goals rely on stable access to critical inputs for EVs, batteries, and wind turbines. However, Europe is more vulnerable than the United States. It relies heavily on imports: 97% of its magnesium comes from China, and 98% of borate from Turkey.[10] It has no large REE mines and only one commercial-scale processing facility–in Estonia.[11] It has modest and underdeveloped reserves, the largest of which are in Spain, Portugal, and Finland.

The growing demand and geographic concentration create strategic vulnerabilities, exposing the United States and particularly Europe to potential supply chain disruptions

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Comparing strategic approaches

United States

The Biden administration focused on reshoring and diversifying supply chains by providing tax credits and funding for mining, processing, and R&D via newly adopted laws, and pursuing trade policies protecting domestic industry. It also negotiated bilateral agreements with allies and funded mining investment projects.

In his second term, President Trump has adopted a more aggressive approach: Signing an agreement with Ukraine and proposing a deal with the Democratic Republic of Congo, invoking emergency powers to fast-track domestic mining, and calling for the annexation of Greenland and Canada

In his second term, President Trump has adopted a more aggressive approach: Signing an agreement with Ukraine and proposing a deal with the Democratic Republic of Congo to increase access to minerals, invoking emergency powers to fast-track domestic mining, and calling for the annexation of Greenland and Canada. In late April, he issued a controversial executive order to expedite permits for companies to mine in U.S. and international territorial waters.[12]

China

China's strategy dates to the 1970s, with decades of state-led investment in mining, refining, and downstream technologies. Today, industrial policy and state-backed financing maintain Beijing's grip on the market. It provides subsidies and tax incentives for mining. State-owned enterprises act as companies and arms of state policy. It has also integrated rare earths into its broader industrial targets for EVs, semiconductors, and military tech. China has also pursued mining rights abroad in Africa, Latin America, and Southeast Asia, using state-backed financing to fund infrastructure-for-minerals deals. Chinese companies too flood markets with cheap supplies to drive out domestic competition. And since 2020, it has made export controls a key component of its economic statecraft.

European Union
The EU's nascent strategy is based on the green and digital transition, sustainability, and strategic autonomy. The Critical Raw Materials Act, adopted in 2023, and the European Raw Materials Alliance, launched in 2020, shape Brussels' approach. Europe has a centralized strategy, with clear targets and frameworks. It emphasizes environmental standards, recycling, reuse, and waste reduction in its processes. However, permitting is slowed by strict environmental standards and public resistance. It also has limited infrastructure and lags in midstream capacity.

Emergence as a geopolitical tool
U.S.-China tensions are escalating into a mineral trade war. After Trump raised tariffs on Chinese imports to 145% in April, China imposed export restrictions on seven key REEs and magnets, which are particularly important to the United States. China's response will protect its domestic industry while undermining U.S. competitiveness in key sectors. Trump responded with threats of further tariffs and directed the government to review U.S. supply chain vulnerabilities and the development of ways to increase production without relying on imports. Tariffs may raise input costs for U.S. manufacturers before alternative supply chains can be established. The United States faces long lead times for new mining and processing infrastructure.

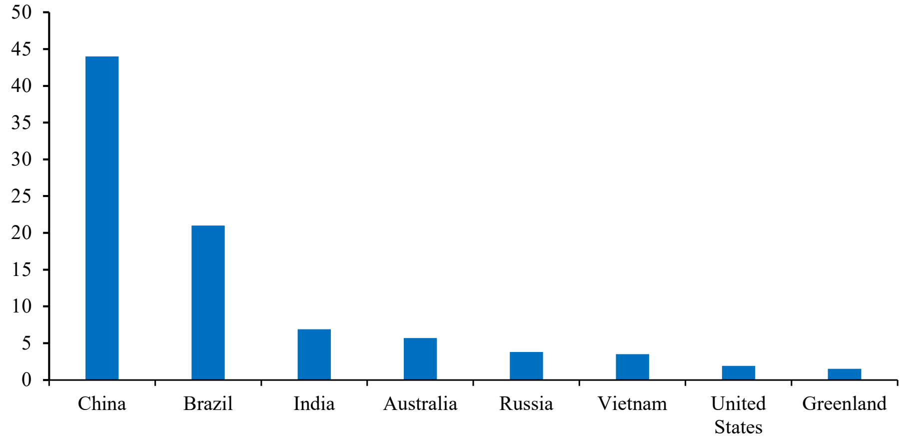
U.S.-China tensions are escalating into a mineral trade war

