INDOSUEZ WEALTH MANAGEMENT

CIO PERSPECTIVES

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Europe: "Whatever it takes" 2.0[1]

It's the "Whatever it takes" moment for future German Chancellor Friedrich Merz. In our Global Outlook client presentations, we have repeatedly said that "Europe is cheap, it's cheap for a good reason, and we would not be courageous to buy Europe only for the reason it is cheap, we need a strong catalyst". Here we go: can the situation get any better? We take a positive view on the latest developments in Europe but are cautious not to chase the rally waiting for a better entry point, especially as uncertainty runs phenomenally high around Trump tariffs.

Trump triggers the German « big bazooka »

As we mentioned in our February Monthly House View (Europe: What If?), Europe has been facing a visible confidence crisis, exacerbated by political instability in key countries like France and Germany. The Old Continent has also been grappling with structural issues that have eroded productivity over time, widening the gap in innovation and competitiveness with the United States. European stocks have made a historically high comeback in 2025 (Chart 1), a massive relief rally after six months of non-stop bad news.

We had our doubts on whether this rally would be sustainable without any further catalysts. Those potential catalysts were a more lenient Trump on trade tariffs, a cease-fire in Ukraine and a cultural change in Germany towards debt, via a reform in the German debt brake[2]. The latter seemed to us to be unlikely given the cultural dislike for debt in Germany (remember in German, the word for "DEBT" also means "GUILT"). Nevertheless, there is nothing like a crisis to prompt Europe into action. **The trigger was Donald Trump's drastic decisions to stop military support to Ukraine and trade tariff threats**, this first prompted Europe and then Germany to take drastic measures of their own.

On the European level, **the Rearm Europe proposal** can thus far be summarised as 800 billion EUR (approximately 5% of Euro Area GDP), through:

- The activation of the national safeguard clause of the Stability and Growth Pact, allowing European Union (EU) countries to increase their defence spending by an average of 1.5% of GDP, or 650 billion euros that could be released over the next four years.
- A "new instrument" to provide 150 billion euros in loans to member states to finance joint defence investments in pan-European capabilities.

The German proposal is the real game changer, with three elements to that:

1. German proposal to exempt defence spending in the budget surpassing 1% of GDP from the debt break limit, pretty much an unlimited window.

[1] In reference to Mario Draghi's 2012 speech, considered to be the turning point in the euro crisis.
[2] German debt brake: a constitutional rule limiting the total deficit to 0.35% of GDP per year.

2. German proposal to launch an off-budget infrastructure fund of 500 billion euros over the next 10 years, to address the structural under investments in Germany and to regain competitiveness AND restore growth, this is new as well. That is equivalent to roughly 1% of GDP every year. The money can be used for civil and population protection, transport, energy, education, care and science infrastructure, in addition to hospital investments and research, and digitisation.
3. German proposal that Länders (German federal states) can also have a structural deficit of 0.35% of GDP a year, from the current 0% (approximately 15 billion euros).

This is also a U-turn that a few weeks ago seemed unthinkable. As a reminder, the German stimulus package during the pandemic was 130 billion euros.

A boost to Euro Area GDP growth

We have not yet revised our Euro Area GDP projections, currently at 0.8% for 2025 and 1.2% in 2026, as we need to understand the exact numbers of the proposed packages, but these are our main assumptions:

- In the very short-term, can the current German government get this through parliament before the new government takes over on 24 March? Most likely they will, unless the Green Party changes their mind or some hardliners on the debt brake within the Friedrich Merz's CDU decide to opt out. We believe a political signal of such magnitude would be difficult to withdraw, even if workarounds and partial options are probable.

- How will European consumers react? Confidence has improved with hopes for recovery due to political stability in Germany and France and renewed European unity, including the United Kingdom's return. However, the absence of US protection and a threatening neighbour may impact consumer morale. Large fiscal spending might lead to higher taxes or the perception of future tax increases. This stimulus is not about additional private consumption (it's not a Trump pandemic check), but rather a positive supply shock (less inflationary, but requiring more time to impact GDP growth figures).

- **Revisions for the Euro Area GDP growth could be significant, likely impacting 2026-2027 rather than 2025**, with a positive boost for industries. World Bank research shows that public investment in infrastructure effectively stimulates the economy due to the "multiplier" effect, where each dollar of investment generates 1.5 dollars in economic activity, double the impact of tax cuts. Among various public spending categories, infrastructure investment displays the highest multipliers, making it a particularly powerful economic stimulus, especially during economic downturns. A proposed 1 percentage point increase in annual infrastructure spending could boost German GDP growth by 1.5 percentage points, potentially raising 2026 Euro Area GDP growth from 1.2% to 1.7% (the highest since 2018), everything else held constant and excluding positive spillovers to other European countries.

