



iFlow

QUARTERLY INVESTOR TRENDS
Q2 2025

Debt Dynamics

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INTRODUCTION

The second quarter of 2025 underscored a pivotal shift in the global economic and financial landscape. The era of U.S. exceptionalism appears to be waning amid mounting concerns over the sustainability of global growth, as central banks outside the Federal Reserve adopt easing measures and trade negotiations remain unresolved.

Simultaneously, geopolitical tensions – including the ongoing conflicts in Ukraine and the Middle East – have intensified defense spending and led to sustained volatility in commodity prices, further complicating an already difficult market environment.

Against this backdrop, the relative calm in equity markets contrasts with heightened volatility in bond markets, placing debt dynamics and the intersection of geopolitical and economic risks at the forefront of investor focus heading into the third quarter. Our proprietary iFlow data provides a unique lens into these developments, revealing critical trends in currency flows, hedging behaviors, and cross-border asset allocation.

In this report, we look at the following key themes:

- **The limits of the U.S.' ability to run budget deficits.** The evolving challenges of U.S. government debt management highlight the diminishing returns on borrowing and the complex tradeoffs between growth, inflation and debt.
- **Increased risk of steeper yield curves.** The heightened risks in U.S. and global bond markets are characterized by rising yields, shifting investor demand and the potential for increased risk premia, particularly in longer-dated instruments.
- **Fiscal constraints temper LatAm carry appeal.** Despite a Q2 rebound in flows driven by tariff relief, commodity support, and attractive real rate spreads, investor concerns persist around fiscal discipline, especially in Brazil and Colombia, where central bank hikes and election risks loom. Argentina's policy shift has improved stability, but fiscal policy remains a key regional risk factor.
- **Limits to EUR gains, despite ongoing USD weakness.** The prospects of the euro as a reserve currency alternative are dim, as structural economic and asset market foundations still require significant strengthening despite positive policy initiatives within the Eurozone.
- **Ongoing pressure for Asian FX and bond adjustments.** There has been volatility amid policy responses in APAC sovereign bond markets, where central banks are navigating the dual pressures of rising yields and domestic economic uncertainties, with notable divergences between Japan's yield curve management and China's disinflationary environment.

This report also offers detailed macroeconomic outlooks for key regions including the U.S., EMEA, and APAC, alongside forward-looking market forecasts from our expert strategy team. These insights aim to provide investors and market participants with a nuanced understanding of the risks and opportunities shaping the global financial system as we move into the second half of 2025.

