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.

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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

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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

[1] https://www.tradeweb.com/newsroom/media-center/insights/blog/tradeweb-government-bond-update--april-2025/

[2] https://www.theguardian.com/business/2025/apr/28/trump-tariffs-shipments-us-ports

[3] https://www.uksteel.org/steel-news-2025/trump-declares-25-tariffs-on-steel-imports-to-the-u

[4] https://cincodias.elpais.com/opinion/2025-05-01/la-incertidumbre-global-continua-pesando-en-la-macroeconomia-y-las-finanzas.html

[5] https://www.euronews.com/business/2025/03/19/how-will-germanys-debt-reform-impact-its-stock-and-bond-market

[6] https://www.euronews.com/business/2025/03/19/how-will-germanys-debt-reform-impact-its-stock-and-bond-market

[7] https://home.cib.natixis.com/germany-s-fiscal-stimulus-redraws-eurozone-economic-map

[8] https://www.reuters.com/markets/europe/german-fiscal-bonanza-adds-european-debt-strains-defence-challenge-2025-04-01/

[9] https://cincodias.elpais.com/opinion/2025-05-01/la-incertidumbre-global-continua-pesando-en-la-macroeconomia-y-las-finanzas.html

[10] https://cincodias.elpais.com/opinion/2025-05-01/la-incertidumbre-global-continua-pesando-en-la-macroeconomia-y-las-finanzas.html