Crises catalyse change

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The Trump trade wars are now in full swing, it seems. Steep US import tariffs took effect on goods from Canada, Mexico and China, though some of it was paused again. The uncertainty remains. The European Union (EU) is likely to be next, especially since US President Donald Trump seems to believe that the EU was created to rip off the US. In fact, the EU and its predecessors were created with US support both to prevent a repeat of the catastrophic wars of the first half of the 20th century, and to be a bulwark against Soviet expansion.

Today, Europe runs a large goods trade surplus with the US, meaning that it exports more than it imports, particularly cars, machinery, pharmaceuticals and chemicals. This is like a red flag to a bull for Trump. But it misses half the story. Europe imports more services from the US than it exports to it (think consulting, financial services and software). European investors have also poured money into US markets, meaning that the US 'exports' financial assets to Europe. Trump, however, only seems to care about goods deficits, partly because his typical supporter is more likely to be a blue-collar worker in a factory than a white-collar worker in a multinational bank.

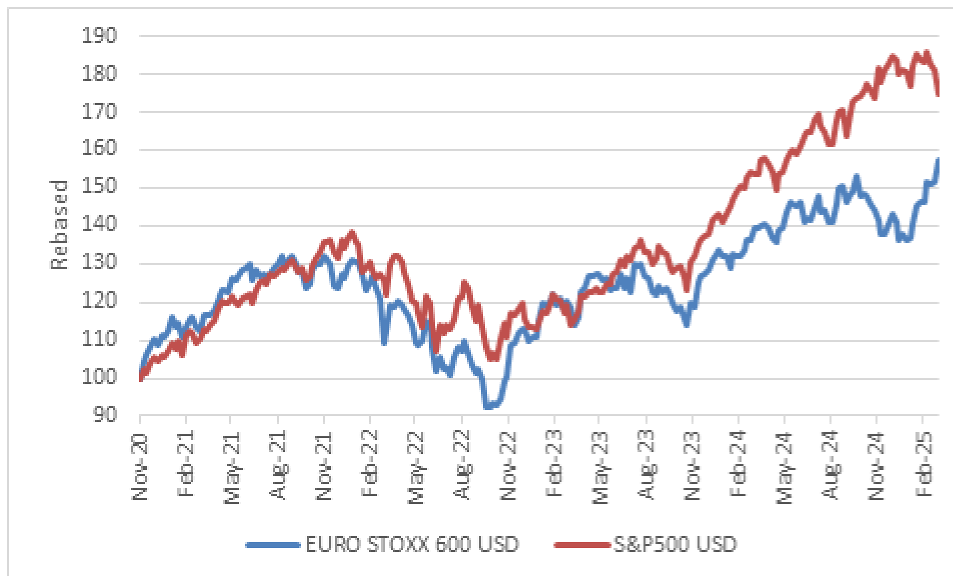
US tariffs on European goods will hurt the latter's economy at a time when growth has been tepid. The US is its largest external trading partner, though trade between EU countries is around 1.6 larger than trade between the EU and non-EU countries (this is a big lesson for Africa). If Europe retaliates with tariffs of its own, it will disrupt the trading networks that developed and deepened across the Atlantic over the past eight decades, a period when the US and Europe were close allies.

Shock and awe

However, the biggest shock has probably not been on the economics side, but rather in the realm of security. Trump's lukewarm views on NATO point to a shrinking of the American security umbrella that currently stretches over Europe. His apparent siding with Russia over the war in Ukraine jolted European capitals. That Europe should take more responsibility for its own defence is correct. That the US should abandon Europe altogether and in fact seem rather hostile to it while cozying up to Russia instead would be a profound shift in geopolitics. As with many things Trump-related, it remains to be seen what substance is and what is theatre.

The fascinating thing, then, is that European equity markets have been on a tear higher since the start of the year, while the S&P 500 has given up all its post-election gains. More on this below.

Chart 1: European and US equities



Source: LSEG Datastream

Collectively, Europe is a massive economy, only behind the US and China and with a population of more than 500 million mostly affluent people. The problem is that unlike the US and China, it is not unified politically or culturally. It is an economy, but not a country, though even the economic unity lacks in important areas.

