ADVOCATE CAPITAL MANAGEMENT, LLC

Euro Government Bond Selloff – Too Much, Just Right or Not Enough?

For every action there is an (un)equal and opposite reaction

- Newton's Third Law of Motion (with a modest Advocate edit)

The selloff in European government bonds in the last 2 days has been stunning. Yesterday 10yr German bund yield rose more than 30bps, the biggest daily yield rise in more than 30 years! The euro-denominated government bond selloff continued for the second straight day, rising another 10bps today. With yields in the Eurozone rapidly approaching their highest levels since 2011, what should investors make of this selloff? Advocate's analysis shows that the recent market reaction may have priced in more than the entire amount of the "REARM Europe" proposal.

Recent Developments

The recent selloff in European government bonds has been rapid as leaders of the EU nations vote today (6 Mar) on a plan ("REARM Europe") proposed by the European Commission that would[1] :

1) Activate the national escape clause of the Stability and Growth Pact to permit member countries to spend more on defense without breaching EU's fiscal rules. An example in the statement shows that raising every member's defense spending by 1.5% GDP would result in €650Bn of spending in the next 4 years. It would allow defense spending in excess of 1% of GDP to be exempt from EU fiscal rules (which limits deficits to no more than 3% GDP and total debt to no more than 60% GDP),
2) Launch of a new loan program of €150Bn for "defense investment" to pay for not just weapons procurement but also to help develop the additional infrastructure that is required,
3) Direct more EU budget towards "defense-related investments",
4) Get private investments involved in the EU's defense ramp-up via the Savings and Investment Union and the European Investment Bank.

According to the European Commission, the proposal could mean up to €800Bn in extra defense-related spending in the next 4-year period[1].

The burning questions on investors' minds are:

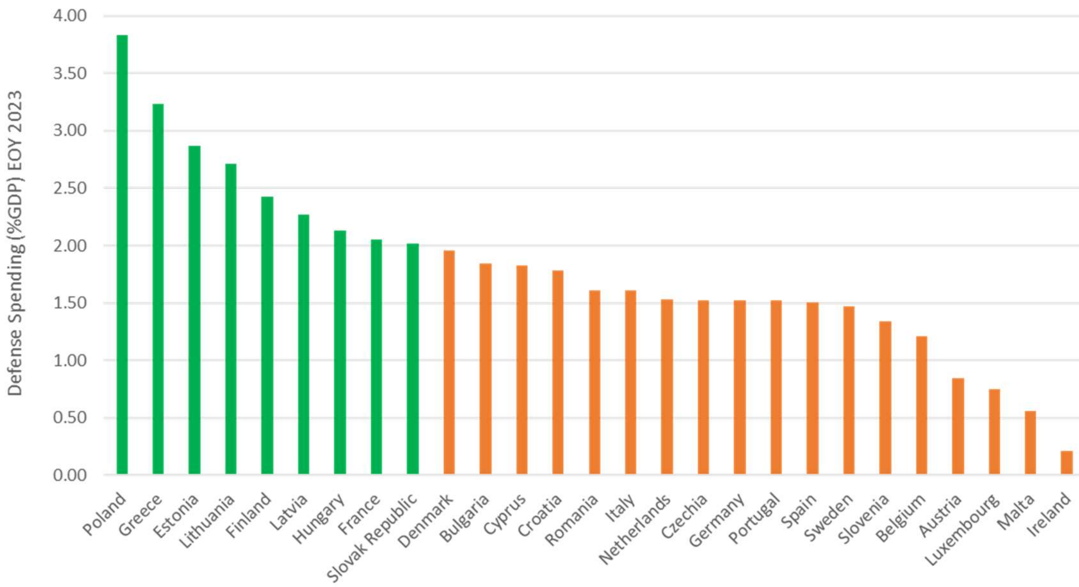
1) Is the €800Bn of spending outlined by President von der Leyen realistic and reasonable?
2) How much of the "REARM Europe" proposal has already been priced in by recent interest rate movements?