The EU reality gap and policy recommendations
The race to secure critical and rare earths will define global power dynamics in the coming decades. Yet for now, the issue of rare earths and critical minerals is primarily a policy concern for the United States and China.

The EU has taken steps to reconfigure its critical mineral supply chains. However, it lags far behind. The EU should accelerate action, forge new alliances, and invest in resilient, sustainable supply chains before it falls too far behind. Rising prices, supply chain disruptions, or import restrictions will erode the EU's industrial competitiveness, energy security, and clean energy goals.

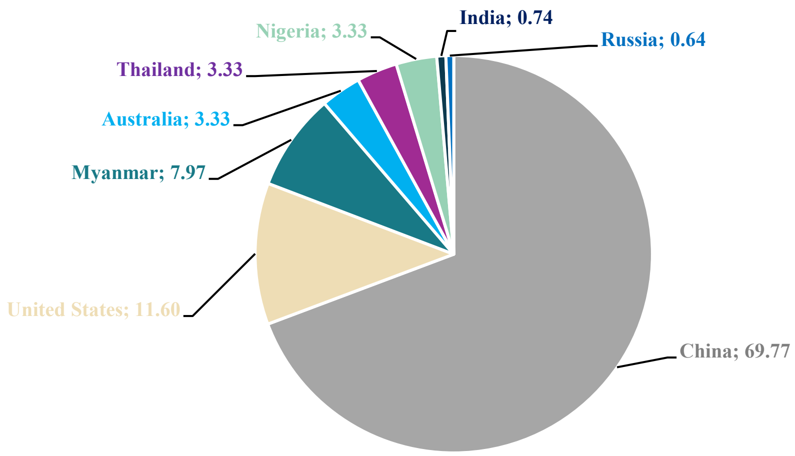
The EU should accelerate action, forge new alliances, and invest in resilient, sustainable supply chains before it falls too far behind

EXHIBIT 1.0 – LOCATION OF RARE EARTH RESERVES IN 2024
(IN MILLIONS OF TONNES OF RARE EARTH OXIDES)



Source: U.S. Geological Survey.

EXHIBIT 2.0 – GLOBAL DISTRIBUTION OF RARE EARTHS PRODUCTION IN 2024
BY COUNTRY INDICES IN 2025 (PERCENTAGE)



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The EU's Push for Administrative Simplification

Cutting red tape to boost competitiveness

→ The EU has launched a "simplification revolution" to cut red tape and ease regulatory burdens on businesses, especially SMEs, in the face of mounting pressure.

→ These efforts may not ultimately yield the changes needed to boost European competitiveness and growth, but they represent an admission by EU policymakers that they must begin the process of simplifying regulations and deregulating.

EU announcement

The European Union (EU), long known for setting global regulatory standards, is rethinking its approach. Amid growing criticism that complex and burdensome regulations stifle economic growth and competitiveness, the European Commission announced plans to simplify existing legislation and reduce red tape to help European businesses, particularly small and medium-sized enterprises (SMEs) to better compete globally, especially with counterparts in the United States and China.[1]

Assessment of the problem

Companies in Europe trying to scale face excessive compliance demands, with businesses spending roughly €150 billion annually on paperwork

Reports by Mario Draghi (September 2024) and Enrico Letta (April 2024) laid bare the issue: inconsistent and restrictive regulations hinder European businesses. Companies in Europe trying to scale face excessive compliance demands, with businesses spending roughly €150 billion annually on paperwork.[2]

