Europe: The wake-up call has been heard

More defense, more investment, more debt, more growth

IN A NUTSHELL

— Because of political developments in the U.S. and doubts about the loyalty to the NATO alliance, Europe could develop its conventional defence capabilities and become less dependent on the U.S.
— Germany is planning substantial investments in infrastructure and defence, financed by an extension of the debt brake and a special fund of EUR 500 bn. This could increase new borrowing and the government debt ratio, but also boost economic growth.
— The announcements led to a rally in equity markets and a slump in German government bonds, with yields rising. We believe that the euro could strengthen in the short to medium term and German equities, especially mid-caps, may benefit from the planned spending.

Financial policy upheavals could have a positive impact on growth

In light of the latest political developments in the U.S., which have raised doubts about the U.S.'s loyalty to the NATO alliance and called into question continued support for Ukraine, there is a growing realization in Europe that it may be less able to rely on the U.S. for security than it has in the past. Therefore, conventional defense capabilities in Europe could be significantly expanded.

The latest developments in Germany and Europe point to major fiscal and political changes that are also likely to have a significant impact on the financial markets. According to the potential future chancellor, Friedrich Merz, the Federal Republic of Germany has reached a “whatever it takes” point, which requires consistent and rapid action. In light of the massive changes in the geopolitical environment, military capacities should be rebuilt quickly and decisively. To this end, all defense spending exceeding one percent of gross domestic product (GDP) is expected to be exempted from the debt brake. The debt brake had previously only allowed for a cyclically adjusted new debt of 0.35 percent of gross domestic product. In addition, a special fund of 500 billion will be set up for infrastructure spending, to be spent over a ten-year period on disaster protection, transportation infrastructure, hospitals, energy infrastructure, science, research and development and digitization. A new commission of experts will also review the debt brake and outline reforms by the end of 2025. This shift reflects a growing consensus that fiscal space will be needed to stimulate growth and address new challenges. Both measures still have to be approved by parliament. The future coalition partners want these changes to be adopted by the outgoing parliament before the newly elected parliament convenes. In the new parliament, a blocking minority is held by fringe parties that oppose supporting Ukraine and increasing defense spending.

We do not expect any fiscal discipline to now be abandoned in Germany. According to our calculations, the additional measures are likely to increase annual new borrowing by around two percentage points more than would otherwise be the case. This could take us into the 3 percent range in the coming years; 4 percent of GDP could also be conceivable for a short period. The national

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debt ratio may also rise to around 70 percent of GDP over the next ten years. However, Germany is still far from being a "high debt country" threatened with downgrades by rating agencies.

Strengthening defense and security is also being discussed at the EU level. EU leaders in Brussels will consider Commission President von der Leyen's "REARM Europe" plan, which could create a new EU instrument for budget-backed loans. However, participation could be limited to a "coalition of the willing," potentially excluding some states. There is also a discussion about whether defense spending by member states should be excluded when calculating the deficit ratio. At the same time, the European Investment Bank is expanding its mandate to finance defense, and joint efforts such as an austerity and investment union are underlining the ambition to combine private and public capital.

We expect the measures planned by the government to accelerate growth in Germany and are therefore raising our growth forecasts. We estimate that Germany will grow by 0.4 percent this year and by 1.6 percent next year. The reason for this is that it will take some time for the effects to be reflected in the growth figures. As infrastructure spending is being treated as a lower priority, the effects here could take even longer to materialize. For the eurozone as a whole, our new growth forecasts for this year and next are 1.0 and 1.5 percent respectively.

Markets in turmoil

Market reactions to the announcements were significant. German equities rose sharply and there were also strong positive signs at the European level, for example in the Euro Stoxx 50. German government bonds, on the other hand, experienced a real slump, with yields rising sharply – on Wednesday, Bunds had their worst trading day in more than 40 years. As a result, yields on 10-year Bunds have risen by around 40 basis points since the close of trading on March 4th. The yield curve in the 2-10 year range steepened to around 60 basis points and continues to trend higher. Bunds also underperformed swaps and U.S. Treasuries. The yield spread over 10-year U.S. Treasuries has narrowed by 40 basis points since the end of February. The Bund/Swap spread in this maturity range fell to a record low of minus 16 basis points. For 30-year maturities, the spread reached minus 60 basis points.