Not all European countries belong to the 27-member EU (notably Norway, the UK and Switzerland), while only 19 EU members use the common currency, the euro. Sweden, Denmark and Poland, among others have kept their national currencies. Austria is a member of the EU and the euro area, but not of NATO, while Sweden and Finland only joined NATO in 2024. Turkey is a member of NATO, and its football teams play in UEFA competitions, but it has given up its long-standing goal of joining the EU. It remains a matter of debate whether it is really part of Europe or not. Similarly, Russia straddles two continents, but its economic and political centre of gravity is on the European side. The invasion of Ukraine, however, means it now stands firmly in opposition to the rest of Europe as a menacing threat. Ukraine itself is not an EU member but aspires to be. For this note, therefore we'll use the term "Europe" quite broadly, though clearly there are cases where these distinctions matter. During the European debt crisis of 2010 to 2012, for instance, it mattered greatly which countries used the euro currency and were therefore at risk of a destabilising exit from the euro area.

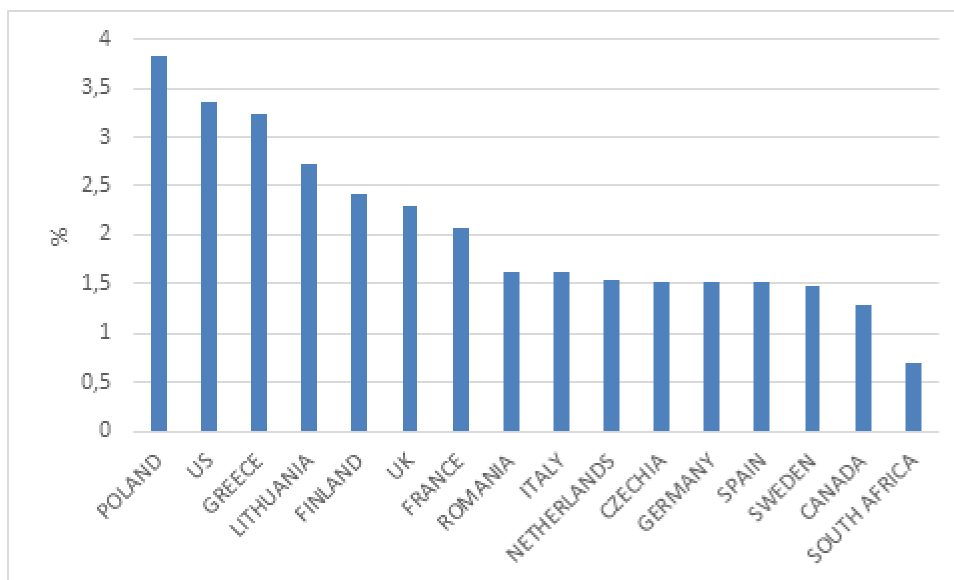
Fragmented

Though there are overarching and shared institutions, in key respects, each European country retains sovereignty and still sets its own agenda. The biggest problem areas are fragmented capital markets and military spending. Though there are pan-European benchmarks, each country has its own stock and bond markets. Some of these are quite small, limiting the pools of capital available for ambitious firms to fund their growth. Many of the few exciting tech start-ups in Europe have opted to list in the US instead, for instance. The lack of a single Europe-wide bond market is also a big problem for the international use of the euro compared to the US, whose massive and liquid bond market makes the dollar attractive for global reserve managers. The market for bonds issued by the EU is growing in the wake of the pandemic response fund, NextGen EU, which will raise up to €712 billion, but that is still small compared to markets of individual countries. Therefore, most investors in euro-denominated bonds are picking up country

specific risks (Germany versus. Greece or Spain versus France, for example) that they might not necessarily want.

On the military side, Europe has plenty of financial and manufacturing muscle, but it doesn't translate into warfighting capability. Again, each country has its own defence force, with independent strategies and preferences for hardware. There is insufficient coordination and standardisation, which means reduced interoperability between weapons systems. Europe should have a much stronger defence force than Russia, with an economy 10 times and population three times larger. However, it doesn't. Russia benefits from scale and each rouble spent on military hardware goes further than the corresponding euro spent in Europe. It also retains its Soviet-era stockpile of nuclear weapons. A strong military is also a national priority in Russia, but not in many European countries. Some, like Poland, do take their defensive capabilities seriously, while others clearly do not spend 2% of GDP on their militaries, the target set by NATO.