This overregulation is seen as one reason Europe lags economically. The EU's GDP gap with the United States has doubled from 15% to 30% since 2002.[3] Europe also has just four of the world's top 50 tech firms, reflecting its difficulty in fostering innovation and growth under existing rules.[4]

Proposals

EU leaders launched a "simplification revolution" to create a clearer legal framework and reduce administrative burdens, especially for SMEs

EU leaders launched a "simplification revolution" to create a clearer legal framework and reduce administrative burdens, especially for SMEs. Proposed targets include a 25% reduction in reporting requirements for large firms and a 35% cut for SMEs.[5] The aim is to free up resources for growth, innovation, and competitiveness without abandoning the core policy goals.

In February 2025, the Commission adopted the first package of proposals to simplify EU rules and boost competitiveness in sustainability, finance, and EU investments.[6] It would reopen and simplify many existing laws, such as the Corporate Sustainability Reporting Directive (CSRD), the Corporate Sustainability Due Diligence Directive (CSDDD), and the Carbon Border Adjustment Mechanism. The Commission has also published a draft proposal for amendments to delegated acts under the EU Taxonomy Regulation for public consultation.

The European Council passed this under a fast-track process in April, underscoring the urgency of providing legal certainty to EU companies. For some firms, the proposed regulations would delay CSRD and CSDDD deadlines by up to two years, giving businesses more time to adjust to the new regulations. It would retain the reporting obligations for larger companies while exempting SMEs. The quick agreement will give EU policymakers time to agree on substantive changes to the CSRD and CSDDD, which are also proposed as part of the sustainability omnibus package.[7]

Political and institutional reactions

Business groups, some right-leaning politicians, and some Member States back these simplification efforts. The EU's main business lobby, BusinessEurope, supports simplification and submitted 68 proposals to reduce regulatory burdens.[8] They include streamlining cross-border rules, cutting bureaucracy, and lowering compliance costs. Some Member States, like France and Germany, two of the most influential EU Member States, have also called for a delay in compliance deadlines.

Business groups, some right-leaning politicians, and some Member States support simplification efforts

NGOs, left-leaning lawmakers, and some companies warn that reopening laws to simplify regulations could backfire. They argue that reopening these laws could weaken them, especially as a more conservative European Parliament would welcome the chance to water down existing regulations.

EU regulators are also urging caution. Financial supervisors worry that some reforms might undermine protections built after the 2008 crisis and have stressed that economic growth shouldn't come at the expense of financial or environmental safeguards.[9]

Obstacles to reform

U.S. President Trump's efforts to compel countries to eliminate or reduce nontariff barriers as part of his trade negotiations may also influence reform efforts. As the EU seeks tariff relief from the United States, Trump may ask the bloc to halt implementation of regulations that impose burdensome requirements on U.S. businesses.

As policymakers pursue reforms, officials and lobbyists will seek deeper reforms to undermine the regulations, while others will fight all changes to protect the underlying measures

The EU's complex policymaking process presents serious hurdles. Legislative proposals must navigate numerous review mechanisms and political negotiations. As policymakers pursue reforms, officials and lobbyists will seek deeper reforms to undermine the regulations, while others will fight all changes to protect the underlying measures. There's also a risk that, once reopened, laws could either be watered down or become stuck in political deadlock.

Already, critics are challenging the reform process. In April, eight NGOs filed a complaint with the European Ombudsman, alleging the Commission failed to provide public consultation on the omnibus proposals.[10]

Conclusion

The EU's efforts may not ultimately yield the changes needed to boost European competitiveness and economic growth, but they represent an important admission: The EU must begin the process of simplification and deregulation

The EU's decision to delay and tweak some landmark regulations signals a shift from idealism to pragmatism. It also aligns with U.S. President Trump's goal of reducing regulations for American companies.

The EU's efforts may not yield the changes needed to boost European competitiveness and economic growth, but they represent an important admission: The EU must begin the process of simplification and deregulation.

