OUTLOOK

Economic rebalancing: trade tensions, increased defense budgets and repercussions on markets

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François RIMEU

Senior Strategist

Significant increase in defence budgets in Europe

At the end of January we wrote that the risk surrounding the trade war seemed underestimated on equities, in particular with **the questioning of the dominance of American technology** following the emergence of new competitors in the AI sector (Deepseek, Mistral, etc.). The month of February rather proved us right with American indices continuing to underperform while the MSCI China soared by more than 11% over the month. The upward revision of the risk of a tariff war was also expected to result in falling rates (risk on growth greater than inflationary risk) and again this is rather what happened, particularly in the United States where 10-year rates fell by more than 30 bps. On the other hand, we did not anticipate the German government's announcements regarding its budget deficit objective. These are massive:

- **Military spending above 1% of GDP** would be excluded from German balanced budget amendment.

- **Creation of a special off-budget fund of 500 billion euros over 10 years**, or 1.1% of GDP per year, dedicated to investments in infrastructure.

All this is still to be taken conditionally and it will have to be voted on by parliament and there will have to be no opposition from the constitutional court, but the context now seems favorable to pass this type of reform.

Europe, for its part, announced at the same time the "ReArm EU" plan which should give states more room to increase military spending again:

- 150 billion euros in loans to all Eurozone countries.

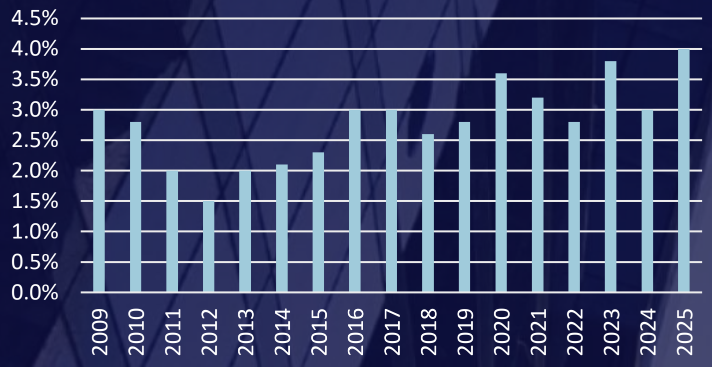
- **Incentivizing member states to increase their national budgets** by offering them to derogate from the budgetary rules by excluding military spending from the calculations. Ursula Van Der Leyen estimated this new "budgetary margin" at around 650 billion euros over 4 years, or around 1% of GDP/year.

- **Simplified use of the European Investment Bank (EIB) to authorize the financing of projects related to the defense sector**, which is not the case today.

Here again, it is substantial in theory. But in practice it will be much more complicated since countries do not all have the same budgetary margins or the same desire to increase defense-related spending as significantly. The direction is nevertheless clear: less budgetary orthodoxy in the Eurozone.

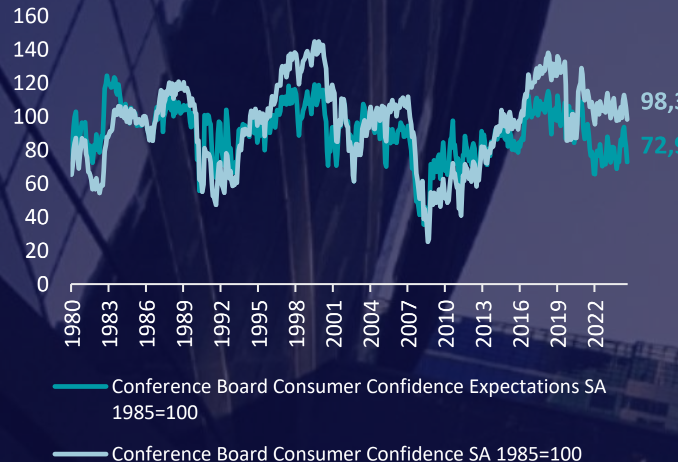
The Chinese government has also expressed its desire to increase its support for the economy by announcing a forecast budget deficit of 4% in 2025 with the aim of achieving, as in 2024, 5% growth. It is too early to tell whether this will be enough given the likely tariff war with the US, but it is also significant. This should allow the positive momentum on Chinese stocks to continue in the coming weeks.

