"Europe: A Continent in Waiting," an EU Macro Update

Introduction

What are the main differences between different European economies right now? Will the two traditionally strongest nations be able to recover from these years of weak economic performance and political uncertainties? In this article we will try to tackle these questions, as well as exploring the principal macroeconomic divergences between the United States and Europe, and what this means for rate cycles in 2025.

Europe & USA

Different macroeconomic landscapes in the USA and the Euro Area have resulted in different rate cutting paths for both regions in the last 9 months, and now the story continues to be the same. The Fed kept the fed funds rate steady at the 4.25%-4.5% range in January due to inflation that seems to persist and remains above expectations, and a labor market that is still solid, with an unemployment rate that dipped to 4.0% in January 2025, marking its lowest level since May. As highlighted by the data, the United States is experiencing a period of economic growth (annualized 2.3% in Q4 2024), unlike the Euro Area, which has a stagnant consumption issue, and is not growing (annualized 0% in Q4 2024). For this reason, the market expects a 25bp rate cut at the next ECB meeting on March 6, while the Fed is not expected to cut rates, with the decision set for March 19.

In the next 6-24 months, monetary policy is likely to continue to diverge, as the USA is only pricing a modest 2-3 cuts in the next 12 months and Europe's growth continues to stagnate.

Newly proposed tariffs are another element which would apply a two-fold pressure on this widening interest rate gap. On Wednesday Trump announced his plan to impose 25% tariffs on the whole of the European bloc, citing that its existence was a means of "screwing the United States".

This aggressive trade policy would result in grave inflationary pressures on the US, which would be compounded by the rest of their proposed tariffs. This would hamper the Fed's 2% inflation target, nudging the Fed's fund rate to stay higher for the foreseeable future.

At the same time export volumes would decrease in Europe producing yet another drag for European growth. This would likely have to be tackled by monetary easing, spurring the mentioned increased interest differential

Germany

A few days ago, one of the most closely watched elections ever in Europe took place: the election for Germany's federal parliament, the Bundestag. This was an election with a voter turnout of 83.5%, something that hadn't happened since the reunification of East and West Germany.

The results were much as expected, starting with the victory of the CDU/CSU, which won 28.6% of the votes and secured 208 seats. This is the centre-right party, led by Merz, who campaigned on tougher immigration policies and a reform plan aimed at restarting the German economy, which has been in recession for two years, even at the cost of massive cuts to welfare.

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The second-best result in the country, and the best ever for the party, went to AfD, which got 20.8% of the votes and 152 seats, doubling its support compared to 2021. AfD built its success on opposition to immigration, the green transition, and further European integration.

It's the East Germany that supports AfD the most, showing how there are still two sides to Germany, which, despite reunification, are still competing for dominance in the country. AfD also focused heavily on young voters, with targeted social media campaigns, and even received support from Trump and his running mate, J.D. Vance. It's definitely a relevant topic that young people are becoming increasingly conservative. Even Scholz commented: "We live in a democratic country, and we are fighting for democracy… The fact that a far-right party like AfD can achieve such results in Germany is something we cannot simply ignore." For now, the coalition to keep the far right out of government still holds, for now...

In third place comes the centre-left SPD, the party of outgoing chancellor Scholz, which suffered a collapse at the polls, recording its worst-ever result in a federal election, with just 16.4% of the votes and 120 seats, losing 86 compared to the previous election. Next are the Greens, with 11.6% of the votes and 85 seats, followed by Die Linke with 8.8% and 64 seats.

In the coming months, we expect that Merz will try to form a new government together with what's left of the SPD. In fact, the Bundestag has 630 seats in total, meaning an absolute majority requires 316 seats. However, the parties disagree on many issues, and the idea of another unstable coalition like the so-called "traffic light coalition" that governed over the past three years, is something many Germans are already worried about.

