Europe's year of two halves, while the US walks an inflation tightrope

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- **Europe's H1 margins will be under pressure, but the headwinds should blow through**
- **The US Federal Reserve is hawkish due to the yield curve's bear steepening, while tariffs may front-load growth and inflation**
- **European and US policy could move in opposite directions. Low European valuations could mean outperformance, despite low short-term growth, trade fears and falling margins. It could be time to buy**

The US

At the start of 2023 and 2024, expectations for US real GDP growth were 0.3% and 1.3% respectively. The stock market went on to boom as expectations were revised upwards. 2025 is the first time since 2022 that expected US growth is more than 2%. Few consider a recession possible.

Bank deposits have returned to pre-pandemic levels. Money market funds have grown but are typically held by the very rich, so households will have to cut spending if deposits are not to fall further. Money market funds as a percentage of the S&P 500 market capitalisation are the lowest since 2000: liquidity may be high in absolute terms, but not relative to the stock market.

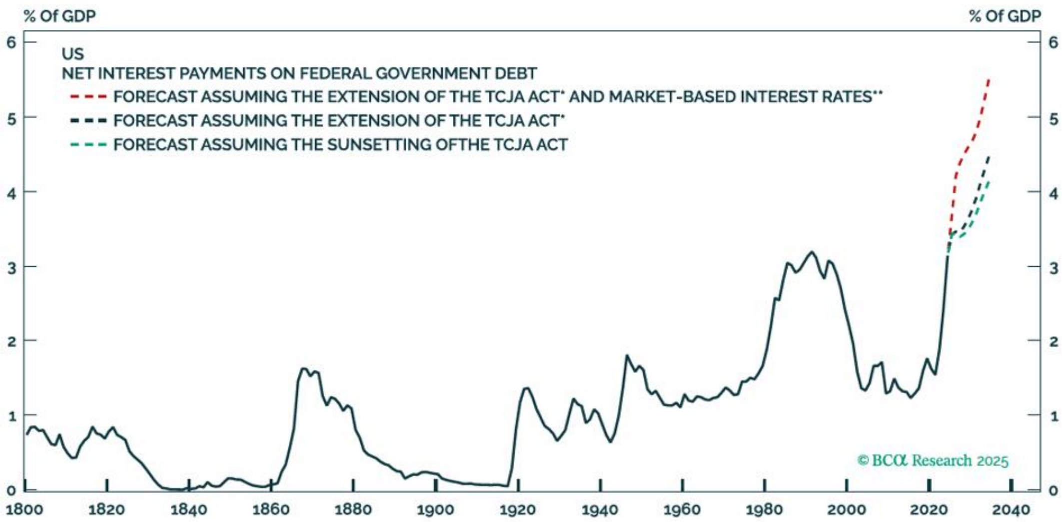
Despite near-full employment, credit card and auto loan delinquencies are the highest since 2011 when unemployment was double the current rate. Consumer credit is falling. Despite strong December payrolls, the job finding rate continues to fall; the number of unemployed who have lost a permanent job is up 50% from before the pandemic and the median length of unemployment has risen to 11 weeks.

Meanwhile, the housing market is soft because mortgage rates are around 7%. Housing units under construction fell 15% in 2024, while the inventory of completed properties is 55% above the pre-pandemic level. Housing completions now outpace starts and demand is weak. The share prices of US housebuilders are crashing.

This works against the Federal Reserve's aim to reduce inflation, and President Trump's aim to lower the dollar. US CPI and PPI were high in December, but shelter costs – the most persistent source of inflation – have fallen. The Fed's preferred measures of inflation, PCE (personal consumption expenditures) and core PCE, are below expectations. Inflation is falling. However, markets expect just 50bps of rate cuts in 2025, while the 30-year yield rose 75bps during 2024 and one-year yields fell 63bps – a bear steepening. Since 1960 this has only occurred four times, always accompanying severe financial shocks.

In response to the bear steepening, the Fed turned hawkish in December, so is on a collision course with Trump. Term premiums have risen and the market is signalling that the economy can withstand higher long-term rates – "US exceptionalism" might explain this (the US can take higher rates while China and Europe cannot). With employment near-full, Trump is planning tax cuts, so investors will demand a price for inflation risk. However, the Treasury issued $4.5 trillion of debt in 2024 as the Fed shrunk its balance sheet, adding to supply for investors to digest. The government deficit is now 7% and the cost of this debt has risen from 1.3% of GDP in 2016 to more than 3% (Figure 1). If Trump extends expiring tax cuts from his first term, interest payments will rise to 6% of GDP within 10 years, soaking up a third of government revenue.