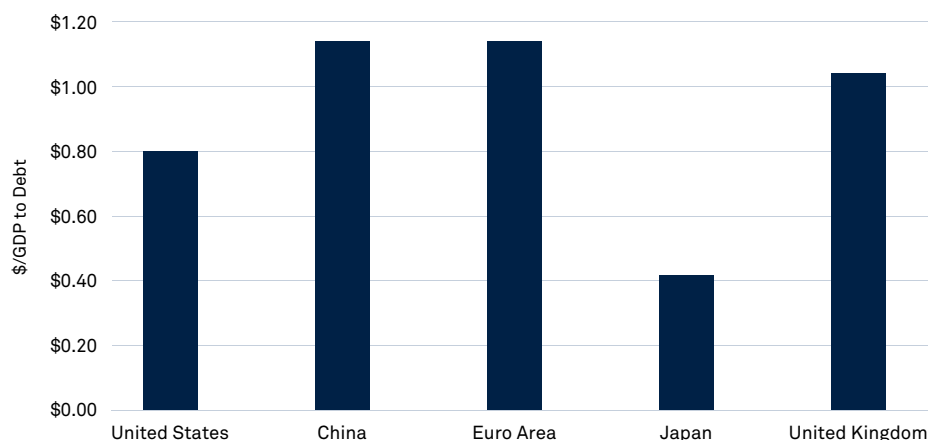
01

U.S. DEBT AND THE ENDGAME

When a government finds itself in a debt crisis, it has several options for resolving the problem. The politically difficult but arithmetically obvious way is to run a budget surplus, using the excess revenues to pay down the debt. Governments can also try growing their way out of the problem by allowing GDP to determine the effective interest rate. They can also try inflating the problem away. But as we saw in Q2, not all inflation is planned, and oil shocks can't be ruled out. A surprise bout of inflation would raise nominal GDP and erode the real value of payments on existing debt. There are some heterodox approaches as well. Sustained inflation and financial repression would force the private sector to hold more government debt. Traditional models show a sustained inflation rate of 5% would cut debt by 38% over ten years. The [history of U.S. debt from 1946–1974](#) shows inflation has in the past helped to reduce the nation's debt, lowering it by 33% during this period. Financial repression, primary surpluses, restructuring or default, and one-off asset sales are some of the other ways to eliminate debt problems. Since the Reagan era, the U.S. has believed in growing its way out of debt. When choosing this path, governments have the option of using tools like productivity, demographics and infrastructure rebuilding.

Most countries have used inflation to dig their way out of debt, a solution that has plagued emerging markets for decades, as doing so erodes GDP and lowers the real value of investments. Financial repression worked for the U.K. and the U.S. following World War II. The central banks in the two countries capped yields, and pensions were required to hold bonds. During the 1994–1996 period of U.S. bond vigilantism, the Clinton administration, with Congress responding, delivered a primary surplus, with spending cuts, tax hikes and budget rules helping to pay down U.S. debt. The worst outcomes are restructuring and default, with Argentina and Greece the most recent examples of countries suffering from a lack of capital and investment that eroded potential growth.

EXHIBIT #1: RATIO OF DEBT GROWTH



Source: BNY, Trading Economics

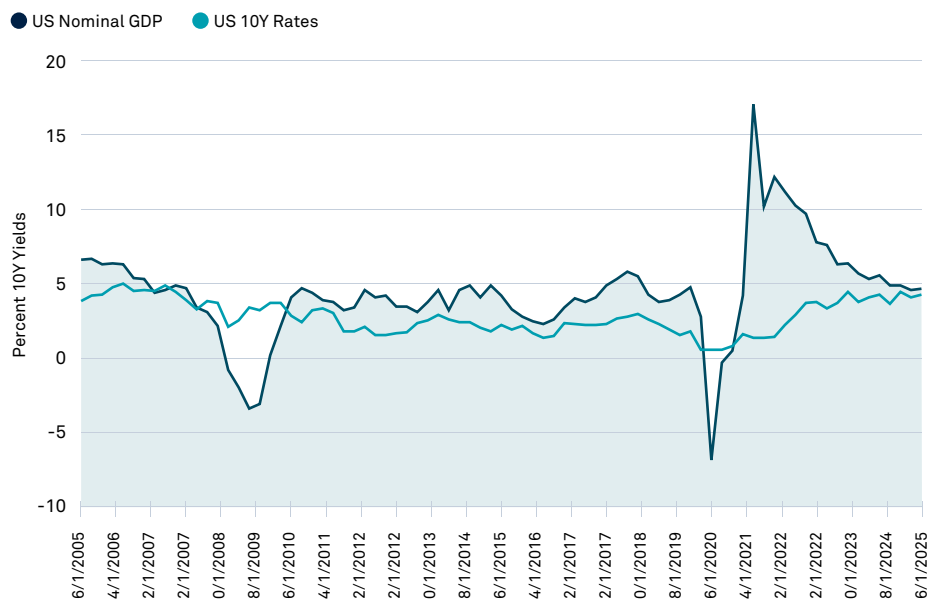
Looking at regions around the world, we can see how they stack up in terms of debt-to-growth ratios:

- **China and the euro area still get “more than a dollar” of output for every debt dollar.** Their debt loads are below 90% of GDP, so one debt dollar sits behind roughly \$1.13–1.14 of economic output.
- **The U.S. is just below parity.** With a debt ratio of 124%, each new dollar the U.S. borrows now anchors about 80 cents of GDP – far less bang for the buck than a decade ago when the ratio was under 100%.
- **Japan is the extreme outlier.** Gross public debt is roughly 2.4 times GDP, so every dollar of debt is backed by only 42 cents of output. Combined with near-zero growth, the “growth-per-debt” metric is effectively nil.