Chart 2: Military spending as share of GDP



Source: Stockholm International Peace Research Institute

Individual countries will therefore have to increase military spending to counter the Russian threat and make up for a reduction of US support. The effectiveness of that spending will also have to be improved through greater coordination and standardisation. This will involve putting the collective interest ahead of national interests in some cases. This includes the UK, which of course left the EU, but needs to work together with countries on the continent. Though there has been non-stop squabbling within the EU since its foundation, at crisis moments it has shown a tendency to innovate and move forward collectively. This should be one of those moments.

The weak powerhouse

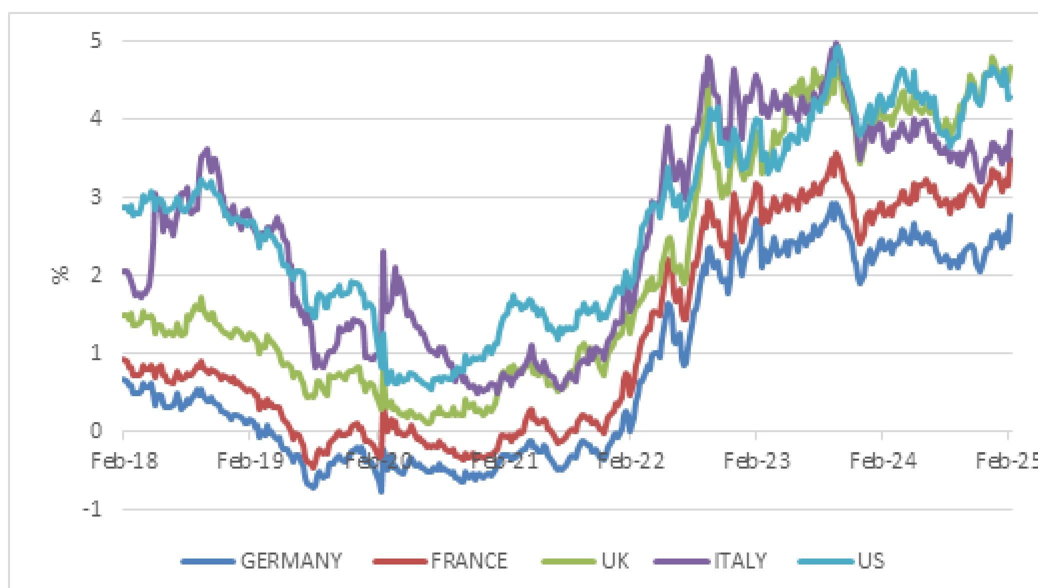
As Europe's biggest economy and industrial powerhouse, Germany should be at the forefront. For obvious historical reasons, there has long been a reluctance to be a military power, but there is also a deep aversion to borrowing, which has in recent years seen large scale underinvestment in public goods like infrastructure. This also has military implications, for instance, since its rail network will struggle to move military equipment around at scale. The anti-debt sentiment went so far that Germany enshrined a constitutional limit on government borrowing in 2009.

This sounds prudent, but there are times when the government must borrow and spend. In deep recessions, the government can borrow at low interest rates and stimulate the economy in the face of a retreating private sector. Governments can also take a longer-term view than the private sector, particularly when it comes to investing in infrastructure and other public goods. Both cases are applicable to Germany, who's economy needs a short-term boost – it has barely grown since the 2020 pandemic – while investment can support long-term growth. Instead, Germany is one of the few countries that reduced its government debt ratio over the past decade.

The excitement was therefore enormous when the country's traditional ruling parties agreed to exempt military spending above 1% of GDP from the constitutional 'debt brake' and to launch a €500 billon infrastructure fund. This could add up to almost a trillion euros over the next decade, or a fifth of current GDP. Borrowing on this scale would have been inconceivable even a few weeks ago but is now necessitated by the Trump shock. Even then, Germany's government debt ratio would only rise from 62% today to around 80%, near the level it peaked at in 2009. It would still be by far the lowest among G7 countries. This stands in contrast to the US debt ratio which jumped from 60% in 2010 to 100% today and is expected to rise above 120% by 2035. This rapid increase in government borrowing partly explains why the US economy grew so much faster than Europe over the past decade or so.

