CENTRAL BANK WATCHER

Trade-offs

- Fed: waiting for the fog to clear
- ECB: agile and easing
- PBoC: timing is everything
- BoJ: hitting pause

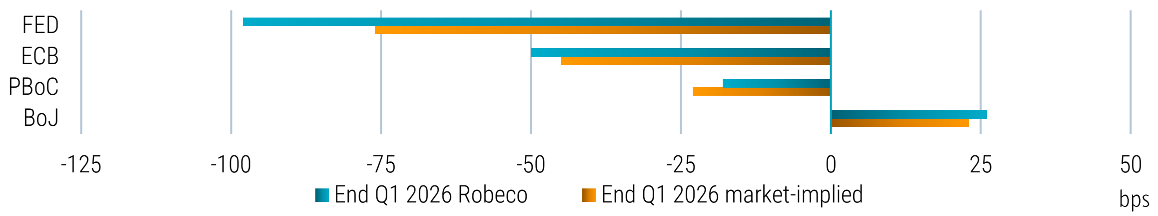
Headlines around US import tariffs have kept market volatility elevated. One thing is clear, however: tariffs for trade with the US will be higher than they were before 2 April. Business conditions have become more uncertain, regardless of the outcome of current trade negotiations. This puts the Fed in a situation where they will be forced to choose between higher tariff-induced inflation and weaker growth.

The ECB faces a different dilemma. For now, with policy rates not yet expansionary, there is a clear case for continuing to cut rates. Inflation has come down and growth is very likely to be hurt by trade tariff uncertainty. Looking beyond the next one to two quarters, things may be different. As we approach the end of this year, the announced large German fiscal stimulus and defense spending might play a more prominent role in supporting growth. At that point, the ECB may face a trade-off between implementing further monetary stimulus or allowing fiscal stimulus to run.

The PBoC remains in a very different monetary policy cycle. It has been easing policy for most of the past seven years and a new stimulus package was announced recently. There is probably more to come, though not in the immediate term.

The Bank of Japan is still in the process of hiking rates, given the resurgence of inflation, but it now also faces an economic environment where growth will be hurt by trade uncertainty. While this clouded outlook has slowed the pace of hikes, we don't think it has derailed it. In our view, more rate hikes are still likely to come.

Figure 1 – Outlook for central banks' policy rates



Source: Bloomberg, Robeco, based on money market futures and forwards, 12 May 2025

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Marketing material for professional investors, not for onward distribution

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The Federal Reserve: waiting for the fog to clear

- On hold amid heightened uncertainty
- Higher unemployment may force the Fed's hands into easing
- 3-5-year USTs remain our preferred tenors

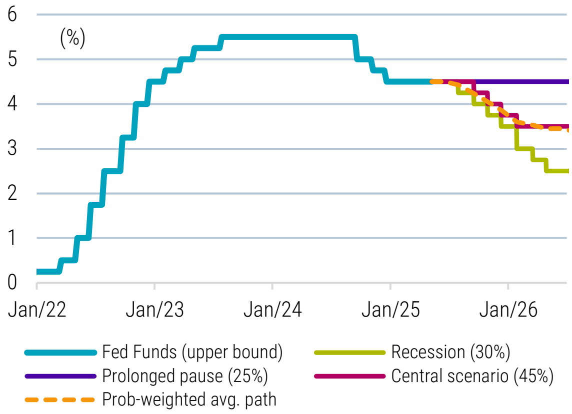
Upcoming tension in the Fed's dual mandate

Having eased by a total of 100 bps in H2 2024, the Federal Open Market Committee (FOMC) has kept the target range for the federal funds rate unchanged at 4.25%–4.50% since. The decision to stand pat in May was flagged and rationalized by the lingering combination of 'somewhat elevated' inflation and 'solid' labor market conditions, amidst 'heightened' uncertainty about how significantly import tariffs will raise consumer prices and slow growth. However, the statement acknowledged that the risks of higher unemployment *and* higher inflation have risen. In other words: a scenario in which the Fed's dual-mandate goals are in tension.