The U.S. has reached a point where it is difficult to grow its way out of the problem.

The U.S. has reached a point where it is difficult to grow its way out of the problem. The country produces just 80 cents in output for every dollar of government debt. While this will allow the country to maintain its debt servicing, it will also likely crowd out future investments in the private sector. Private-sector growth is more important for growth and inflation than public-sector spending. As the case of Japan shows, this equation worsens as debt rises. The value of government spending can still be felt in high-debt nations if money goes into productive investment. Also, debt levels can be broken into liquid buckets, making longer-term debt holders important – like central bankers and pension funds. The role of government in squeezing out the private sector with its borrowing needs usually leads to a political shift that results in new spending being reigned in.

EXHIBIT #2: U.S. NOMINAL GDP VS. 10Y BOND YIELDS



Source: BNY, Bloomberg

Our take:

U.S. history suggests four steps are needed to prevent a debt crisis:

Putting it together, the historically informed baseline for the next decade is a **blended strategy**:

- 1. Keep nominal GDP growth above the average Treasury yield** through a combination of trend productivity gains and inflation that settles a bit above the Fed's 2% target.
- 2. Lean on mild financial repression** (large, rate-sensitive Fed portfolio; Basel rules that reward holding Treasuries; occasional yield management operations).
- 3. Phase in fiscal restraint** once the interest bill, now the fastest-growing outlay, triggers bipartisan action – most likely via revenue raisers first, slower-growing discretionary spending second.
- 4. Hope for growth surprises**, while preparing contingency plans (FDIC backstops, central bank facilities) should bond vigilantes test the ceiling.

Forward look:

The U.S. has one tool that remains key for prolonging the time to crisis - the role of the USD as the world's main reserve currency.

There is no easy way out of U.S. debt. The country faces a tradeoff between growth, inflation and political stability. The U.S. has one tool that remains key for prolonging the time to crisis – the role of the USD as the world's main reserve currency. This allows for a combination of slower growth, modest inflation and quietly repressed interest rates rather than outright default or draconian austerity. The odds favor that pattern repeating, unless economic shocks or political gridlock push the situation to a breaking point.

The issue for the U.S. is that, with the USD being the global reserve currency, the usual tools for trade growth and inflation from FX devaluation are harder to implement as a means for debt relief. Investors globally are now watching not just the U.S. debt level but global ones, with China, Japan, Europe and EM nations all competing for excess global savings. Even as fragmentation has become a common term to describe current global market money flows, money flows continue to be tempered by relative value comparisons of risk and reward.

02

U.S. BONDS ARE THE FOCUS – AND THE RISK

...the outlook for bond yields in the short to medium term is potentially troubling.

Given the relatively unpalatable choices that the U.S. and other jurisdictions face in dealing with the debt, the outlook for bond yields in the short to medium term is potentially troubling. We have liked and been advocates of steepeners – mainly of the bearish variety – in the U.S. for some time. The 2s10s curve currently has a slope of 40–50bp. For reference, in June 2023, the curve was inverted, with a slope of around –100bp. The move to quantitative tightening following the pandemic and the prospect of continued deficit spending has led to increases in long-end yields and a steeper curve.

Our take:

The Congressional Budget Office estimates that the “Big Beautiful Bill” wending its way through Congress will add \$3.3tn to U.S. debt over the next ten years, even after including \$2.8tn in expected tariff revenue. Assuming, once the bill is passed, that the overall spending and revenue numbers resemble the initial projections, we are not sure – as we have repeatedly stated – that investors will be willing to lend to the U.S. at current prices. We think that longer-dated bonds will have to de-rate, leading to lower prices, higher yields and larger associated risk premia before market participants – especially cross-border investors – can be induced to buy bonds. In this vein, we note that waning foreign demand for USTs, especially for longer-dated instruments, has been a feature of the market for the better part of the last 12 months.