[1] Press statement by EC President von der Leyen on the defense package, the European Commission, 3 Mar 2025. https://ec.europa.eu/commission/presscorner/detail/sv/statement_25_673

Current State of European Defense Spending

The latest EU defense spending data (end of 2023)[2] is graphed below. At the end of 2023, only 9 out of 27 EU countries spent more than 2% GDP on defense.

FIGURE 1. DEFENSE SPENDING FOR EU COUNTRIES, END OF 2023. GREEN BARS DENOTE SPENDING ABOVE 2% NATO TARGET



End of 2023 Data. Source: World Bank DataBank

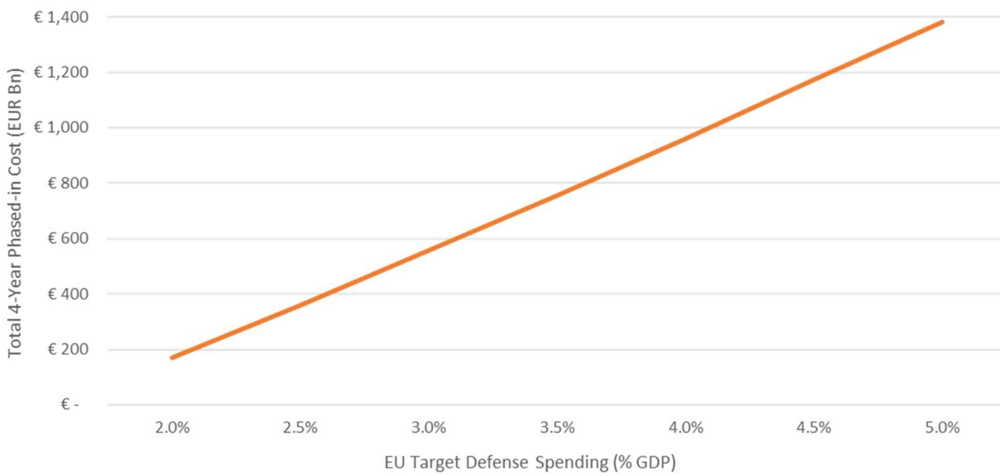
We examine two ways to raise EU defense spending:

1) Raise defense spending to a uniform target (% of GDP) for all EU countries
2) Raise defense spending by an absolute amount (% GDP), regardless of current spending level

We assume a linear ramp-up over the next 4 years to reach each target as it is physically impossible to immediate raise defense spending by a significant amount. Time is required to ramp up recruitment, manufacturing and infrastructure capacities. The total cost of a 4-yr ramp-up to reach various defense spending goals (% GDP) is shown in the following chart. President von der Leyen's €650Bn target spending goal corresponds to raising all EU countries' defense spending to a uniform 3.25% GDP level.

[2] World Development Indicators, World Bank Databank, www.databank.worldbank.org

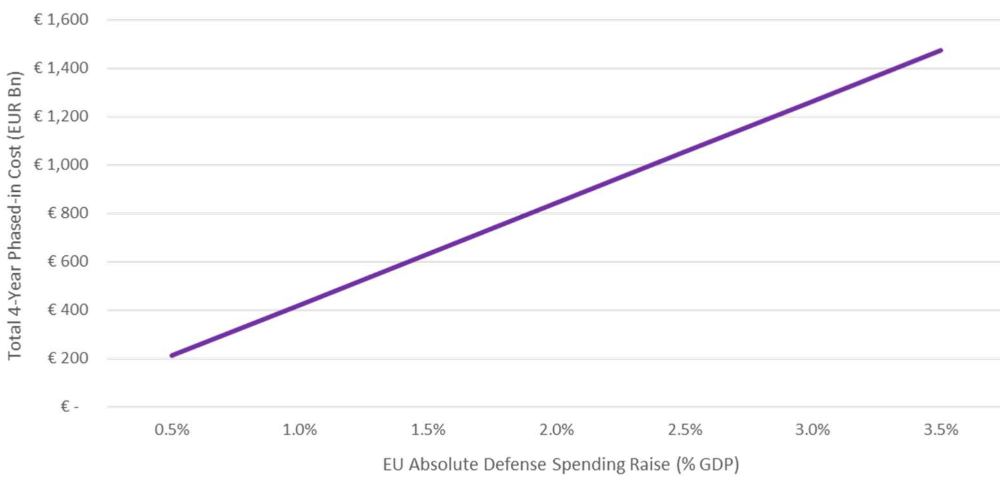
FIGURE 2. TOTAL 4-YEAR PHASE-IN COST TO RAISE EVERY EU COUNTRY'S DEFENSE SPENDING TO UNIFORM TARGET