Chair Powell reiterated that the Fed is in no rush be to adjust policy and is waiting for greater clarity. As the 90-day reciprocal tariff pause does not expire before July, another Fed pause in June seems likely. However, given the risk of rising unemployment in the wake of the drop in business hiring intentions and the Fed's likely eagerness to avoid this, our central scenario sees a resumption of the easing cycle by September, with a total of 100 bps in rate cuts projected by Spring 2026.

We assign a 30% probability to a recession scenario, under which more substantial rate cuts would likely materialize. Conversely, we see a 25% likelihood that the Fed maintains current interest rates into next year, potentially in response to a renewed rise in inflation expectations. Notably, inflation markets are currently pricing in an increase in US CPI inflation to 3.6% by September, up from 2.4% last month. Taking these scenarios into account, our probability-weighted forecast for the fed funds rate is slightly above current market pricing for the second half of 2025 but falls below market expectations in 2026.

Figure 2 – Three scenarios for the Fed until Jun-2026



Source: Bloomberg, Robeco, 12 May 2025. Past performance is no guarantee of future results. For illustrative purposes only.

3-5-year Treasuries remain our preferred tenors

Markets are currently pricing in a terminal policy rate of approximately 3.25%, which is somewhat above the midpoint of the long-run federal funds rate range projected by most FOMC participants. In light of this, we are leaning towards being more constructive on US duration. However, given the diminished safe-haven appeal of US Treasuries, we prefer to wait before extending duration exposure — specifically until 10-year yields approach 4.50%.

Curve-wise, we remain constructive on 3-5-year Treasuries, relative to both the 1-2-year segment, where risks of delayed Fed cuts persist, and over the 10-year and longer maturities, where term premia remain insufficient amid ongoing fiscal concerns. That said, we think Treasury Secretary Bessent will be keen to prevent 30-year yields from breaching the 5% threshold. Potential responses include accelerated bank deregulation and stronger signals regarding increased Treasury buybacks.

Table 1 - What is priced in for the Fed versus our expectations

Fed funds rate (% upper bound)	4.50	Jun-25	Sep-25	Dec-25	Mar-26
Change implied by FF Futures (bps)		-3	-29	-57	-76
Our probably-weighted expectation (bps)		-2	-26	-64	-98
Our central scenario (bps)		0	-25	-75	-100
Fed funds rate central scenario (% upper bound)		4.50	4.25	3.75	3.50

Source: Bloomberg, Robeco 12 May 2025

European Central Bank: agile and easing

- ECB to cut again by 25 bps in June
- Room to cut further, if needed
- Curve set to steepen further

Arriving at neutral

The ECB has maintained a steady pace of rate cuts since October. We think rates will be cut again by 25 bps in their June meeting, bringing the deposit facility (depo) rate to 2.0%.

After this expected step, any further reduction in rates should be less mechanical. ECB policy is no longer restrictive, however, that does not mean the ECB is unable to act if needed. ECB President Lagarde recently emphasized that not being restrictive is "meaningless" because we are not living in a "shock-free world". The US trade tariff announcements have clearly been such a shock. Accordingly, the ECB can be "agile," and Lagarde feels free to reduce rates further if needed. Whether it is necessary to do so will largely depend on the outcome of the current trade negotiations between the EU and US and on the economic damage already done by the trade conflict.

Current inflation conditions provide room to reduce rates further, but for now, economic conditions seem to have held up reasonably well. Forward-looking indicators such as the Eurozone composite PMI and the Ifo expectations index have remained at modest levels but have not declined further. This suggests that the necessity to ease below neutral is not imminent. ECB staff estimate the neutral depo rate to be between 1.75-2.25%.

Front end is starting to look cheap again

The market has priced in a depo rate of circa 1.75% at year-end, implying two additional 25 bps cuts. We think this is not far from where front-end notes look cheap. As time progresses and a June rate cut has occurred, the market will likely maintain the view that further rate easing could still follow. The scenario where a reversal towards more restrictive policy gets priced in is more difficult to imagine. In the coming months, we believe the risks are tilted towards lower rates than those currently priced. Looking beyond summer, this might change. By then a positive growth driver may gain more attention: the large German fiscal stimulus.