It is difficult to pinpoint a single reason for the massive sell-off. In our view, it is likely to be a combination of several factors. The most important seems to be the expected wave of new bond issuance over the next ten years. The impact on supply would be significant if the program is implemented as announced. However, it is currently unclear how this will affect the issuance calendar in the coming years and what the maturity distribution of the new additional bond financing will be. The markets seem to have been caught off guard by the massive spending program and the change of heart by Merz and the Christian Democratic Union (CDU). As positioning appears to have been skewed to the long side, sharp position adjustments may have added to the move.

Asset-class implications

Fixed Income & Currencies

German Sovereign Bonds

The exact impact on bond yields remains difficult to assess. A steeper yield curve and higher total return levels for Bunds are reasonable and likely. The European Central Bank (ECB) is also likely to cut interest rates only twice more in the next twelve months, to 2.25%. The longer end in particular could suffer from rising inflation risk premiums. We will raise our yield forecasts for Bunds across the curve and model a steeper yield curve. We remain tactically cautious as uncertainty remains high. It remains to be seen what the exact spending program will look like; several parameters are still unclear. So far, spending plans are not a budget.

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Currencies

In the short to medium term, the euro should be able to regain significant ground against the dollar. In the longer term, we estimate that the exchange rate could return to levels around 1.10 EUR/USD.

EUR Investment Grade Credit

In a very strong risk-on environment yesterday, credit spreads tightened by an average of 7 basis points, reaching a yearly low with an index level of +83 basis points compared to government bonds, the lowest since the Global Financial Crisis at +74 basis points. This tightening was driven by optimism around adjusted growth and capital expenditure plans, which are expected to significantly benefit the manufacturing sectors and bring traditional industries back into focus. The higher overall yield level is anticipated to attract further inflows into the asset class, providing additional support for credit spreads. However, increased Bund supply could impact swap spread inversion and potentially lead to crowding out fears for government bonds versus investment-grade credit, particularly for rating-sensitive accounts like insurance companies that prefer investing in Bunds over investment-grade credit.

Equities

The significant expected increase in fiscal spending should help to improve investment sentiment in Germany. Nevertheless, structural economic friendly reforms are needed as well. The DAX has re-rated significantly over the last 6 month and is now trading above its historical average but still at a significant discount to the U.S. market. Given that 80% of revenues for the DAX40 companies are generated outside of Germany, the re-rating is more a reflection of improved sentiment rather than the start of an imminent earnings upgrade cycle in our view. Nevertheless, we believe double digit earnings growth is realistic in 2025. After a significant underperformance of German MidCaps, the recent policy shift in is supportive for smaller companies given their higher domestic exposure and therefore stronger gearing to an improved German economy. We believe the rally in MidCaps has further legs in anticipation of an earnings upgrade cycle.

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Glossary

One basis point equals 1/100 of a percentage point.

Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

The Christian Democratic Union of Germany (CDU) is a Christian democratic and liberal-conservative political party in Germany that is considered center/center-right in the German political landscape. The CDU is the sister party of the Christian Social Union in Bavaria (CSU), which operates only in the state of Bavaria.

The Dax is a blue-chip stock-market index consisting of the 40 major German companies trading on the Frankfurt Stock Exchange.

The debt brake limits the German federal government to new borrowing of no more than 0.35% of gross domestic product.

The Euro Stoxx 50 is an index that tracks the performance of blue-chip stocks in the Eurozone.

The European Central Bank (ECB) is the central bank for the Eurozone.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Firms referred to as mid cap generally have a market capitalization of between $2 billion and $10 billion.

NATO is a Western military alliance with currently 30 member states

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

A yield curve shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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