- **US tariffs - Damocles sword**: Trump's threats on tariffs and the heightened geopolitical uncertainties urge us to remain cautious regarding the recovery of consumption. This could offset the growth the benefits of the new spending, which is likely to be more positive for growth in 2026 than 2025. Analysts account a risk between -0.5 and -1 percentage points of possible implementation of tariffs on 2025 European GDP growth – this is not a negligible risk even if the impact should be more sector and country specific, i.e. pharmaceuticals and automobile (Ireland, Germany).

Investment outlook implications

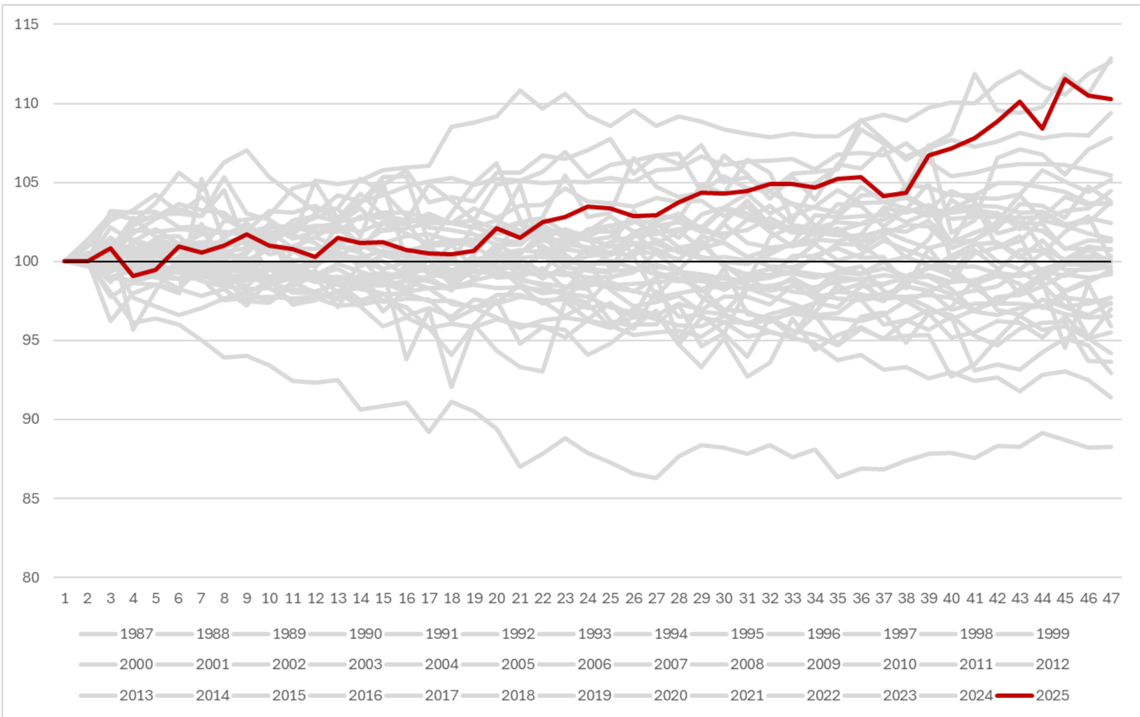
Bottom line, we take a positive view on the latest developments in Europe. The speed at which announcements have been made is staggering and requires a cool mind but also to step back to evaluate long-term consequences. Some uncertainties persist in the European investment case, particularly concerning the execution of these proposals, GDP growth (especially tariffs) and the strength of euro. These factors could have a negative impact on the future earnings of European exporters, for example.

Overall, in most of our portfolios we are constructive on equities, and close to neutrality on Europe. Admittedly the market in Europe has gone very fast in a very short period of time, we are not particularly enthusiastic about chasing the rally. The speed at which announcements have come out, which probably very few people expected, has certainly created a form of panic buying, with investors searching to rebalance portfolios. **Volatility will remain and we might have a better entry point once Trump's tariffs threats hit Europe, so we will remain agile and act upon opportunities**.

On the fixed income side, German bond yields had their biggest surge since 1997, reflecting a high public debt trajectory and especially higher expected potential growth, in Europe's largest economy. We are currently underweight European duration and remain so even after such a strong move.

Finally, our positive stance on the US dollar is under pressure. We believe the market was strongly positioned on the dollar and probably it became a too consensual view, hence some short covering. Yet the path of interest rates on both sides of the Atlantic, more cuts in Europe, fewer in the US, still calls for a limited upside for the euro, although we recognise this could be challenged.

Chart 1: The biggest start of the year outperformance of EU stocks versus US stocks (STOXX Europe 600, 100 = 01.01.2025)



Source: Bloomberg, Indosuez Wealth Management.

Alexandre DRABOWICZ
Global Chief Investment Officer

Bénédicte KUKLA
Senior Investment Strategist

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