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The EU's Digital Euro Plans

A small-scale strategic hedge

→ The digital euro is a strategic initiative by the European Central Bank (ECB) to strengthen the EU's monetary sovereignty in response to EU vulnerabilities and concerns about U.S. policy unpredictability.

→ The initiative is still in its early stages and is being designed as a cautious, small-scale experiment with potential for future expansion.

Introduction

The return of Donald Trump to the White House has revived EU policymakers' concerns about the possible impact of unpredictable U.S. policies, particularly in areas like trade, sanctions, and control over global payment networks.[1] It has also reinforced European concerns about overreliance on U.S.-dominated infrastructure and the dollar-based financial system and underscored the need to reduce vulnerabilities.[2]

Background

In May 2020, 35 countries and currency unions were exploring using a central bank digital currency (CBDC), a digital version of fiat currency issued and controlled by a central bank with the same guarantees.[3] As of February, that number had jumped to 134.[4]

The ECB has emphasized that the digital euro will initially be limited in scope, focusing on low-risk applications and small-scale transactions

The European Commission proposed launching a digital euro in June 2023 and hopes the investigatory phase of the project will be completed by October. The ECB has emphasized that the digital euro will initially be limited in scope, focusing on low-risk applications and small-scale transactions.[5] This approach allows the ECB to gather data, test resilience, and assess public acceptance without inducing systemic shocks.

It has proposed draft legislation for consideration by the Council of the European Union and the European Parliament. EU lawmakers are currently divided on the idea of a digital euro, and it is thus far unclear if they will agree to continue to develop the project after the end of the investigation phase.[6] Their main concerns include the potential for financial instability and privacy risks, with some calling instead for a pan-European private sector solution.[7]

Vulnerability to external shocks

A digital euro represents a strategic hedge against geopolitical volatility, economic pressure, changing terms of service, or service withdrawal threats by bolstering European monetary sovereignty and reducing vulnerability to external shocks.

In an 8 April speech, Piero Cipollone, Member of the ECB Executive Board, emphasized the importance of cash for ensuring financial inclusion and resilience. He also underscored the need to develop a CBDC to enhance Europe's strategic autonomy and reduce vulnerabilities.[8]

Phillip Lane, another ECB Executive Board Member, has also warned about Europe's vulnerabilities. He has noted that foreign payment providers, such as Visa and Mastercard, process 65% of euro area card payments, and mobile app payments dominated by non-European tech firms, such as Apple Pay and Google Pay, account for almost 10% of retail transactions.[9]

Foreign payment providers process 65% of euro area card payments and mobile app payments dominated by non-EU firms account for almost 10% of retail transactions

Risk to financial stability

Some critics are concerned that a digital euro could allow citizens to hold digital euros directly with the ECB, which could trigger a shift away from commercial bank deposits in times of financial stress.[10] If citizens view the ECB as a safer alternative, banks could face sudden outflows, undermining their ability to lend and potentially exacerbating economic downturns.

Some critics are concerned that a digital euro could allow citizens to hold digital euros directly with the ECB, which could trigger a shift away from commercial bank deposits in times of financial stress

However, this risk can be mitigated. The ECB has proposed strict caps on individual holdings – potentially around €3,000 – and has clarified that digital euro accounts will offer no interest. These design choices aim to prevent the digital euro from functioning as a savings vehicle and position it as a transactional tool.

Privacy concerns

Some critics also raise privacy concerns. They believe the digital euro could serve as a "Big Brother" tool that could erode financial anonymity.[11] However, the ECB also announced plans to uphold privacy standards and explore technologies like zero-knowledge proofs that allow for private, yet compliant, transactions.[12]

This perspective also overlooks an important fact: Existing banking systems already require extensive reporting to government authorities. In practice, most digital financial activity is already subject to scrutiny as banks must report suspicious transactions and provide customer data upon request pursuant to anti-money laundering and counter-terrorist financing regulations.

