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What to watch: Higher rates by a fiscal thread, good Eurozone news before the Eurovision, and delayed normalization for cross-asset correlations

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Executive summary

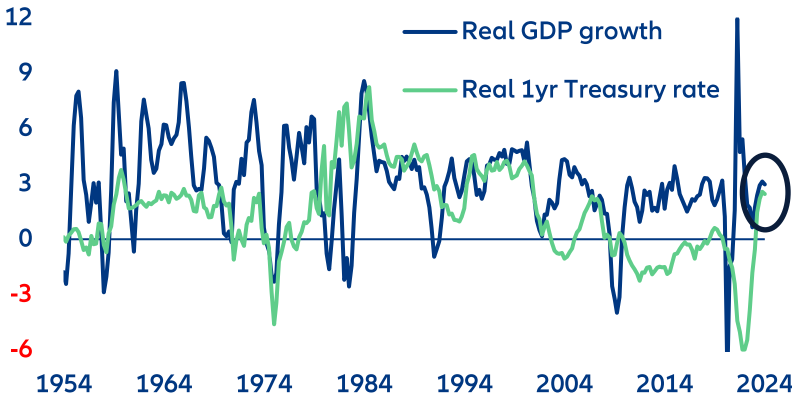
This week we look at three critical issues:

- **US: High interest rates hanging by a fiscal thread.** This week on 1 May, while 160 countries celebrated Labor Day, the Fed was far from idle: Central bank policymakers kept rates steady at a range of 5.25% to 5.5%. Apart from a tiny surprise on the rapid slowdown of Quantitative Tightening as of June, all eyes were on high US growth and sticky inflation questioning the so-called terminal rate. We find evidence that the current market pricing of 4% by end-2025 seems largely influenced by large immigration and loose fiscal policy. The "3% growth / 4% interest rates" regime fueled by loose fiscal policy will push interest expenses and debt-to-GDP ratio to record highs before long. The pending election "just isn't part of our thinking," Chairman Powell emphasized at the press conference yet fiscal consolidation will eventually weigh on growth and interest rates. Our medium-term view for the Fed interest rate is thus closer to 3%.
- **Eurozone: Green shoots for growth just in time for the Eurovision.** Just in time for the Eurovision in Malmö 7-11 May, the Eurozone has emerged from five quarters of stagnation (+0.3% q/q in Q1), indicating the start of a gradual economic recovery. Meanwhile, ongoing disinflation continues in line with expectations, with core inflation dropping to 2.7% – the lowest level in more than two years. However, the economy continues to show a clear divide, with a thriving services sector and a lagging goods sector, each impacting overall growth and inflation in distinct ways. In this context, we continue to expect the ECB to initiate two rate cuts this year, starting as early as June.
- **Cross-asset correlations: Normalization takes time.** Traditional cross-asset correlations broke during the 2022-2023 abrupt interest rates increase. Now that policy rates have peaked across the developed world, markets expect a policy reversal as both inflation and economic resilience reduce. Yet, with the first rate cut in the US being priced further out in the future, a return to normal cross asset correlations will be delayed.

US: High interest rates hanging by a fiscal thread

High US growth and sticky inflation are pushing up estimates of the Fed's "terminal" rates. The neutral (also called terminal or equilibrium) interest rate is the rate at which the Fed policy rate (and by implication market interest rates) settles in the medium term when inflation is at target and GDP at its potential. As such, R* as it is called, is an equilibrium concept that is not supposed to change with the economic cycle but can gradually move over time as structural forces shift. Broadly speaking, economic theory posits that R* is a function a potential GDP growth (which is the sum of trend employment and trend productivity growth) and desired investment vs. savings. Looking empirically at the post World War II period, the observed real interest rate was closely aligned with real GDP growth only during the 1980s and 1990s (Figure 1). This shows that potential growth is not the sole driver of R*. Notably, in the 1950s through the 1970s, and more recently in the 2000s and 2010s, R* was much lower. Many factors related to savings and investment, but also financial regulation, financial repression and monetary policy have certainly played a role in depressing R*. But since the beginning of 2024, with US growth strong and inflation stuck above the Fed's 2% target despite elevated interest rates, market participants have pushed up their estimates of R* considerably. Pricing from financial markets puts the terminal Fed rate as high as 4.25% at end-2025, though macroeconomic estimates put it at around 3%. We also note that real GDP growth and real interest rates look much more aligned since 2022, signaling that previous factors depressing R* are fading (Figure 1).