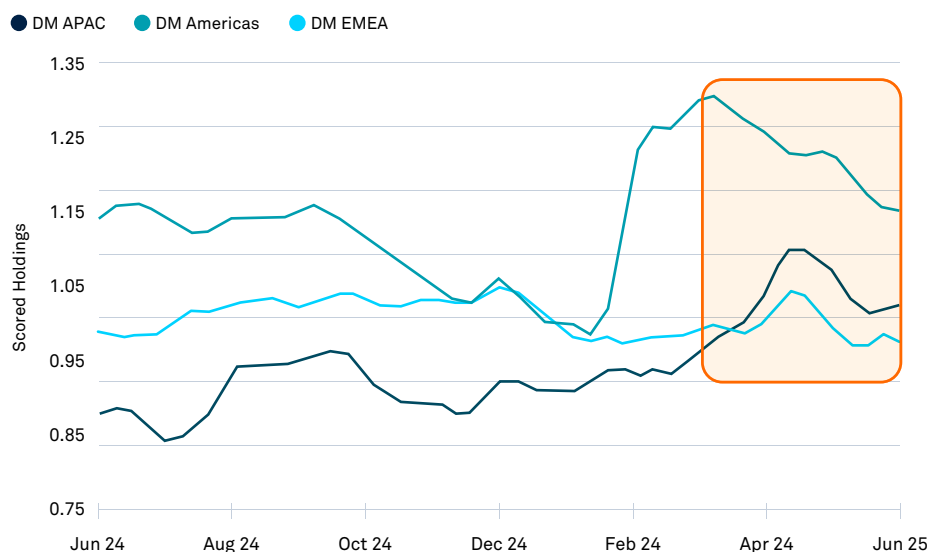
It’s also noteworthy that the increase in nominal yields over the last several years has been achieved almost entirely by rising real yields; inflation expectations at long horizons have not been a contributor to the current level of yields. The rise in real yields has been driven by higher

term premia. The additional compensation required for investors to lend to the U.S. for ten years is now between 60 and 70bp, whereas just a year ago, it was –20bp. Investors are demanding a nearly full percentage point more in yields than they were not too long ago. We think this measure has room to rise, and rates along with it.

Forward look:

We note also that the propensity of yields to rise is not limited to just the U.S.; most of the G10 has seen increases in their bond yields. Evidence from our iFlow custody data illustrates the ebbs and flows of sovereign bond demand around the world. In the chart below, we plot cross-border plot holdings of DM government paper for the Americas, Asia-Pacific and EMEA. By the end of last year, DM Americas bond holdings were especially elevated, at the expense of the APAC and EMEA. Investors subsequently reallocated away from the Americas and towards the other regions, but in the last month or so, demand for all the regions' bonds has begun to wane again.