Most digital financial activity is already subject to scrutiny as banks must report suspicious transactions and provide customer data upon request pursuant to regulations

Cross-border payments

One potential advantage of the digital euro lies in cross-border payments, which remain slow and costly under current systems. A digital euro could streamline international transfers by reducing reliance on intermediaries and outdated infrastructure.[13]

Cross-border payments are one area where digital euro could offer significant improvements

To maximize these potential benefits, it must be expanded beyond the eurozone and interoperable with other CBDCs.[14] Policymakers should also avoid enacting overly strict regulations in the name of preventing capital flight and illicit transfers.

Conclusion

The digital euro is not designed to revolutionize the financial system overnight, and it is unlikely to dramatically alter how Europeans conduct daily transactions in the short-term

The EU's digital euro project is not being designed to revolutionize the financial system overnight and dramatically alter how Europeans conduct daily transactions in the short-term.

Instead, it is a foundational infrastructure that can be expanded if future conditions demand it. Whether triggered by geopolitical crises, technological shifts, or private sector disruptions, the digital euro could provide the ECB with a flexible tool that could be scaled.

The EU's concerns about U.S. policy unpredictability and vulnerability to external shocks, coupled with the ECB's cautious approach and the view that this project is a small, low-risk experiment, will likely overcome EU lawmakers' skepticism.

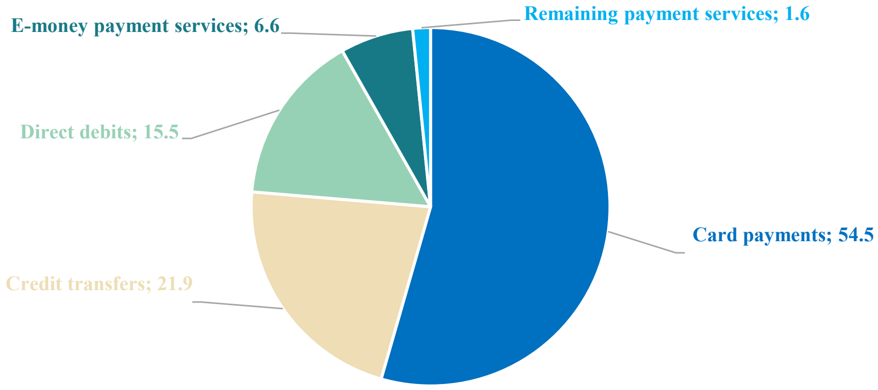
EXHIBIT 3.0 – STATUS OF CENTRAL BANK DIGITAL CURRENCIES FOR EURO AREA AND EU MEMBER STATES

Country/Region	Status	Use Case	Architecture
Andorra	Research	Retail	Undecided
Austria	Development	Retail, Wholesale	Undecided
Belarus	Development	Undecided	Undecided
Czech Republic	Research	Undecided	Undecided
Denmark	Inactive	Retail	Undecided
Estonia	Development	Retail	Intermediated
Euro Area	Pilot	Retail, Wholesale	Intermediated
France	Pilot	Retail, Wholesale	Intermediated
Germany	Development	Retail, Wholesale	Intermediated
Iceland	Inactive	Retail	Undecided
Italy	Pilot	Retail, Wholesale	Intermediated
Hungary	Research	Retail	Undecided
Lithuania	Inactive	Retail	Undecided
Luxembourg	Pilot	Retail, Wholesale	Undecided
Montenegro	Pilot	Retail	Undecided
Netherlands	Development	Retail	Intermediated
Norway	Pilot	Retail, Wholesale	Undecided
Spain	Pilot	Retail	Undecided
Sweden	Pilot	Retail	Intermediated

Note: Architecture refers to the technical and operational design of how the digital currency is issued, managed, and transacted. When intermediated, the central bank issues the CBDC, but commercial banks or payment providers distribute and manage it, similar to the existing monetary system.

Source: Atlantic Council Central Bank Digital Currency Tracker.