Figure 1: Real GDP growth and real 1yr Treasury rate* in the US (in %)

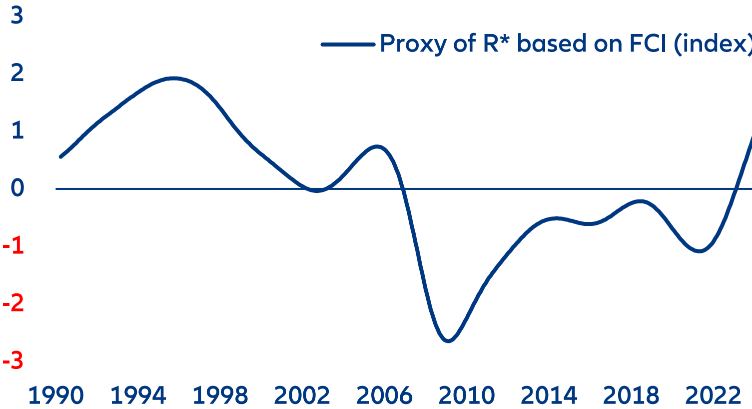


Sources: LSEG Datastream, Allianz Research
**Deflated by the GDP deflator*

We estimate that the neutral rate is currently at its highest since the end of the 1990s at around 4%. Another way to confirm whether R* is higher is to look at financial conditions. If financial conditions tighten, this signals a restrictive Fed stance, i.e. a current Fed Funds rate way above R* (i.e. R* is low). We use the Chicago Fed's Financial Conditions Index[1]) to assess R*. Our R* index is calculated as the difference between the FCI and the current (observed) real interest rate (all normalized), and filtered using a HP filter. A big caveat of this simple approach is that it does not give a point estimate of R*, but has the advantage of taking implicitly into account the changing relationship between monetary policy and economic activity[2]. Our index is shown in Figure 2. It suggests that R* is currently at its highest since the end 1990s. We can infer that R* is thus at around 2% in real terms, or 4% in nominal terms. This is a bit higher than our forecast of the Fed Funds rate at 3.75% at the end of 2025, so we see a modest upside risk to our scenario.

[1] The Chicago Fed's FCI comprises essentially of credit spreads, i.e. market interest rates relative to the risk-free rate, instead of the absolute level of rates. Therefore, it a better indicator to use than alternative FCIs to evaluate R.*
[2] Macroeconomic estimates of R such as the Laubach-William approach often have the flaw of assuming that the relationship between monetary policy and economic activity is stable over time, at odds with empirical evidence.*

Figure 2: Index estimate of the US neutral real rate (R*) based on financial conditions index (normalized)