EXHIBIT #3: CROSS-BORDER SOVEREIGN BOND HOLDS



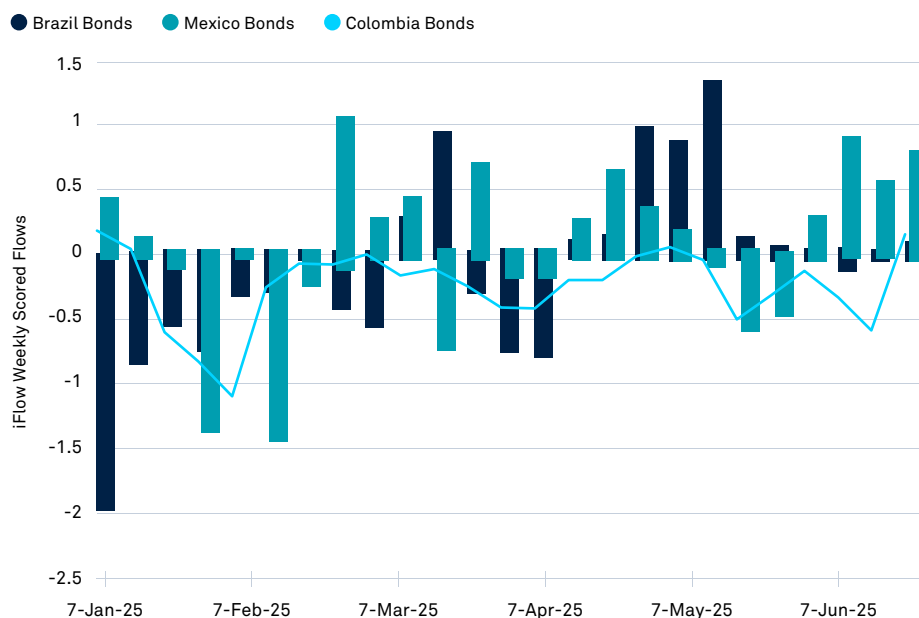
Source: BNY Markets, iFlow

03

THE FISCAL LIMITS OF LATAM CARRY

In a surprise move, flows into LatAm bonds recovered in Q2, as “Liberation Day” led to a consensus that the region is best placed to avoid significant tariff traumas. The region’s real rate spreads made carry attractive again after the pause on Trump’s reciprocal tariffs sparked a global equity rally and reduced market volatility fears. The commodity link in LatAm helped support money flows. The only problem has been fiscal, with central banks, including Brazil’s Copom, continuing to surprise with hikes. Investors are more concerned about inflation risks from fiscal largess than tariffs.

EXHIBIT #4: LATAM BOND FLOWS



Source: BNY

The performance of LatAm against other emerging market bonds also stands out and suggests geopolitical risks are a factor.

Our take:

The LatAm region saw surprisingly good performance from cross-border investors around the world in Q2. The positive performance was bolstered by tariff relief for Mexico, a shift in Copom's rate hike policy, and commodity prices in Chile, Peru and Colombia. The role of FX in LatAm flows has been supportive, with broader USD weakness and high real rates compensating for currency volatility. The performance of LatAm against other emerging market bonds also stands out and suggests geopolitical risks are a factor. Concerns about fiscal dominance that have plagued the region for years detract from this trade.

Forward look:

The credibility of Brazil's fiscal package led to significant selling of those bonds in Q1, with the central bank hiking rates to offset the government money. Only when the central bank slowed its tightening and the government repositioned its fiscal plans did the bond market see inflows. In a longer-term but just as important way, going forward, the Brazil market will be increasingly watching the 2026 election risks and the ongoing potential for more fiscal stimulus. The role of pro-cyclical policy and what it means for the region stands out as a key driver of optimism. Argentina under its new government has turned the corner from Peronist debt and devaluation policies. This has led to lower inflation, a return to global bond markets, and some ARS stability. The implication for the region is that fiscal policy is important, with the next focus for Q3 on Colombia as oil volatility and politics at home drive doubts about the currency detracting from the bond yields.

04

FOUNDATIONS REMAIN WEAK FOR A “EURO MOMENT”

Seminal changes in global perceptions of the dollar and U.S. assets have prompted a broad reassessment of what constitutes a reserve asset. While there is no clear alternative to the dollar and U.S. Treasuries at present, the door is open for other economies and their assets to assume a greater role in the global financial system. Realistically, only the Eurozone and China are seen as large enough to offer a credible alternative reserve base, and both are asserting their credentials in different ways. At the end of May 2025, ECB President Lagarde declared that a “euro moment” was within reach – but that reserve status would be a privilege earned, not granted. She outlined the geopolitical, economic, and legal foundations supporting the euro’s case, but it is evident that the economic – and by extension, asset – foundations remain the weakest.

The asset returns, in both price and yield terms, that have underpinned U.S. exceptionalism in recent years do not require revisiting and are fully acknowledged by core European stakeholders. There is much that Europe must do to boost growth, and we view recent steps by Germany and the broader EU to increase domestic investment – supported by fiscal expansion through defense spending – as positive progress. Germany’s recent decision to extend corporate tax relief has strongly contributed to the DAX’s record performance, even as soft data like PMI surveys point to potential economic weakness ahead. From a market structure standpoint, Lagarde lamented that the Eurozone and EU still offer “relatively few safe assets.” The Eurozone and China are perhaps the only major economies where increased government-backed issuance – even at the cost of higher yields – would be seen as a welcome development capable of attracting stronger inflows. However, the lack of progress

on reforming the structure of Eurozone and EU-wide safe assets continues to limit issuance and stands in the way of achieving a true “euro moment.”