EXHIBIT 4.0 – PERCENTAGE OF NON-CASH PAYMENT SERVICES IN THE EURO AREA (FIRST HALF OF 2023)



Source: European Central Bank.

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Prolonged Volatility and Bond Markets

The impact of U.S. tariffs and German stimulus

→ Dramatic shifts in U.S. economic policy and the announcement that Germany will ramp up investment through the issuance of new debt have caused significant swings in bond yields this spring.

→ Different growth prospects, debt sustainability concerns, political dynamics, and anticipated shifts in monetary policy could all influence how markets respond to changes, creating a more uncertain bond market environment in the months ahead.

U.S. Treasuries and the EU bond markets entered a new era of volatility this spring, with yields exhibiting substantial swings. These movements can be attributed to President Trump's erratic trade policy, and in the case of the EU, Germany's embrace of fiscal stimulus. Combined, these two significant policy shifts have ushered in a high degree of economic uncertainty. While there has been some moderation of bond yields, ongoing concerns over the impact of these policies mean the bond markets will continue to be a source of concern, with some EU countries especially vulnerable to a rise in interest rates.

U.S. Treasuries experience a sharp drop in investor confidence

After a bumpy March for European bond markets, April saw extraordinary levels of volatility in the U.S. Treasury market. Specifically, the 10-year Treasury yield fell to 3.99%, rebounded to 4.49%, and then declined again to 4.17% by the end of April.[1] These swings happened after President Trump announced a dramatic change in trade policy which has shifted the investor focus towards a downgrade of U.S. growth prospects. Specifically, the U.S. introduced a blanket 10% tariff on almost all imports, alongside significantly higher levies for specific economies like China[2] and specific goods such as steel.[3] The concern is that these tariffs will stifle the U.S. economy and could prove inflationary. Indeed, the recent dislocation in the U.S. Treasury market is alarming in itself but also due to its broader implications about whether investor perceptions of U.S. Treasuries and the Dollar as traditional safe-havens are shifting.

The recent dislocation in the U.S. Treasury market is alarming due to its broader implications about whether investor perceptions of U.S. Treasuries and the Dollar as traditional safe-havens are shifting

Although there has been some moderation in U.S. trade policy, tariffs remain at historic levels. This, alongside President Trump's mercurial policymaking, indicates the U.S. and global economy have entered into a new period of constrained growth and elevated uncertainty. Indeed, "the combination of persistent trade tensions, high geopolitical uncertainty, and weakening domestic demand in much of the world suggests that the global economy will continue to navigate turbulent waters", which suggests bond markets will remain jumpy over the medium-term.[4]

Germany throws a spanner in the works

Germany effectively abandoned its *schwarze null,* or debt break, in order to ramp up defence spending to 45 billion EUR and introduce a 500 billion EUR infrastructure fund

The first notable movements in the EU bond market occurred in March after the German parliament signalled a financial *Zeitenwende,* or turning point. Germany effectively abandoned its *schwarze null,* or debt break in order to ramp up defence spending to 45 billion EUR[5] and introduce a 500 billion EUR infrastructure fund.[6]

Although positive spillover effects from Germany's fiscal stimulus could benefit the growth outlook for some of its neighbours, the overall impact of this policy is unclear since this shift may add volatility rather than stabilise Europe's bond markets. Following the announcement, German 10-year bond yields increased 40 basis points.[7] Other EU economies saw their borrowing costs rise in March, too.[8] France's bond yields rose to levels on par with the financial crisis. Meanwhile, Italian bond yields reached nearly 4%.

Importantly, the underlying reasons for these bond movements are not uniform, with this divergence an expected source of ongoing volatility in the bond market. In the case of Germany, it was more a reflection of bond market fundamentals related to increased supply and was accompanied by renewed confidence in German economic growth prospects on the back of more expansionary fiscal policy.