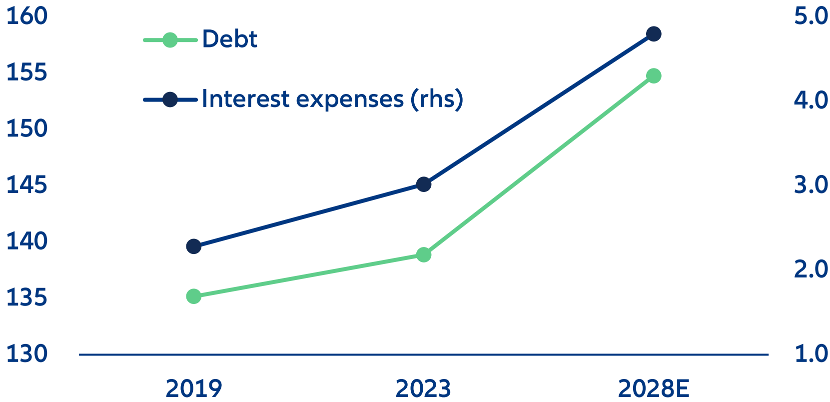


Sources: LSEG Datastream, Allianz Research

However, we doubt that the US economy has entered a new high growth, high interest rate regime for the medium term because of the unsustainability of fiscal policy. Much of the current high GDP-high interest rate environment is explained by strong net immigration and wide fiscal deficits. Strong immigration inflows are likely to be reduced soon following the bipartisan agreement between Democrats and Republicans in Congress, which aims to crack down on unauthorized immigration more forcefully. If Donald Trump wins the White House and Republicans gain control of Congress in November, no doubt immigration will fall more dramatically from 2025. The fiscal outlook is much more uncertain. Neither candidate has laid out ambitious, credible plans to reduce the deficit substantially. But the time of reckoning will come, even if US growth potential is higher. For illustrative purposes, we looked at the General Government[3] debt-to-GDP and interest expenses-to-GDP ratios if a "new" high growth-high interest rate regime scenario whereby US growth averages 3% per year, short-term interest rates reach 3.75% and long-term Treasury yields reach 4% over 2026-28. We assume that inflation is close to target (2.1%) and that the primary balance improves by 0.3pp, thanks to higher growth. Meanwhile, fiscal authorities maintain large structural primary deficits at their 2023 levels (around -4.7% of GDP). Figure 3 depicts the projections on debt-to-GDP and interest expenses-to-GDP ratios in the "high growth, high rate" environment. The interest-to-GDP ratio would climb to 4.8% of GDP by 2028, from 3% in 2023 – an all-time high in recent history. Likewise, the debt-to-GDP would go up rapidly, from 139% of GDP in 2023 to 155% in 2028. In summary, the combination of large primary deficits and a less favorable GDP growth-interest rate differential (the rise in the effective interest rate is bigger than the rise in GDP growth) would deteriorate US public finances substantially. While there is no certain threshold beyond which financial markets start to take notice and demand higher premia on US debt, we think, at some point, the US administration will be forced into fiscal consolidation. Tight fiscal policy would eventually weigh on growth – and interest rates – though the magnitude will remain highly uncertain. The bottom line is that the combination of high interest rates, elevated growth and loose fiscal policy is not sustainable in the medium term. Our view on the medium-term Fed interest rate is around 3%.

[3] The General Government encompasses the Federal government and state & local governments.

Figure 3: US General Government debt-to-GDP and interest expenses-to-GDP ratios in "high growth-high interest rate" environment (%)

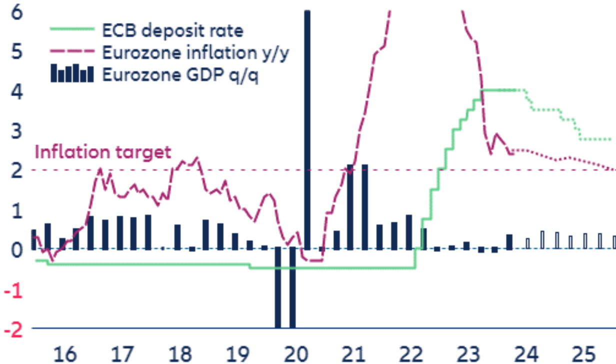


Sources: LSEG Datastream, Allianz Research

Eurozone: Green shoots for growth just in time for the Eurovision.