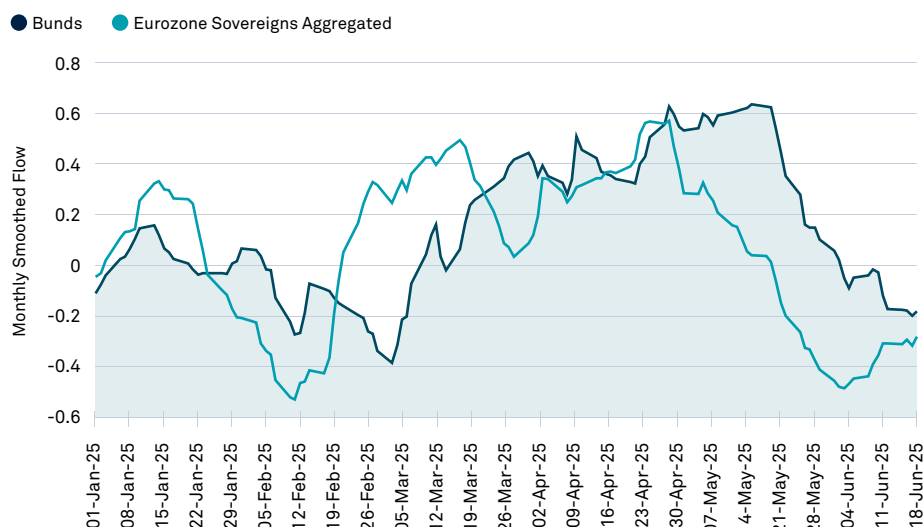
Our take:

Addressing Lagarde’s concern about the lack of safe assets requires the permanent removal of fragmentation risk. Although the Eurozone is likely to expand next year, with Bulgaria now approved for entry, we expect that questions over intra-Eurozone divergence will only intensify. Asset allocation has performed well so far this year, but we have consistently noted that flows remain highly concentrated. In equities, only defense and aerospace have seen significant gains – now more than 50% above the average over the past year. In fixed income, surge flows occurred only in Bunds through April (see Exhibit #5). Given that the aggregate figure was clearly negative, it follows that other markets were net sold. A recovery is now underway, with non-German names attracting renewed interest, but achieving reserve status and removing fragmentation risk will require more synchronized sovereign flows and greater ratings convergence across the Eurozone. Further joint issuance – whether for defense or other shared initiatives – will aid the process, though volumes will take time to reach critical mass. Market participants need not worry about demand, particularly with current yield levels. Lagarde’s speech [referenced a study](#) showing that increased issuance of supranational and agency debt (e.g., SURE, NG-EU and KfW) led to spread compression versus Bunds. Shifting the issuance burden toward such targeted programs represents a more politically acceptable path to strengthening the foundations of EU and Eurozone sovereign paper – an essential step before aspiring to reserve status comparable to the U.S.

A parallel part of this process must include European growth being driven more by domestic investment and demand. We believe cross-border investors will find strong marginal interest accordingly. The euro could also appreciate over time without concerns about corporate earnings translation or subsequent drags on household income.

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EXHIBIT #5: MONTHLY SMOOTHED FLOW, BUNDS VS. EUROZONE SOVEREIGNS AGGREGATED



Source: BNY

Forward look:

While the market is now positioned for a re-rated euro, the degree of optimism appears disproportionate to where the Eurozone currently stands on its path to “earning” reserve privileges. In the near term, the Eurozone and broader EU remain reliant on export growth, despite recent policy efforts to reduce exposure to U.S. trade. President Lagarde noted at the last ECB meeting that exports to the U.S. represent just 17% of total non-intra Eurozone exports, and that any impact would be manageable. This marks a shift from the April narrative, where trade disruptions and a stronger euro were viewed as potentially undermining the inflation target from the downside. Such risks have not gone away. We foresee a more difficult road ahead in H2 2025, with business cycle indicators struggling to generate any momentum. This will increase the likelihood of renewed ECB easing or at least a more defensive stance. Meanwhile, structural reforms will take time, and hard data will likely fall short of what is currently priced in. As a result, we lean toward EURUSD ending the year closer to 1.10, rather than making a sustained attempt at 1.20.