Higher borrowing costs will raise concerns about debt sustainability

The associated upward movement in bond yields could also undermine positive spillover effects from German fiscal stimulus and make some EU countries' debt unsustainable

While Germany can manage higher borrowing costs due to its low debt-to-GDP ratio, other European countries are more vulnerable. It is probable that German fiscal stimulus could lift economic forecasts for other EU countries that are closely tied to the German economy. However, the associated upward movement in bond yields could also undermine this positive spillover effect if it makes those countries' debt unsustainable.

An increase in bond issuance by Germany also means other EU countries face greater competition to attract investors. As a result, they may have to pay higher yields to borrow. This matters as it comes at a time when there are growing demands on government spending.

Deft policymaking could help steady market nerves

In this context, decisive and predictable policymaking that supports productive investment will be essential. Unfortunately, current political dynamics across the EU and within EU countries individually are unlikely to have a stabilising impact on EU bond markets. In Germany, for instance the turbulent election process ultimately leading to the selection of Chancellor Merz opens the door to more political tensions down the road at the European level.

Monetary policy and bond market volatility

Given recent challenges with persistently high inflation across the bloc, any sign that inflation is making a comeback and of anticipated tightening by the ECB would provoke a robust reaction from Europe's bond markets.

Alternatively, U.S. tariffs could negatively offset any boost in growth from German fiscal stimulus requiring looser monetary policy by the ECB.[9] Some analysts argue that the ECB's benchmark interest rate could dip to as low as 1.25% if tariffs sufficiently dent global trading, and by extension, EU growth.[10]

Bond markets will also be highly reactive to any divergence of ECB and Fed policy. Indeed, in contrast to the ECB, in its latest meeting on May 7th, the Federal Reserve kept its benchmark rates unchanged at 4.25%-4.5%, despite President Trump's public calls for immediate rate cuts to stimulate the economy, as Chairman Powell cited ongoing economic uncertainty and the potential inflationary impact of recent tariffs. This suggests that yields on U.S. and EU bonds, depending on how the economy evolves, could be a source of volatility as investors become more attuned to risk and adjust their capital flows accordingly.

Conclusions and implications for bond markets

While bond yields have normalised somewhat since March's spike, this is likely to be a temporary respite. The economic costs associated with U.S. tariffs and the potential impact of German fiscal stimulus across the EU and will likely create reactive movements in the Treasury and EU bond markets as the situation on either side of the Atlantic evolves. Notably, not all countries will experience the same degree or direction of movement in bond yields. German bonds are expected to maintain their safe haven status but the market's confidence in U.S. Treasuries could further erode, resulting in an asymmetrical and stark movement in bond yields across developed countries.

The potential impact of German fiscal stimulus across the EU and the economic costs associated with U.S. tariffs will likely create reactive movements in bond yields as the situation evolves

Notes

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India’s Manufacturing Ambitions in the Context of the Pakistan Conflict

Evaluating potential impact

→ India is rapidly growing economically and is increasingly seen as a viable manufacturing alternative to China, though it will not soon replace China as the global manufacturing hub.

→ Despite the current ceasefire, the nature of the recent India-Pakistan conflict erodes investor confidence and potentially undermines India’s broader economic ambitions.

Indian boom

When India surpassed the UK as the world’s fifth-largest economy in 2022, Indian Prime Minister Modi avowed, “We have left behind those who ruled us for 250 years… We will not stop now.”[1]

India had an average annual GDP growth rate of 7.8% from 2021-2024 compared to 5.4% for China.[2] Projections indicate India will continue to grow faster than China, gradually narrowing the gap. Its economic growth is driven partly by more investors seeking to diversify out of China due to U.S. tariffs, geopolitical risk, and rising Chinese labor costs. Companies like Apple and Samsung have expanded their production in India.[3] Western companies also view India as a cheap alternative for diversifying their supply chains. As well, India has a demographic edge. It has surpassed China in population and has a younger and expanding workforce compared with China’s aging and shrinking population. These trends have led many to wonder if India could become the world’s manufacturing hub.