The Eurozone is re-emerging from stagnation and disinflation is progressing slowly but steadily. After five quarters of stagnation, the Eurozone economy grew at +0.3% q/q (1.3% annualized) in Q1 2024, rebounding from a technical recession in the second half of 2023 due to the downward revision of the previous quarter. Net exports should have contributed positively, bolstered by robust US demand and declining imports. Looking at country-level data, domestic demand should have improved, too, with a continued investment recovery and a mild uptick in still lackluster consumption. Meanwhile headline inflation stayed put at 2.4% y/y in April while core inflation fell by 0.2pp to 2.7% – the lowest in two years. Even more encouraging, the month-over-month core inflation rate, which is exempted from base effects, fell to 1.8% m/m annualized and seasonally adjusted, thereby undershooting the ECB's inflation target. Overall, this week's data print confirms both our and the ECB's expectations of a slow but steady disinflation process and a soft pickup in growth, with the latter being supported by consumption amid rising real wages. We therefore stick to our call of two rate cuts this year, followed by three more cuts in 2025. However, barring any adverse data shock before June, the initial rate cut could occur as early as June, earlier than our previous July prediction, as more ECB officials have expressed a preference for acting sooner (Figure 4).

Figure 4: Eurozone growth, inflation and monetary policy outlook

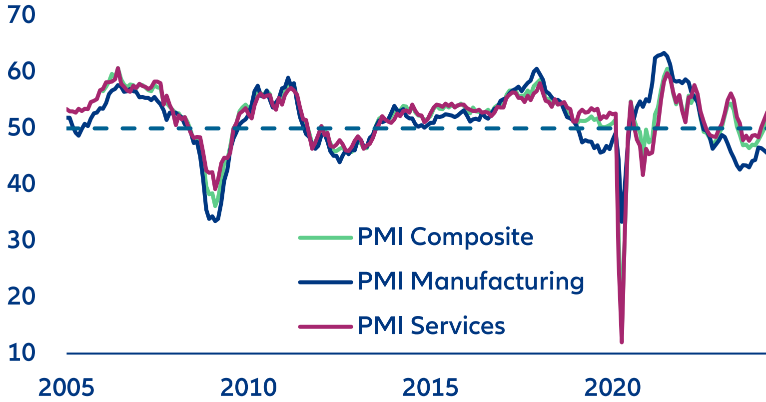


Sources: LSEG Datastream, Allianz Research

Beneath the surface, significant economic divergences persist both across countries and sectors. Inflation varies widely, ranging from as low as 0.6% in Finland to as high as 4.9% in Belgium. Among the four largest economies, Italy remains at the lower end with only 0.9% inflation, followed by France and Germany both at 2.2%, while Spain

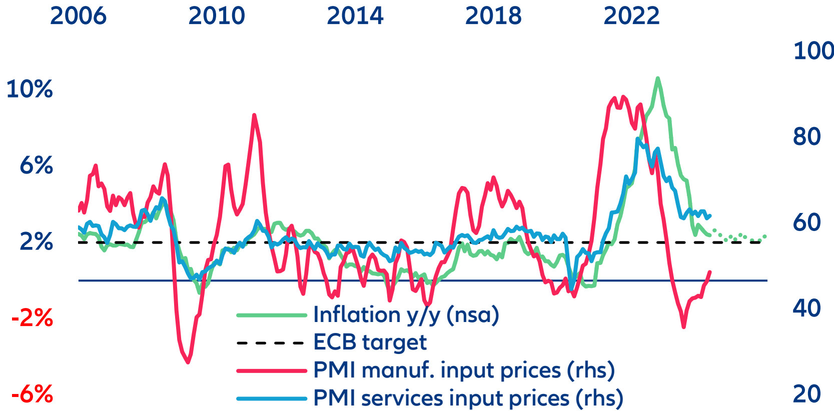
is at a four-month high of 3.3%, largely due to rising food prices. However, the most notable divergence is not between countries but rather among economic sectors. While the service sector is seeing robust and increasing demand, manufacturing continues to decline. This unusual and long-lasting divergence is particularly evident in surveys among purchasing managers (PMIs), shown in Figure 5. Presumably the Eurozone economy is still in an adjustment process following two major supply shocks: Covid-19 and the conflict in Ukraine, with the subsequent rises in energy prices. The sectoral split also continues to transmit to inflation trends. Services sector inflation in the Eurozone is still the leading force of core inflation even though it finally began to decelerate slightly to 3.7% y/y in April after maintaining a rate of 4.0% for five consecutive months. However, details in the PMI surveys reveal that input prices in the services sector continue to rise strongly compared to historical averages (Figure 6). This confirms our view that disinflation will continue to be slow from here on as the bulk of the consumption basket (45%) stems from services.

