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Monthly commentary
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GLOBAL MACRO VIEWS

Opportunities amid Europe's gloomy outlook

Europe is struggling in the shadows of U.S. exceptionalism. The continent faces headwinds of fiscal uncertainty, structural growth challenges and trade policy uncertainty. While there are few catalysts to spur growth in 2025, there are opportunities for investors to stay selective in portfolios.

The euro area averted a recession in 2024 thanks to resilient labour markets and the European Central Bank (ECB) beginning to exit restrictive policy rates. The central bank is poised to extend its rate-cutting cycle through 2025, with the deposit rate likely to reach 1.75% by year-end. While looser monetary policy would be a tailwind to growth, uncertainty – stemming from U.S. tariffs, fresh elections and lack of a fiscal impulse – is likely to weigh on sentiment.

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1. Bracing for tariffs under Trump 2.0

The new U.S. administration has Europe in its sights as a target for trade tariffs. Heightened trade policy uncertainty is set to weigh on confidence in the region and subsequently shave 0.3%-0.5% off real GDP growth in 2025, underpinning our forecast of subdued 1% growth in 2025. Sentiment in Germany, Europe's largest economy, is already depressed amid high energy costs, geopolitical tensions and a structural slowdown in manufacturing activity. The risk of U.S. tariffs could further damage confidence, tipping Germany into a mild recession at a time of constrained fiscal capacity given uncertainty from the upcoming election.

Despite few catalysts to spur 2025 growth, opportunities exist for selective investors

With the euro slumping close to parity against the U.S. dollar and European equities trading at a steep discount to U.S. peers, compelling valuations point to select opportunities. Relatively weak earnings expectations of around 8% this year reflect economic headwinds, supporting our expectation for European equities to underperform the tech-led U.S. market. This warrants a selective approach with European cyclicals, while healthcare, technology and energy are poised to benefit from the secular trends around power generation, decarbonization and automation.

For European corporate credit, trade uncertainty alongside margin and earnings pressure from higher interest costs and wages will likely see credit metrics deteriorate, albeit from a healthy position. Our preference remains in sectors with stable earnings like consumer staples, communication and select financials, which have attractive valuations and strong balance sheets. Despite trade concerns likely to spur volatility and modest spread widening, high carry should drive cash into European credit markets, with the potential for positive excess returns.

2. Making sense of Germany's limited fiscal flexibility

Germany has been under pressure since the invasion of Ukraine and the loss of cheap Russian gas for its energy-intensive industries. It has few alternatives owing to the country decommissioning its nuclear fleet over the past decade. High energy costs and increasing direct manufacturing competition from China means structural challenges are likely to persist, heightening the need for fiscal support. But the reinstatement of a constitutional law that limits annual structural budget deficits to 0.35% of GDP means that much-needed public investment to spur growth is now unlikely.

German bond investors began pricing in the scope for such stimulus after the recent collapse of the country's governing coalition. However, material changes are unlikely in 2025 even if a new government could create a more stable coalition and pave the way for modest fiscal flexibility through constitutional reform. Expected protracted negotiations after the February 2025 elections and political resistance to reforming Germany's debt rule points to tepid economic activity. As such, with inflation progressing to 2% through the year, the ECB poised to extend its easing cycle and growth pressures remaining, the 10-year German bund yield could trade closer to 2.0%

Fiscal deficits combine with political uncertainty in key markets

3. Positioning in the periphery

Peripheral countries such as Spain, Cyprus and Greece have seen strong growth with further tailwinds ahead. These countries alongside Italy should be helped by large Next Generation EU spending that is largely backloaded for 2025-2026. Alongside prospects of ECB rate cuts and lower German bond yields, this bodes well for peripheral bonds' total return performance.

Periphery spreads, including Spain and Italy, should find further support, as the hunt for yield offsets any widening pressure from the risk of escalating geopolitical tensions. The key risk to our view stems from a weakening U.S. economy weighing on tourism inflows through 2025.

4. Preparing for more French uncertainty

Another round of French Parliamentary elections loom in 2025 amid limited support for the current minority coalition from parties across the political spectrum. After the historically unprecedented swift ousting of former Prime Minister Barnier and ensuing uncertainty, a higher political risk premium in French government bonds over German peers is warranted. This high political uncertainty scenario points to fair value of 80-to-90 basis points (bps) once markets settle after anticipated choppy price action in coming months.

Persistently high fiscal deficits and deteriorating debt dynamics imply mildly higher net issuance in 2025, with ongoing reliance on foreign investors. International investors in French debt may seek higher yields to compensate for the political risks. A lack of political space for Prime Minister Bayrou to implement stronger fiscal consolidation (as per Barnier's plans) raises downgrade risk for France into the single A rating bucket, which could trigger meaningful outflows and outsized spread widening. While we are underweight in French government bonds, should this scenario materialize, we would use the opportunity to tactically cover shorts.

5. Unlocking value in U.K. gilts

While elevated services inflation has kept policymakers cautious, forward-looking signs of easing wage growth and downside growth risks leave scope for further policy rate normalization. Importantly, the U.K. macro backdrop is challenged by the burden on corporates from tax hikes embedded in the 2024 budget and concerns about further increases. The probability of fiscal tightening in Spring 2025 is high, as signs of weaker growth and higher projected interest costs will warrant material revisions to the Office of Budget Responsibility's economic and fiscal projections. This points to public spending cuts, and if some of the fiscal adjustment comes through further tax increases, an initial inflationary cost shock would likely be offset by a fundamentally more dire growth picture.

The risk of job cuts and subsequent easing in underlying inflation is likely to prompt the Bank of England (BoE) to reduce rates at a quicker pace in the latter half of 2025 and supports greater rate cuts than the less-than-75bps priced in by markets. We think 100bps of rate cuts or more are likely in 2025. Together these factors should feed through to lower gilt yields, with the 10-year yield likely to move back below 4% in the second half of 2025.

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