China's budget deficit as a % of GDP



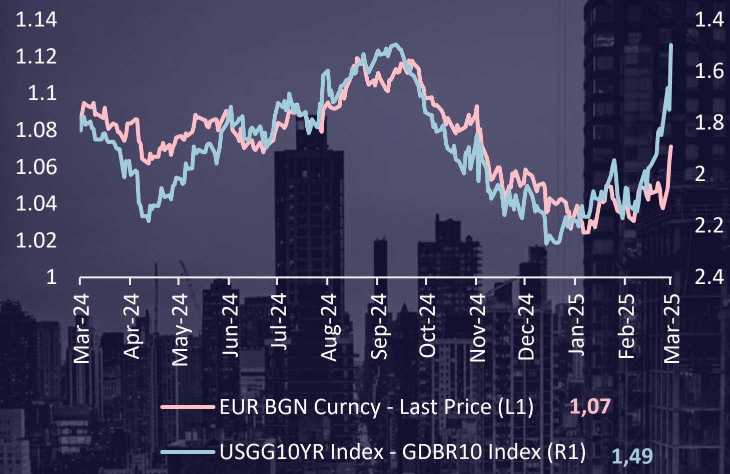
Source: Groupe La Française, data as of 05/03/2025

US Consumer Confidence Survey (NY Fed)



Source : Groupe La Française, data as of 28/02/2025

European rates tighten and euro rises



Source: Groupe La Française, as of 05/03/2025

"the context remains extremely encouraging for gold, the Swiss franc and real rates vs. nominal rates."

Towards a weakening of American growth?

Last month also confirmed the lower dynamism of American growth with a series of disappointing figures: retail sales, PMIs and the Conference Board survey all came out well below expectations. The growth outlook remains solid for the moment in the United States, at 2.3% for 2025, **but the risk seems to be oriented downwards over the next 6-9 months, for various reasons:**

• **Decrease in immigration** (even though it is one of the reasons for strong US growth over the last 2 years). In January, the number of people crossing the southern border was 61k compared to a high of 270k in September 2023 and 190k in June 2024.

• **DOGE**: Elon Musk seems serious about his desire to reduce federal spending: -77k employees in mid-February (source: US government), with the objective of laying off at least the maximum number of "contract workers", representing 200k employees. The effect is not negligible, especially if we take into account the second-tier effects on the private sector.

• **Customs duties and retaliation**: many uncertainties but it should be negative growth and bullish inflation in the short term.

• **Real wage inflation down**: wage inflation is falling while inflation remains high, knowing that the latter is certainly underestimated (on the healthcare part for example).

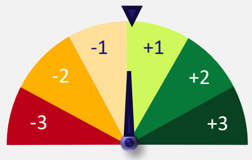
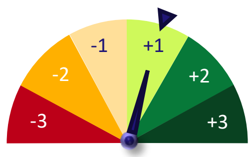
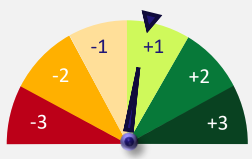
• **Wealth effect that is dissipating**: this is one of the reasons for American "exceptionalism" for the past 2-3 years. The very strong gains on financial assets and the induced wealth effect (stocks, tech, AI, crypto) have indeed enabled durable consumption and strong confidence on the part of economic agents.

• **High expectations**: we have already discussed this several times with very different contexts across 2023 and 2024. This remains relevant with fears of recession at its lowest levels. It would therefore be easier to disappoint.

The European economic situation is improving very slightly (Sentix, ZEW, IFO) but remains very fragile. European and German announcements will be positive for the short-term outlook for the Eurozone if there is a follow up. The consensus should therefore gradually adjust upwards.

This possible improvement combined with the disappointments concerning the American economic situation has led to a very strong tightening of European and American rates and a significant rise in the Euro, surprising the market consensus. Given the strength of the announcements and our outlook for the US economy, **it seems to us that movement could continue on the European currency.**

While it is difficult to have strong convictions at the moment, given the current geopolitical instability and the low visibility concerning customs duties, **it seems that the context remains extremely encouraging for gold, the Swiss franc and real rates vs. nominal rates.**

Assets	Outlook	Strategic Vision
EQUITY		We maintain our positive forecast on Chinese equities (recovery, AI, momentum) with a risk budget in line with that of our indices.
FIXED INCOME		Credit spreads have held up very well to the volatility of recent weeks, including during the European bond sell-off. Very slightly positive outlook with a preference for euro vs usd assets.
RATES		We take note of the new European paradigm which greatly limits the potential for a decline in European rates. Preference for real vs. nominal rates.

March Outlook

The world is unstable and the markets volatile, which does not argue for significant risk-taking. The outperformance of European stocks is for the moment only the result of multiple upward revisions and not of a real improvement in earnings prospects, which could limit the future potential for appreciation. The context argues for a continuation of the upward movement on gold, perhaps even more than before.

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AGENDA

6th March
Governing Council of the ECB

05-07 March
China PC Annual Meeting

12th March
US CPI

17th March (probably)
German Parliament Vote

19th March
FED interest rate decision