This is a historic moment, which forces Germany, the EU's informal leader, to take a clear and firm stance to help Europe become less dependent on Trump's United States. The first crucial step will be to overcome the so-called "debt brake", something Merz wants to push through as soon as possible, even with the current Bundestag, which hasn't yet been fully reconvened after the election, in order to take advantage of the window for a qualified majority. This will be a key decision, after two years of recession and five years of overall economic decline, to kickstart investments and growth, while also addressing the highly controversial issue of military spending.

France

'Let them eat cake'; an apt mantra for the current state of the French nation even though politicians will it not to be so. As is common knowledge, debt-to-GDP figures in the French Republic have continued to stay at dangerously elevated levels, with 2024 estimates lying at 111.3% of GDP. This ugly-rearing figure relents despite the combined futile efforts of various prime ministers. Michel Barnier, who is now known as the shortest-tenured prime minister in modern French history, was the most recent (failed) challenger of this debt. His debt proposal, marked by €60bn euros in tax hikes and spending cuts, was met with an outcry from far-leaning French parties in both directions. A notable complaint was that the tax-heavy nature (austerity measures consist of 70% tax hikes) of the proposed budget would jeopardize Macron's supply-side legacy. This meant that for the unfortunate Barnier, his budget proposal would never see the light of day, as the no-confidence vote forced him to resign.

Now, there is a new dawn in the French Republic; centrist Democratic Movement member Francois Bayrou was elected as prime minister in late 2024. But just like his predecessor, Bayrou was faced with no-confidence votes when his budget proposal with €30bn in spending cuts and €20bn in tax hikes was put to the attention of parliament. Such a budget would change the 2025 deficit projections from 6% to 5.4%.

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It likely wouldn't come as a surprise that markets fear this 'dawn' to be nothing but a flash in the pan. OAT Bund 10YR spreads are currently at 72 bps and have as of recently peaked at approximately 90 bps, a clear sign of the market's distrust of Bayrou's fiscal plans, or better yet, France's receptiveness to such proposals. In fact, things have gotten so bad that Moody's has lowered France's long-term issuer rating from Aa2 to Aa3 in late 2024, citing a 'substantially weakened' French financial state in the coming years.

But despite these fiscal troubles, Macron remains hungry for innovation: 109 billion euros in AI investments over the coming years was announced by the French president. With energy costs remaining heightened across the Eurozone, the low costs provided by French nuclear energy will prove crucial for mass buildout of data centers. It's important to note that nuclear energy makes up two-thirds of France's electricity, and that France sells its 57 reactors' energy to Eurozone neighbors bound by previous promises to forgo nuclear energy.

Italy

The Bank of Italy sees the Italian GDP accelerating to expand 0.8% in 2025 and 1.1% in 2026. Since 2021 Italy has outperformed France and Germany in terms of economic growth, but as we said in the previous article, this growth came mainly from previous ECB stimulus.

In the last two years the central role of the construction sector has clearly emerged. This was driven by projects financed by the National Recovery and Resilience Plan (NRRP), and to this was added the so called "Superbonus", an housing renovation tax credit, which has incentivized massive interventions of energy efficiency and seismic improvements of buildings. Even though the measure has been progressively reduced, with deductions falling to 90% in 2023, to 70% in 2024 and to 65% in 2025, its impact has contributed to supporting the growth of the sector in recent years.

In terms of deficits, this phase-out of sizable housing tax credits and buoyant revenue are expected to push the government deficit significantly down in 2024, to 3.8% of GDP. The deficit is forecast to fall further in 2025 and 2026, to just below 3% of GDP. By contrast, the debt ratio is set to rise over the forecast horizon, reaching 139.3% of GDP in 2026, driven by the lagged impact of the housing renovation tax credits accrued in the deficit until 2023.

The Italian economy is now aligning with the euro area average. This year, as we said, real GDP should gradually accelerate, benefiting from the further implementation of the NRRP and the acceleration of private consumption which looks to remain the key growth driver for Italy, supported by the strength of the labor market. As confirmed by the data, the unemployment rate has reached a low of around 6.4%, the lowest level in the last 50 years.