Figure 5: Eurozone's sector divergence since Covid-19 continues



Sources: S&P, Allianz Research

Figure 6: Input prices continue to rise strongly in the services sector



Sources: S&P, LSEG Datastream, Allianz Research
Notes: Dotted green line depicts Allianz Research forecast

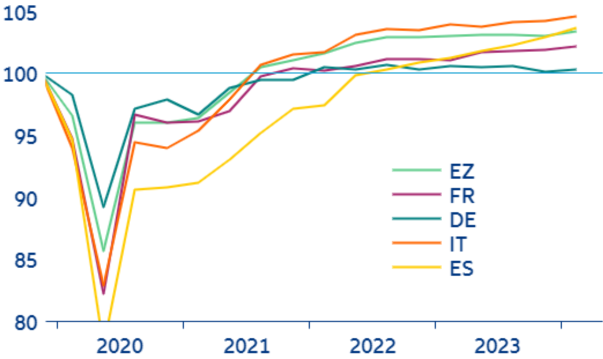
Germany managed to avoid a recession, thanks to an increase in construction investments and exports. However, the decrease in household spending paints a less optimistic picture. While there are positive signs, with services contributing to economic growth, manufacturing remains a concern. In the first quarter of 2024, German GDP grew by +0.2% q/q after a (revised) decline at the end of 2023 of -0.5%. Despite growing optimism among consumers, businesses and investors, challenges persist. Weakness in the industry sector, declining construction activity post a mild winter, high interest rates impacting investment and subdued export demand are key issues. Although the labor market is still robust, with rising wages and slowing inflation, households remain cautious about spending. With limited fiscal flexibility and ongoing debates on the government budget for 2025 – with an estimated shortfall of at least EUR20bn – we anticipate modest growth of +0.1% in 2024 and +0.9% in 2025.

The French economy is showing encouraging signs of accelerating momentum, but fiscal consolidation will weigh on prospects. French GDP grew by +0.2% q/q in Q1 2024. GDP growth for Q3 2023 was also revised slightly higher (+0.1pp). The breakdown by expenditures and production was positive overall. Household consumption accelerated to +0.4%, fueled by a rebound of food consumption and healthy gains in services (notably, transportation and hospitality). This was reflected in a strong increase in tradable services production (+0.8%). On another positive note, corporate investment rebounded (+0.5%, after -0.8%), with strong spending in both manufacturing products and services. Exports performed quite well (+0.5%, revised higher in Q4-23), with increased shipments of agrifood and other manufacturing products. However, this was not reflected in increased manufacturing production (-0.1%) as corporates were destocking further. The weak spot was residential investment (-1.5%). Nevertheless, construction output stabilized (+0%), which suggests that non-residential spending posted strong gains (infrastructure, commercial). Fiscal consolidation was not visible yet, with public consumption continuing to post healthy gains (+0.6%). But with EUR10bn of savings already enacted for the rest of the year, an additional EUR10bn likely (i.e., 0.7% of GDP in total for 2024) and, as revealed in the April draft budget, EUR30bn planned for 2025 (1.1% of GDP), the scope for a strong growth rebound will remain contained.