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05

NAVIGATING RISING YIELDS IN APAC SOVEREIGN BONDS

EXHIBIT #6: CUMULATIVE SCORED FLOW, JAPAN AND CHINA SOVEREIGN BONDS



Source: BNY Markets, iFlow

Government bond markets across the APAC region experienced significant volatility in the first half of 2025, driven by a steepening of the U.S. Treasury yield curve and idiosyncratic domestic factors. We expect these dynamics to persist well into the second half of the year. The South Korean and Indonesian government bond markets also warrant close attention. Investor allocation to these economies has

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been strong in 2025, although for different reasons. Looking ahead, their bond markets face mixed signals: monetary easing remains supportive, but growing fiscal demands are creating supply-side pressures. Across the region, currency volatility has also posed challenges, prompting central banks to manage capital outflows carefully. Bank Indonesia's commitment to defending the rupiah limits its policy space to lower rates further. Meanwhile, South Korea's new government is preparing its second supplementary budget of the year – amounting to KRW 30.5tn – following a KRW 13.8tn package in May. This could result in an additional KRW 19.8tn in sovereign bond issuance. While foreign investors still see value in these markets from a total-return perspective, there is growing concern about the potential market impact of increased bond supply.

Among regional central banks, the Bank of Japan (BoJ) faces the greatest challenge in managing its sovereign bond yield curve. The BoJ kept interest rates unchanged in June but retained a tightening bias in response to broadening inflationary pressures. Labor shortages and persistent wage growth are expected to remain elevated as external macroeconomic uncertainty recedes and the domestic recovery gains momentum. Notably, the Japanese Trade Union Confederation (Rengo) reported a 5.46% annual wage increase – the highest since 1991.

These factors have put additional pressure on the Japanese government bond (JGB) market, especially given Japan's substantial gross debt burden. The sharp, accelerated rise in yields on longer-dated JGBs this year has resulted in material valuation losses. Domestic life insurers have reduced their JGB holdings, further fueling the sell-off. The upward yield trajectory is expected to continue. Market participants and the BoJ have been particularly concerned about heightened volatility, with 30-year and 40-year JGB yields reaching peaks of around 3.20% and 3.70%, respectively, in May, before settling closer to 3% at the time of writing.

Interestingly, despite consistent foreign inflows into JGBs – as captured by iFlow data and official sources – such investment has provided limited support to the market. Acknowledging these challenges, the BoJ has intervened by adjusting its tapering schedule. Instead of tapering ¥400bn per calendar quarter through March 2026, it will reduce bond purchases by ¥200bn per quarter from April 2026 to March 2027. This slower pace provides flexibility to respond to further abrupt increases in yields. The Ministry of Finance is also adjusting its issuance strategy by cutting the supply of longer-dated bonds and increasing issuance of 2-year JGBs. In addition, there have been discussions about promoting domestic bond ownership by corporates and financial institutions as the BoJ normalizes its balance sheet.

At the other end of the spectrum, Chinese government bonds (CGBs) have been trading under persistent disinflationary pressure amid ongoing economic uncertainty. Weakening momentum in China's recovery, coupled with underperformance in local equity markets, has driven a surge of inflows into sovereign bonds. Monetary easing and fiscal stimulus have so far failed to meaningfully shift asset allocation preferences. In Q2, 10-year and 30-year CGB yields hit record lows of around 1.6% and 1.85%, respectively.

Our take:

While low long-end yields theoretically support lending and investment, they also risk anchoring market expectations of structurally weaker long-term growth. Although a sharp rebound in yields is unlikely in the near term, further downside movement is limited. There is little room for further policy rate cuts, and forthcoming increases in government bond issuance may put upward pressure on yields as authorities continue fiscal expansion. A stronger catalyst for higher yields would be a sustained rebound in equity sentiment, which has remained subdued amid persistent trade and tariff uncertainties. On the capital flows front, the bias still leans toward outflows. However, there are tentative signs of a turnaround, with nascent inflows into Chinese assets across currencies, equities and fixed income. Of note is the rising IPO pipeline in both Hong Kong and mainland China.

