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Instant Thoughts

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Firing on All Cylinders

- **The likely-to-be German chancellor Friedrich Merz declared to loosen the debt brake. It would exempt any defense spending over 1% of GDP from the debt brake, a taboo that has been politically unthinkable before Trump's return.**
- **It won't give front-end bund owner serious buyer's remorse though.**
- **The wild card here is the term premia. The 2s10s spread of the bund could hit 100bp in extreme cases. The steepening drive might lead to a 10-year bund yield of 3%, not enough that we will no longer call it a low-yielder, but enough to instigate the interests of fast money and Japanese lifers.**

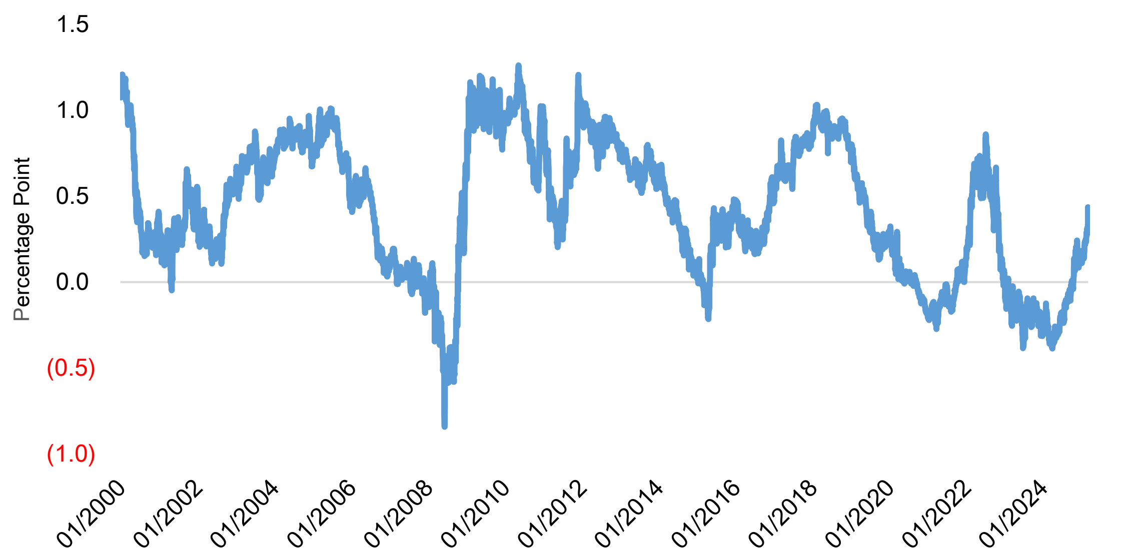
So de Gaulle got America right all along – Atlanticism is an illusion. Now the European nationalists seek to return to a mythical past highlighted by industrial glory, and the globalists want an immediate riposte to Trump's assault on NATO. The money needed are eye-watering.

Still, the tradeoff is one of the great fallacies of political science. The likely-to-be German chancellor Friedrich Merz declared to loosen the debt brake in two ways. It first sets up an off-budget special purpose vehicle of EUR500bn for infrastructure investment, a saleable proposal to German electorates. The real fireworks came when Merz announced that it would exempt any defense spending over 1% of GDP from the debt brake. The exemption essentially lifts the spending ceiling for rearmament, a taboo that has been politically unthinkable before Trump's return.

Unceiled spending is a different concept from unlimited spending. The exact target may only be pinned down after the NATO summit in June, and whether the debt will be Europeanized is still under discussion. Yet the details are fundamentally trivial. Merz can't ram the Roosevelt-like deal, in an already sclerotic state, down bondholder's throats without inviting a backlash.

In our view, it won't give front-end bund owner serious buyer's remorse. The ECB's reluctance to push the policy rate way below its neutral rate of 2.25% is fairly priced in. The wild card here is the term premia. Excluding the spillover from the U.S., the 2s10s spread of the bund could hit 100bp in extreme cases (Exhibit 1). An epochal shift in the German fiscal regime can count as one. The steepening drive might lead to a 10-year bund yield of 3%, not enough that we will no longer call it a low-yielder, but enough to instigate the interests of fast money and Japanese lifers.

Exhibit 1: Term Premia of 10-year Bund (Excluding the Spillover of U.S. Treasury)



Source: Diebold and Yilmaz (2009), Bloomberg, Shanghai Commercial Bank

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