Figure 3 – German 2-year yield (%)

Source: Bloomberg, Robeco, 12 May 2025. For illustrative purposes only.

After the April ECB meeting, we sold German 2-year Schatz and recently took profit on this trade. We see some further upside potential in front-end yields, but do not expect 2-year Schatz yields to go much beyond 1.9% for now. The relatively stable ECB outlook, as described above, should also support bonds up until the 5-10 year area of the curve. Further support may come from any deterioration in risk sentiment, as German Bunds have recently acted as a genuine safe haven. We remain less optimistic about the prospect for 10+ bonds. Looking at historical easing cycles and at the supply outlook, we see continued steepening potential in this part of the curve.

Table 2 - What is priced in for the ECB versus our expectations

ECB deposit rate (%)	2.25	Jun-25	Sep-25	Dec-25	Mar-26
Change implied by market pricing (bps)		-20	-40	-45	-45
Our probably-weighted expectation (bps)		-25	-40	-50	-50
Our central scenario (bps)		-25	-25	-25	-25
Depo rate central scenario (%)		2.00	2.00	2.00	2.00

Source: Bloomberg, Robeco; 12 May 2025

People's Bank of China: timing is everything

- PBoC delivers long-awaited easing
- Size of policy rate cut underwhelms
- A very flat 2s10s curve

A broad package with an underwhelming cut

Both we and the market had been anticipating new easing measures from the PBoC for some time. These were finally announced shortly after news broke that China and the US would engage in talks aimed at de-escalating the ongoing trade tensions — a notably strategic moment for such a move.

The PBoC's stimulus package included the following key components:

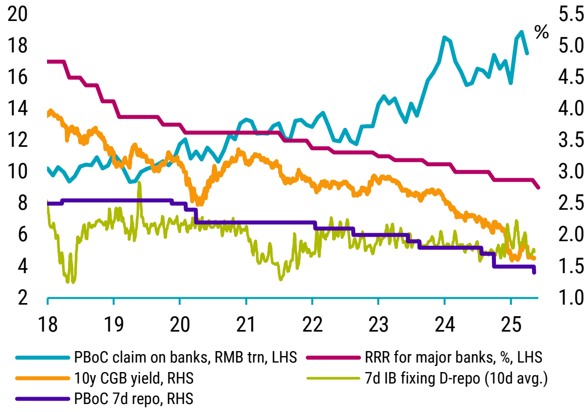
- A 50 bps cut to the reserve requirement ratio (RRR) for commercial banks
- A 25 bps reduction in mortgage loan rates under the housing provident fund
- A 25 bps cut across all structural lending facilities
- An additional RMB 1.1 trillion in new relending quotas, targeting service consumption, elderly care, technology, and small enterprises
- A 10 bps cut to the key policy rate (to 1.40%), which was somewhat underwhelming in terms of the size of the reduction

In our assessment, the PBoC is not yet finished with its easing cycle. Core inflation remains subdued at just 0.5% year-over-year, which is uncomfortably low. While recent monetary and credit data show tentative signs of improvement, the stabilization in home sales is not yet convincing enough to support expectations of a sustainable property market recovery. Additionally, Chinese consumers continue to exhibit caution in their spending behavior, as evidenced by the sustained preference for time deposits at banks.

That said, we believe the PBoC will be cautious about exerting excessive downward pressure on the renminbi, particularly if it aims to foster a more constructive dialogue with the US on trade.

Looking ahead, we expect balance sheet expansion to remain the PBoC's primary policy tool. Our base case includes one additional RRR cut and a further 20 basis points of policy rate easing. Overall, our outlook on policy rates is broadly aligned with current market expectations (see Table 3).

Figure 4 – PBoC policy levers – multiple fronts



Source: Bloomberg, Robeco 12 May 2025. For illustrative purposes only.

A very flat 2s10s curve

After reaching 1.90% in March, 10-year CGB yields are back near 1.60%, the level seen at the start of the year. 2-year yields are hovering around the latest level of the policy rate of 1.4%. As such, the 2s10s curve is at the flattest level in years

Looking ahead, we expect the 2s10s CGB curve to re-steepen, in the wake of large supply and perhaps some further signs of growth recovery – the trade shock notwithstanding. As we believe the secular downtrend in Chinese growth and rates remain intact, we would (already) turn more constructive on 10-year CGBs in the 1.80-1.90% area.