End of 2023 Data. Sources: World Bank DataBank, Advocate

Alternatively, "REARM Europe" proposes to raise ***each*** EU country's defense spending by a specific amount (% GDP), without regard for its current level of spending.

FIGURE 3. TOTAL 4-YEAR PHASE-IN COST TO RAISE EACH EU COUNTRY'S DEFENSE SPENDING BY ABSOLUTE AMOUNT



End of 2023 Data. Sources: World Bank DataBank, Advocate

Advocate's estimate of the 4-yr ramp-up cost for each EU country to raise its defense spending by 1.5% of GDP is €632Bn, very close to President von der Leyen's number of €650Bn. The actual supply impact on the euro-denominated government bond market is less because 7 EU countries (Bulgaria, Czech, Denmark, Hungary, Poland, Romania and Sweden) have their own currencies and therefore additional government bond supplies in those countries do not impact the euro-denominated government bond market. Taking only euro area (EA) countries into consideration, the 1.5% raise in defense spending equals a cumulative increase of €536Bn of government securities supply over the next 4-years. Adding in the new €150Bn loan facility as new supply, ***we see a €686Bn increase in the size of the euro-denominated government bond market over the next 4 years resulting from the "REARM Europe" proposal***.

EC's 4-year timeframe to spend this money is not unreasonable, but will critically depend on the ability of defense contractors and manufacturers to ramp up production and for Europe to develop new infrastructure necessary to manage the higher defense spending regime. Any implementation delays would lessen the 4-yr cumulative impact on the euro government bond supply.

How Much Supply Has Already Been Priced in by the Recent Bond Market Selloff?

To determine how much interest rates should change in response to anticipated supply, we apply the methodology outlined in our recent publication[3]. In brief, we estimate a rate-to-supply change ratio of approximately ***5bps per percent market increase***.

Applying that ratio to the euro-denominated government bond market:

1) Latest data on total size of euro-denominated government securities is €11Tn as of the end of Q2-2024.
2) Every 10bps rise in euro government bond yield thus prices in €220Bn of additional supply.
3) Based on Advocate's rate-to-supply change ratio, the 2-day cumulative rise in 10yr German bund yield of 40bps corresponds to €880Bn of additional government bond supply. We use changes in German bund yield as a proxy for the broad euro-denominated government bond market due to its high liquidity and market transparency.

Even counting the €150Bn new loan facility as new supply, we see less than €700Bn increase in the size of the euro-denominated government bond market. ***The €880Bn of supply priced in by the recent market move is 128% of the entire 4-year impact of the EC "REARM Europe" proposal***. Advocate believes ***the recent euro bond market selloff may have overreacted by about 10bps relative to the anticipated additional supply from the "REARM Europe" proposal.***

Final Thoughts – Market Over-Reaction to EC Defense Proposal

The €800Bn of additional defense-related spending in EC's "REARM Europe" proposal assumes a 4-year ramp-up in EU members' defense spending by 1.5%. Advocate's analysis shows that the total impact on the size of the euro-denominated government bond market is less than €700Bn over the next 4 years. The bond market selloff in the 2 days since the EC's announcement of the proposal has already, in Advocate's view, priced in considerably more than the anticipated supply increase. Unless the "REARM Europe" proposal is upsized by almost 30% in the near-term, Advocate believes the recent selloff is an overreaction and may pose a short-term buying opportunity for investors.

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[3] 2024 U.S. Elections – A Probabilistic Fiscal Analysis of the Harris and Trump Tax Plans, Advocate Capital Mgmt, 18 Oct 2024.

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