News of the planned borrowing – it must still be approved by the outgoing parliament – predictably rocked the bond market, with German yields jumping the most in one day in over three decades (bond yields and prices move in opposite directions). Germany could have borrowed this money at low to negative interest rates not that long ago. It must now pay considerably more, though still not as much as the US or UK.

Chart 3: 10-year government bond yields, %



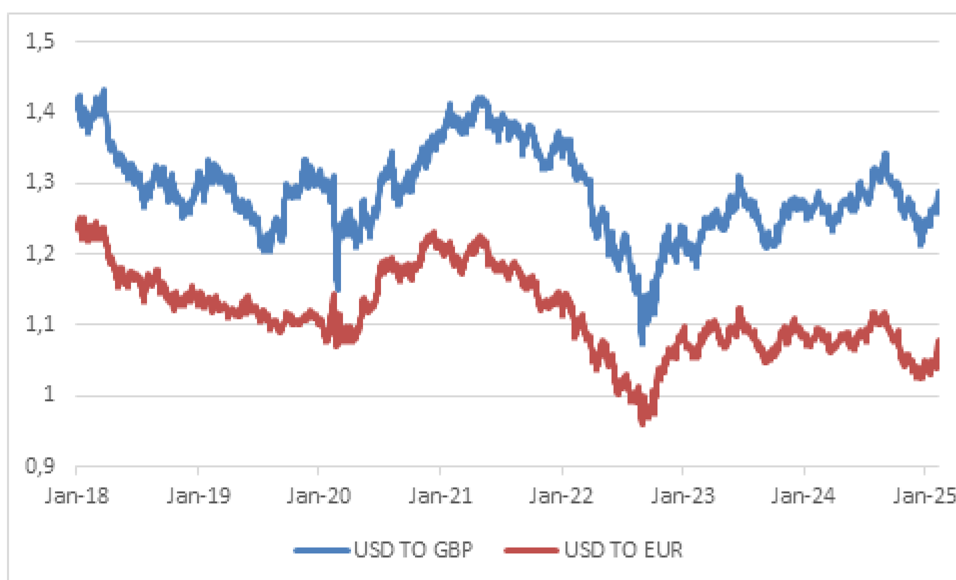
Source: Datastream

For equity markets, the point is not that Europe has structurally low economic growth rates, partly due to demographic headwinds, a constrained regulatory environment and the fragmentation described above. That was priced in long ago.

What was not priced in is the rapid expected increase in defence spending, and the cyclical boost it could deliver. A cease-fire in Ukraine would also benefit the broader European economy, notably through lower energy prices, though the longer-term security concerns would remain. The decline in the oil price in the past few days following OPEC's announced production increase will benefit Europe as a net importer. Lower interest rates – the European Central Bank cut rates last week – also support a cyclical recovery. Europe's economy relies more on bank lending than the US, and so benefits more from falling short-term rates, even if long bond yields are higher. Despite a challenging backdrop, the outlook for European equities, long unloved and attractively priced, has suddenly improved.

There have been false starts in the relative performance of US and European equities over the past decade, a period in which the US stocks beat Europe by 6% per year in common currency. This might be another head fake, but the ingredients for a more sustained rotation are in place, considering how elevated US valuations are, the deterioration of the US economic outlook and the fact that the euro has room to rebound against a very strong dollar (the weak euro depressed returns from European equities when translated back into dollars). Though the broader UK equity market has not bounced to the same extent as continental equities, it can also benefit from stretched valuations relative to the US and a currency that can rebound from relatively weak levels.

Chart 4: Euro and pound vs the US dollar



Source: LSEG Datastream

We are in the midst of significant geopolitical and economic shifts. Where all this is headed is unknown, so be sceptical of anyone who speaks with confidence about what the end game is. There are two key lessons from the extraordinary events of the past two weeks in Europe that are applicable to South African investors. Firstly, in the realm of politics (as in life) it usually takes a real crisis to effect serious change. Despite being a rich and sophisticated society, Germany made spectacularly poor strategic choices over the past 15 years. Things had to get really scary for its leadership to change course. They might still get this wrong, but the incentives for getting it right have increased substantially. Secondly, when it comes to markets, change can happen quickly and unexpectedly. People often look at undervalued investments and ask what the catalyst will be for a value unlock. These catalysts are usually impossible to predict. Often, it is

not even about the news being good. The news must just not be as bad as was priced in. But to benefit, you need to be invested.