Table 3 - What is priced in for the PBoC versus our expectations

PBoC 7-day reverse repo (%)	1.40	Jun-25	Sep-25	Dec-25	Mar-26
Change implied by forwards (bps)		0	-14	-19	-23
Our probability-weighted expectation (bps)		-2	-11	-17	-18
Our central scenario (bps)		0	-10	-20	-20
PBoC 7-day reverse repo in central scenario (%)		1.40	1.30	1.20	1.20

Source: Bloomberg, Robeco; 12 May 2025

Bank of Japan: hitting pause

- Trade uncertainty is causing a rethink of the rate setting path
- Hard data, still in good shape
- Bond market functioning concerning long-maturity bonds

Normalization postponed

At the May Monetary Policy Meeting (MPM) the BoJ revised down its growth and inflation forecasts for the next two years, and maintained its current policy rate of 0.5%. Although no change was expected, the downgrades to growth and inflation were larger than the market had anticipated. In addition, Governor Ueda stated at the press conference that the 2% price stability target is likely to be reached "in the second half of the projection period." This implies that the BoJ is on pause until October 2025. Uncertainty surrounding tariffs was the primary reason for the change in growth and inflation.

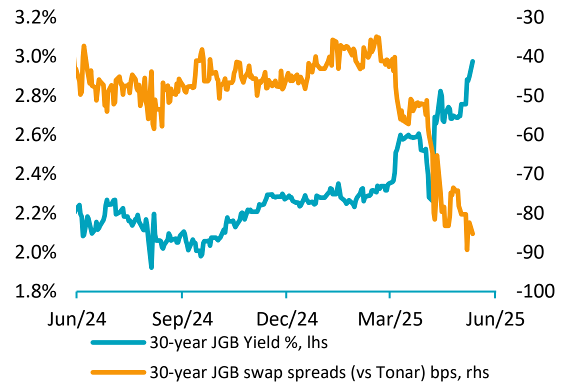
Deal or no deal

For the Japanese economy it will be crucial to reach a free trade deal with respect to the auto sector, as it accounts for roughly a third of all Japanese exports to the US.

Meanwhile, domestic hard data continues to suggest the economy is in decent shape. Spring wage negotiations have settled around a 3.8% rise in base pay, a further increase of 0.2 % versus last year. This should drive realized wage growth higher over the coming year.

In our base case, we expect the next BoJ hike to take place around December 2025. This is earlier than what is currently priced in. Additionally, we expect the market to start pricing in another hike during 2026, revisiting the 1% policy rate level previously mentioned by multiple BoJ members as a target. This leads us to be modestly underweight Japanese duration.

Figure 5 – Long-end JGB yields and swap spreads



Source: Bloomberg, Robeco 12 May 2025. For illustrative purposes only.

Long-end JGBs, in search for a new marginal buyer

With the heightened volatility in risk assets, the functioning of the Japanese bond market became shaky. Shorter tenor JGBs started to price in less hikes from the BoJ, while long-end yields rose. The move was also visible in government bond underperformance versus swaps, with 30-year maturity bonds widening by a staggering 30 bps move within a few trading sessions. This process of curve steepening and swap spread tightening could continue until either the Ministry of Finance shifts its issuance plans to shorter tenor government bonds or the BoJ implements a form of targeted support for the long end of the curve. Even though valuation levels are attractive, both in swap spreads and long-maturity yields, volatility in this part of the curve is currently too high for most buyers to step in.

Table 4 - What is priced in for the BoJ versus our expectations

Policy balance rate (%)	0.25	Jun-25	Sept-25	Dec-25	Mar-26
Change implied by OIS (bps)		0	9	18	23
Our probability-weighted expectation (bps)		0	10	20	26
Our central scenario (bps)		0	0	25	25
Policy balance rate in central scenario (%)		0.50	0.50	0.75	0.75

Source: Bloomberg, Robeco; 12 May 2025