The Italian economy proved resilient again, but do underlying drivers hide surprises? GDP has been revised down to +0.1% q/q from a solid +0.2% growth in Q4 2023 when restrictive monetary policy and weak global demand hit the economy the most. But Italy's activity expanded slightly above our and consensus expectations in the first quarter of the year at +0.3% q/q, confirming that Italy is leading the race in the post-pandemic era (Figure 7). The preliminary release stated that domestic demand – gross inventories – had a negative effect while net exports contributed positively. On the supply side, agriculture, industry and services all posted increases in value added. However, the manufacturing sector exited contraction only in March, when the PMI increased to 50.4 after almost a year below the recession threshold. But as it fell back to 47.3 in April, with both output and new orders declining, the sector is clearly not out of the woods yet. It is also likely that the Superbonus tax incentives have left one last mark. Looking ahead, the drag from the slowdown in construction activity will weigh on the investment outlook, only partially offset by the RRF spending and recovering confidence. Moreover, despite Italy showing one of the lowest inflation rates in the Eurozone, we expect consumption to pick up only from the second quarter of the year. Finally, mounting fiscal pressures clouds the outlook for the Italian economy.

Spain: strong growth here to stay? The Spanish economy grew by +0.7% q/q in the first quarter of 2024, well above consensus and our expectations (+0.4% and +0.3%, respectively), keeping up the pace seen in the last quarter of 2023. Growth was driven by both domestic and external demand. Household consumption grew by +0.3% and investment rebounded by a strong +2.6% after declining in H2 2023. Exports and imports grew by +2.4% and +1.1% respectively. This would mechanically raise our forecast for 2024 from +1.9% to +2.4%, but we remain cautious around the outlook, given the proved volatility of gross fixed-capital formation and the uncertainty around the actual spending of NGEU funds through 2024.

Figure 7: GDP divergence among Eurozone economies since Covid-19 continues, GDP normalized (2019=100)

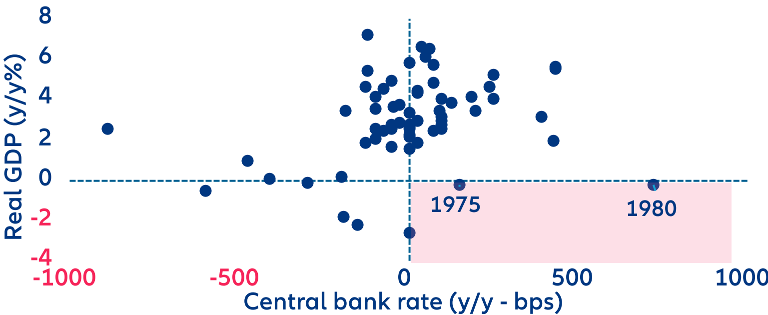


Sources: LSEG Datastream, Allianz Research

Cross-asset correlations: Normalization takes time

The uncertain timing of the policy pivot is keeping asset valuations unstable. Shifts in interest rate expectations have been crucial in shaping future price projections across various asset classes, acting as a vital barometer of the forthcoming economic environment and corporate financing costs. However, this traditionally consistent positive correlation shifted starting in 2022 as stagflationary pressures altered market dynamics, resulting in an inversion of the conventional impacts of monetary policy expectations. In the past, central banks have typically raised interest rates when economies show signs of overheating, a scenario often accompanied by rising corporate profits. However, 2022 marked a departure from this usual pattern as stagflationary pressures—a mix of stagnant economic growth and high inflation—prompted a shift in market dynamics. Investors repositioned their expectations, preparing for a scenario reminiscent of the mid-1970s and early 1980s when central banks, facing sharply rising inflation, were forced to increase rates even amid a recessionary environment. The repositioning happened even though the US finally managed to avoid a full-fledged recession (Figure 8).