We expect Italian growth to keep being very muted for the foreseeable future. The slowdown is driven by weak manufacturing and falling exports over the past 18 months. The stimuli that have characterized the growth during the post-Covid period will end: the "Superbonus" in 2025 while the funds allocated for the NRRP will end in 2026.Given that Italy is the third largest country by capital key, this will likely play a significant role in shaping the ECB's future decisions.

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Spain

The PIGS standout has proceeded to do exactly that: stand out. With the country being deemed the best performing rich nation of 2024 by The Economist, markets are so confident in this roaring nation that BONO-Bund 10-year spreads are at 68 bps, a smidge lower than even their French counterpart's relationship with the prudent German debt. This may seem slightly counterintuitive, as debt-to-GDP remains at quite a high 105.15% estimated for 2024. But, when you put into perspective that this figure has been on a steady decline year-on-year since an explosion of the budget during COVID (the figure ballooned to 120.3% from 98.2% in 2020), it provides some rationale as to why it's there in the first place.

Additionally, unemployment has been on the decline: most recently, the figure was reported at 10.61% for 2024 Q4. All this was possible while keeping inflation at a modest 2.8% for the year. Naturally, companies fared just as well in the Spanish nation, as the IBEX-35 soared 14.2% in the year.

However, things are far from being perfect in this country. For instance, one must look no further than the Spanish real estate market, which has been plagued by high prices that are symptomatic of the low supply of housing relative to demand. This doesn't necessarily mean that there aren't any houses available; for instance, in a 2023 Bank of Spain annual report, it was recorded that 4,000,000 properties were not being occupied in the country. Instead, the reasoning for such a misallocation was interpreted to be poor housing quality, misaligned financial incentives and distrust in Spanish legal frameworks amongst owners. In response to the crisis, however, Spanish prime minister Pedro Sánchez has proposed a 100% real estate purchase tax on all non-EU buyers despite the fact that only a mere 87,000 of Spain's 587,000 real estate transactions in 2024 were actually made by foreign (including EU) buyers. These housing market tensions are further amplified by inflationary pressures from a booming tourism sector, with inflationary touristic forces in the midst of a record year (94 million tourists in 2024), working-class Spanish locals feel the heat.

Conclusion

The overall picture remains pretty grim in Europe, at least for now. Every major country analyzed has some bright spots, like increased political stability in Germany and France, and a budding labour market in Italy and Spain, however the totality of the data suggests sluggish growth will persevere, albeit with a mostly tamed inflation. We believe that a European growth recovery will have to be heavily spurred by monetary stimulus. This is why we believe that the ECB will continue cutting interest rates by around 100 bps until the 175-275 bp range is met. With the Fed's interest rate path looking increasingly murky, the looming increasing interest rate differential opens up considerations for where the future of the euro-dollar rate might be in the next 12 months. We expect the dollar to continue to appreciate against the euro in a journey towards parity in 2025 despite the massive gains it has already made in the last two quarters. The main risks to this view are grave growth shocks in the USA or a rapidly undershooting inflation, both scenarios we see unlikely with Trump's Tariffs starting to take action, a US Manufacturers PMI which has been rising and beating consensus expectations for the last 3 months, and restrictive immigration policies which put pressure on the job market and wage growth especially.

Another supporting factor for this view lies in both regions' deficit concerns. There are widespread concerns about Trump and Musk's ability to reduce the USA's budget deficit, especially in the wake of potential tax cuts. These doubts could reverse the recent gains made by that part of the curve due to future supply concerns. In Europe on the other hand, further steps in issuance of European Bonds (NGEU), instead of single country

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bonds, particularly in regard to increased military expenditure, would probably help the longer end of single country European bonds to stay at lower yields.

Another interesting question remains that of European defence stocks. Euro-defence stocks have enjoyed their best week since the start of the Russia-Ukraine conflict and will continue to make headlines amidst growing defence budget discussions across the whole continent. With Trump in the white house, and less political stability between traditional Western allies in times of war, we believe that the red hot defence stocks have room to run especially after this week's controversial encounter between Trump and Zelenskyy.

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