Forward look:

Managing government bond market volatility will remain a key priority for APAC central banks.

Managing government bond market volatility will remain a key priority for APAC central banks. Recent interventions suggest that the risk of higher yields remains a clear concern. This is a key focus point for the BoJ and the upcoming upper house election in Japan. In China, the ongoing push of debt solutions make higher yields counter to government plans. We expect policymakers to continue tailoring their responses to local conditions, whether by moderating the pace of tapering, as seen in Japan, or by implementing active sovereign bond purchase programs, as practiced in Indonesia, India and South Korea. In the short term, additional shocks may arise from rising inflation premia linked to oil supply disruptions. These premia could exacerbate bear steepening across the region, where central banks had previously remained relatively comfortable with their inflation outlooks.

BOTTOM LINE

The four key themes as we move into Q3 are clear:

- **Geopolitical risks and market volatility:** From surprise election results across Europe, including in Romania and Poland, to the conflict between Israel and Iran, there were many serious geopolitical events in Q2. The role of USD and U.S. bonds as safe havens was tested, too. While there is no alternative the greenback, there is still a home bias that can be used to hedge it. This will continue in Q3.
- **Shift in investment allocation:** Investor interest in private equity has gained some focus in Q2, with the greater market uncertainty, coupled with endowments shifting from these holdings to more liquid ones on the back of tax and political pressures. Credit and bonds are therefore seeing more interest, with 55-45 target ratios for equity to fixed income in play. This will keep yield curve steepening trades focused on levels over spreads.
- **Fed policy and inflation:** The ability for the FOMC to look through tariff price increases on the consumer remains a concern, along with new worries about commodity prices. The role of government spending not just in the U.S., but also in the EU and Japan adds to rising views that rate easing bias is disappearing. How central banks handle fiscal risks remains key to Q3.
- **Secular solutions offsetting current fears on growth:** There is optimism that AI can solve productivity and demographic issues in major economies. The consensus for equities is that Q2 will see a modest slowdown in earnings. With respect to bonds, global easing may be nearing the end, but rates are unlikely to go higher. For FX markets, ongoing hedging of U.S. assets will continue for now. The role of technology in driving upside surprises continues in Q3.

If USD is to maintain its role as the world's reserve currency, the U.S. needs to manage the tradeoffs between growth, inflation and debt while also being prepared for potential economic and geopolitical shocks. While there may not currently be a viable alternative to the U.S. dollar, global investors are increasingly wary and are therefore displaying more of a home bias. The role of the CNH and EUR will remain key to how the USD role progresses not just in reserves but also in trade and payments.

Meanwhile, the U.S. bond market faces heightened risks due to rising levels of government debt and shifting investor demand, with longer-dated bonds likely to see higher yields and increased risk premia. This trend is reflected globally, as bond yields across G10 countries have risen and cross-border demand for sovereign bonds fluctuates.

The prospects for the euro to assume the status of reserve currency alongside the U.S. dollar are constrained by weak economic and asset foundations despite positive policy steps and increased issuance of safe assets within the Eurozone. If Europe is serious about weaning itself off of U.S. defense spending, structural reforms, synchronized sovereign flows, and greater ratings convergence are essential to reduce fragmentation risk and build reserve credibility.

APAC sovereign bond markets are navigating significant volatility driven by U.S. yield curve shifts and domestic factors, with central banks like the BoJ adjusting policies to manage rising yields and market pressures. While Japan faces challenges from accelerated long-term yield increases, China's bonds trade under disinflationary pressures amid economic uncertainty, and other regional markets balance supportive monetary easing against fiscal supply pressures.

These shifting dynamics underscore the importance of managing yields and defining appropriate asset allocation strategies in volatile markets.



iFlow

Written by BNY's Markets Macro Strategy Team

BOB SAVAGE

Head of Markets Macro Strategy

JOHN VELIS

Americas Macro Strategist

GEOFF YU

EMEA Macro Strategist

WEE KHOON CHONG

APAC Macro Strategist

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