Figure 8: US real GDP vs Fed Funds rate

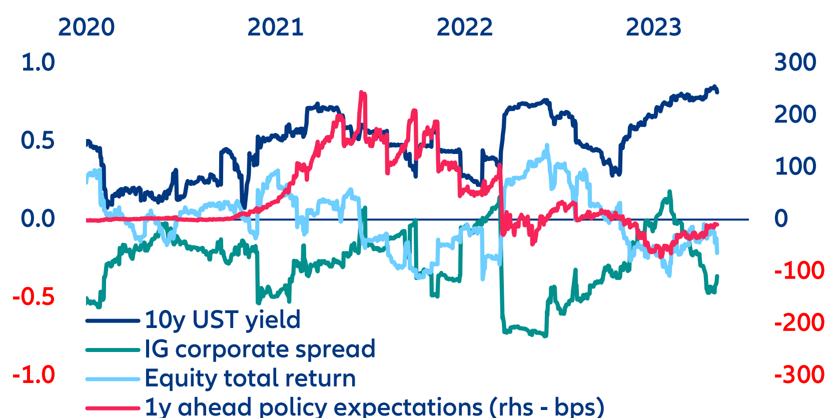


Sources: LSEG Datastream, Allianz Research

In this economic landscape, and especially in equity markets, a notable shift occurred in 2022 when the traditional positive correlation between higher policy rates and stronger equity returns—driven by robust corporate fundamentals—turned negative amid the anticipation of a stagflationary environment. This shift underscored a growing concern that rising policy rates might not only combat inflation but also presage a recession. The impact was also felt across the yield curve, intensifying the pass-through effect from the short to the long end. In contrast, the corporate bond market remained resilient since despite the upward adjustment in rate expectations, the demand for corporate bonds continued unabated, supported by solid debt-servicing capabilities that were bolstered by significant bond issuances during the low-yield period of the pandemic. However, by the fourth quarter of 2023, as markets fully accounted for the anticipated peak policy rate—a stance confirmed by central banks' cessation of rate hikes—the correlations again became highly volatile and lacking directionality as markets participants started debating on the timing and size of the policy pivot. In this regard, markets began to reposition, anticipating rate cuts due to weakening economic momentum and easing inflationary pressures in early 2024. Yet, this initial market adjustment has been short-lived, particularly in the US, where a surprisingly resilient economic backdrop, coupled with more persistent inflation, suggests that any potential rate cuts might be pushed further out in the year. This ongoing uncertainty about the size and timing of the policy pivot continues to cause market correlations to oscillate frequently between positive and negative, making it difficult to discern a clear short-term

trend and blurring the true relevance of policy rate expectations as a predictor or determinant of future capital market returns (Figure 9).

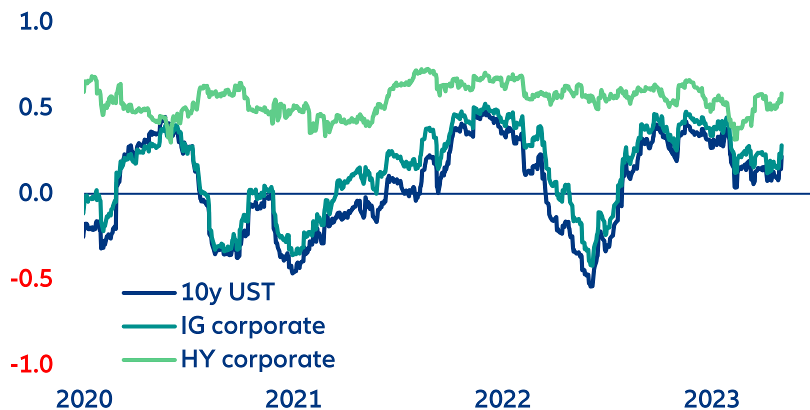
Figure 9: 3m rolling correlations between daily changes in 1y ahead policy expectations and asset classes



Sources: LSEG Datastream, Allianz Research

Despite the current unstable equilibrium, expectations remain that a policy shift will materialize later this year, leading to a gradual return to traditional market dynamics. This anticipated shift should see equity markets stabilizing or improving due to lower financing costs, while corporate credit may trade sideways or widen slightly as central banks reduce interest rates. Long-term yields are also expected to decline, influenced by movements at the short end of the curve. However, until the first-rate cut is confirmed, correlations between asset classes will likely continue to fluctuate, and the clarity of future policy decisions in shaping current valuations and pricing will remain obscure (Figure 10).

Figure 10: 3m rolling correlations between daily US equity returns and other asset class returns



Sources : LSEG, Datastream, Allianz Research

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