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MARKET OVERVIEW MARCH 2025

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EUROPE IS PANICKING!

Donald Trump had set the tone during the presidential election campaign. However, it is in panic that the European Union (EU) is trying to react to the threats of customs tariffs and the American geostrategic shift. After announcing a revision of its most contested directives adopted under Ursula von der Leyen's first term as President of the Commission, the EU seems to want to unravel part of its programs on the energy transition, for the benefit of a significant strengthening of its military defense capabilities; priorities seem to have changed in the emergency. The markets are taking note of the trade tensions between the United States and the rest of the world. On the stock market, AI ecosystem stocks are being badly battered.

EUROPEAN UNION FORCED TO ACT – A BIT OF GEOPOLITICS

In recent weeks, Europeans have been shaken to an extent that remains unprecedented in the history of international relations between Western democracies (speech by US Vice President JD Vance at the Munich Security Conference, clear threats to increase customs duties by 25%, cessation of military support for Ukraine and repayment of aid granted by the United States in exchange for access to its rare earths, clearly displayed contempt for EU institutions, etc.). **Donald Trump will have finally achieved what the repeated crises of recent years had failed to trigger: the awakening of Europe** through two sets of initiatives, the first of which had been highly anticipated since the publication of the Draghi report. On the one hand, there are **five omnibus laws on competitiveness** - the first presented at the end of February called *the Clean Industrial Act* - which are based above all on work to simplify standards (eg limiting the scope of application of the CSRD and CS3D directives) and on a more proactive energy policy, and on the other hand, a **security/defense component which sanctions the United States' desire to turn away from European issues** and make peace in Ukraine on the back of the Old Continent. As far as competitiveness is concerned, much remains to be done, as we explained in our previous monthly letter. For defense, the efforts required are enormous and raise the question of the priorities of community policies between the fight against global warming, support for the competitiveness of sectors in difficulty (automobile, steel, chemicals, etc.) and increases in military budgets. **The financial markets have chosen: the sharp rise in European defense stocks and tensions on interest rates reflect hopes for a radical change of direction in Europe.**

We nevertheless recall that during Ursula von der Leyen's first term as President of the Commission (2019-2024), the adoption of the *Green Deal* and the recovery plan called *NextGenerationEU* had largely contributed to fueling a valuation bubble in the renewable energy sector and hydrogen, a bubble that has since crashed against the wall of the realities of the 2021-2022 energy crisis (the case of hydrogen is the most symbolic). Are European defense stocks destined to suffer the same fate, after having experienced exceptional stock market performance in recent weeks? The question may seem absurd given the desire displayed by European governments to boost military spending - hundreds of billions of euros are mentioned - in order to give credibility to their foreign policy and regain a certain strategic autonomy with regard to the United States. The management of the economic crisis linked to the pandemic (issuance of a common debt) and the treatment of the energy crisis (undeniable success in replacing Russian gas imports) have convinced the markets of the Europeans' ability to react quickly and effectively in periods of chaos. In the present case, namely the redefinition of international relations, one can nevertheless be surprised that Europe has remained so inactive in the weeks following Donald Trump's victory in the presidential election of 5 November 2024. The political crises in France and Germany as well as the transition period before the entry into the race of the new European Commission partly explain this lethargy. However, Donald Trump's first term (2017-2021), his positions on the war in Ukraine, his electoral programme and his speeches left no room for doubt: Western Europe should assume an ever greater share of its own defence and no longer rely solely on the umbrella offered by NATO. One can legitimately think that the EU has waited too long while the new American administration today confirms the strategic shift of the United States: their only adversary remains China, the other countries, even those considered friends or allies, are at best only partners with whom Uncle Sam signs transactions.

Do the EU and the United Kingdom have the human, financial and industrial resources to match their military ambitions? Are we heading towards a necessary entry into a "war economy", a term widely overused by political leaders more focused on communication than action, such as Emmanuel Macron in June 2022, and more recently his

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Minister of the Economy, Éric Lombard? **Will this new shock, this time geopolitical, further strengthen the interventionism of the State in the economy, which takes advantage of each crisis (*subprime* , sovereign debt, global warming, pandemic, energy crisis, etc.) to strengthen its hold on society via a deluge of standards and regulations?** The conclusions of the Draghi report on the competitiveness of the Union, however, have as a corollary the necessary reduction of the nuisance power of the centralizing State in the economy, of a reduction in its scope of intervention in the face of the irrefutable need of the private sphere for more oxygen, freedom, tranquility, space, etc., a policy that the American Administration aims precisely to deploy across the Atlantic, with major deregulation and tax cuts financed by increases in customs tariffs.

The geostrategic problem that arises is the following. Since the end of the Cold War, Europeans have always used the defence sector as a variable for budgetary adjustment - most often in favour of social policies - taking advantage of the security offered by NATO. The abandonment of any desire for power has been synonymous with the end of military service, a considerable reduction in investment in equipment, a drop in the production of ammunition stocks, a clear loss of military culture among the elites and new generations who have not experienced wars on the Old Continent. **Going back is a challenge that would inevitably call into question the purpose and therefore the very organisation of the Union** (built above all as a vast single market). A common defence and shared purchases of equipment would require more common debt issues, a revision of European budgetary rules - removing the defence sector from the calculation of deficits - and probably more federalism, since defence is not a reserved area of the Union. This would be a real cultural revolution, given that each of the twenty-seven EU member states expresses very different sensitivities in matters of foreign policy - to say the least (difficulties in conceiving of a common position with regard to Turkey, China, Russia, etc.).