Projections indicate India will continue to grow faster than China, gradually narrowing the gap

Reality check

Modi launched the “Make in India” campaign in 2014 to boost employment and transform the country into a manufacturing hub. It has made some progress in attracting foreign investment and boosting some sectors, like electronics and defense, but it has largely fallen short of its goals.

In 2023, manufacturing in China was 26.4% of GDP, compared to 13.4% in India.[4] Chinese exports were valued at a massive USD 3.38 trillion in 2023, while the value of Indian exports was much lower (USD 431 billion).[5] China’s manufacturing sector is deeply embedded in global supply chains and has a diverse production capacity. India’s manufacturing shows promise, particularly in electronics, but it is currently more focused on lower-tech industries.

China has other advantages. It has a central consolidation of power, has an economy approximately five times the size of India's, opened its economy to market forces ten years before India, and has pursued an export-led manufacturing growth economic model for decades.

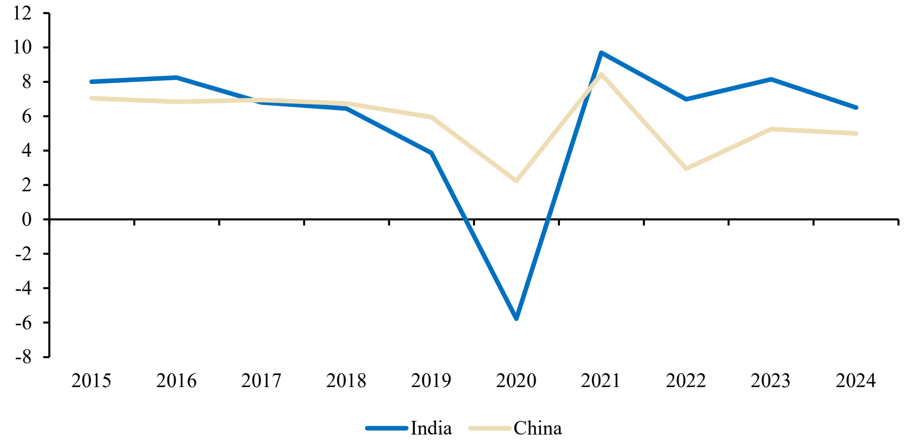
India's most recent military clash with Pakistan has not helped it burnish its image as a safe, stable place to invest

India's most recent military clash with Pakistan has not helped it burnish its image as a safe, stable place to invest. Sparked by a terrorist attack on the Indian side of Kashmir, the two nuclear-armed countries engaged in a series of military attacks from late April to early May until they agreed to a U.S.-brokered ceasefire on 10 May. A full-on war appears unlikely at this time, as both sides can claim success and do not have an incentive to continue. Many investors have likely factored in the potential for a cross-border skirmish into their investment risks. Indeed, conflict between India and Pakistan has been a long-standing reality for decades, rooted in post-colonial British partition. Yet the bold attacks and quick escalation of the latest conflict were alarming, leaving many to wonder what might happen when the two countries clash again. Nonetheless, European Union (EU) exposure is minimal. The EU is India's 10th largest trading partner, accounting for 64.9 billion euros, or 15% of India's total merchandise exports, in 2023.[6]

India will unlikely replace China as the world's primary manufacturing hub in the medium term

India will unlikely replace China as the world's primary manufacturing hub in the medium term Nonetheless, it could help secure a greater portion of China's market share if it reforms infrastructure bottlenecks, eases bureaucratic red tape at the federal and state levels, and improves the uncompetitive trade environment. Securing a more enduring peace with Pakistan would certainly help ease investor concerns and support India's broader economic ambitions.

EXHIBIT 5.0 – INDIA *VS.* CHINA ANNUAL GDP GROWTH RATE, 2015-2024



Note: India's 2024 GDP growth is a projection.

Sources: World Bank, Indian Ministry of Finance, and Chinese National Bureau of Statistics.

Notes

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Notes

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