The sinews of war remain money. However, we can doubt the ability of the EU and its member states to simultaneously keep several irons in the fire that require considerable financial resources. The Draghi report estimated the annual needs for public and private investment at €750-800 billion per year (5% of EU GDP) to catch up on the competitiveness gap accumulated for at least a decade, and thus strengthen potential economic growth. In the absence of a real EU budget, the latest recovery plan presented as exceptional in its size and format - issuing common debt - was for €750 billion spread over several years. Due to a lack of projects and human skills, it must be stressed that the funds are far from having been fully used. As an aggravating circumstance, the financing was to be based on new resources specific to the Union through a CO_2 border tax mechanism. Since the mercantilist countries, led by Germany, ultimately opposed it, the carbon adjustment mechanism will only affect imports of basic products (steel, cement, fertilizers, aluminum, etc.) from 2026, and not semi-finished and finished imported products - nonsense. The funds obtained will thus be largely insufficient to reimburse the aid programs to the States that will therefore ultimately be called upon to contribute! **Investments in the ecological transition require immense needs, underestimated by European governments** - the case of the considerable delay taken by Germany in the complete overhaul of its electricity network, regularly on the verge of collapse, is a textbook case. **Finally, the demographic aging of the Old Continent has become unmanageable in countries that have not taken into account the age pyramid in the deployment of their social policies** - this is the origin of the political blockage in France. **In short, Europe will have to choose: either save the planet or protect its borders by reviving a defense industry that is not part of the sectors favored by the European taxonomy that aims to attract capital flows to the greenest activities** - strategic autonomy prohibits favoring the purchase of American equipment. **Progressive circles will have to eat their hats!** When they are in power - their influence is still decisive, as shown by the already criticized content of the first omnibus law - they will not fail to slow down the efforts of Europeans to conquer their strategic autonomy. **In terms of figures, the military spending of the twenty-seven amounts to 326 billion euros in 2024, up 30% since 2021 (at current prices), or less than 2% of the Union's GDP** , compared to around 850 billion dollars on the American side, or nearly 3% of GDP. In other words, **reaching 3% of European GDP** - a symbolic objective that must be considered a minimum - **requires a little less than 200 billion euros per year of additional spending.** And these amounts will remain far from a so-called "war economy"! At the end of the Cold War, in 1986, the United States was still spending 6% of its GDP on defense; the peak was reached during the Korean War, at 14% in 1953.

The only good news: Russian military spending will barely reach 130 billion euros in 2025 (more than 6% of GDP). The size of the Union's economy remains an obvious asset for financing its strategic shift.

The lack of foresight of European governments over the past twenty years could be laughable if it did not reflect an obvious influence of ideology in the management of public affairs. Some will say that the new European Commission has become aware of it late; others that it is, on the contrary, under the influence of industrial pressure groups, which are not very keen on defending ecology. What is happening before the eyes of investors is in any case historic. In the long term, this crisis will result in two opposing eventualities: either a more integrated Europe, whose institutions will be redefined, with a federal budget worthy of the name that will require a union of capital markets and greater fiscal integration, or the hypothesis of an existential threat if the Member States prove incapable of agreeing quickly on the essentials. The rise in European stock market indices seems to indicate investors' preference.

US INDICES BREATHE , EUROPE CROWS

While European indices are taking full advantage of the hope of a revival of the Union (results of the German elections, compass for competitiveness), American markets are marking time. The main stock market indices whose members are weighted by their market capitalization are clearly suffering from the declining performance of the "Magnificent Seven" (technology leaders Alphabet, Amazon.com, Apple, Nvidia, Meta Platforms, Microsoft, Tesla), penalized by **questions about the profitability of investments in generative artificial intelligence (AI)** , particularly since the announcements concerning the Chinese startup DeepSeek (read our monthly letter of February). Since their peak last December, the index of these seven icons of the American stock market is down by around 15 **%. In reality, the entire AI ecosystem**

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has been suffering on the stock market for several weeks: semiconductors, data center equipment, and energy producers are subject to sometimes severe profit-taking given the high visibility in certain segments. The intensification of trade tensions and weak American consumer confidence are also contributing to the weakening of American indices, which is accompanied by a drop in Treasury bond yields (10-year rates at their lowest in four months).

This breath of fresh air from Wall Street is obviously welcome given the high cost of American stocks in general, and more particularly in technology sectors. Above all, it confirms the urgent need to better diversify investment portfolios outside of indices that are too concentrated, because they are built on the basis of market capitalizations. We note that the main equally weighted American stock market index (each component has an identical weight independent of its market capitalization) has tended to outperform in recent months. **This distrust of generative AI ultimately benefits Europe, whose indices are less exposed to technology sectors.** International managers are arbitrating in favor of lower-valued European assets, which is benefiting the banking sector in particular, which has risen 25% since the beginning of the year.

CONCLUSION

The awareness of Europeans of the need for a wake-up call is undeniable, but much more will be needed to correct the lost decade and ensure that the Union is respected on the world stage. The better performance of European stock markets since the beginning of the year, in an economic climate that nevertheless remains generally gloomy, reflects both the hopes raised by Europe's revival and the high cost of American indices. **Nevertheless, investors will no longer be able to be satisfied with a catalogue of good intentions and tolerate the imperfect execution on the ground of the ambitious public policies decided at the top. The shaky and ultimately disappointing management of the** *NextGenerationEU* recovery programme is an example that should not be repeated.

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