Figure 1: Debt burden set to increase dramatically with tax cuts



Source: US Congressional Budget Office/Office of Management and Budget/IMF/Bloomberg, January 2025

Before his inauguration Trump pushed to remove the 2025 debt ceiling to enable additional tax cuts, but 38 Republican congressmen voted against this. So, the debt ceiling remains in place and the government remains funded. Increasing the deficit would fuel inflation, and an inflation/fiscal crisis will not help House Republicans get re-elected in 2026. When Trump was elected in 2016, bond yields were 1.5%; now they are 4.5%.

A further problem is the strength of the dollar. It has risen because of US exceptionalism and expected tariffs. Yet this runs counter to Trump's aim to make US manufacturing competitive – ironically, euphoria about US growth makes it less likely to happen. Surging long-term yields will offset any cuts to short-term rates. It will also make tax cuts less likely by increasing the cost of debt servicing. So, US rates need to fall. However, this is not a given, so high expectations of US growth are less likely – the opposite of 2023 and 2024 when growth accelerated, and the equity market delivered more than 20% each year amid low expectations.

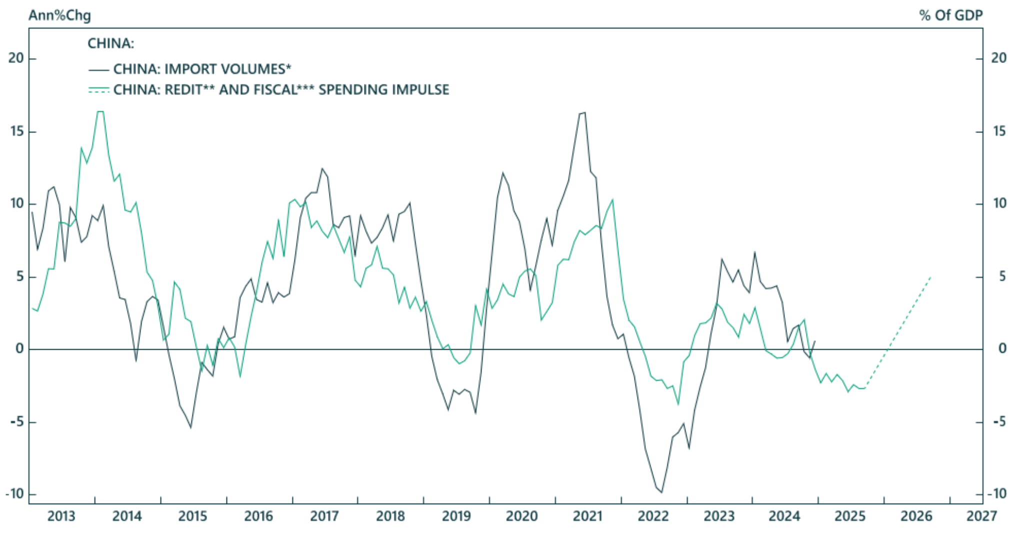
Harsh tariffs early in the administration will front-load growth and inflation, bringing a painful inventory adjustment. Governments have been ejected all over the world because of inflation, so Trump cannot afford this. If inflation runs above target, only an undershoot will reset expectations. Since inflation below 2% is unlikely, expectations will rise.

The Bank of Japan tried for years to get inflation to 2% and failed – but it may get there now, ending its zero interest-rate policy (ZIRP). This might not seem important, but Japan has been a big source of the world's liquidity, as the Japanese hunted overseas for decent cash returns, impacting the valuations of other asset classes. US tech's earnings yield (valuation) detached itself from the home market real bond yield in 2022 to attach itself to the negative equivalent in Japan. Then in August 2024 as the yen rose, US tech fell. If Japan does indeed end ZIRP, real yield rises will cut liquidity and hit US tech valuations.

Europe

The European economy will not recover in H1 2025 due to weakness in China. Despite the Chinese government loosening fiscal and monetary taps, China's fiscal and credit impulse is contracting at 2.5% of GDP. This means imports will fall, hitting Europe. Even if China is successfully stimulated, Europe would not enjoy the benefits until later, though stocks would respond (Figure 2).

Figure 2: Don't expect a positive 'China effect' until late 2025



Source: BCA Research, 2025. *Shown as six-month moving average, China Customs. ** Cumulative aggregate financing excluding equity financing and local government bonds issuance, including LGFV swap 2015-18. ***General (central and local) government, government-managed funds spending and special infrastructure fund 2015-17.

European fiscal policy remains tight: the European Commission estimates there was a contraction of 0.5% in 2024. The drag will not be as bad this year, but it will hinder growth in H1. Bankruptcies are at record levels in France and rising in Germany and Holland. The German Ifo business climate index has fallen to Covid/global financial crisis levels. In addition, capital expenditure intentions are falling, consistent with GDP weakness, and worsened by tariff anxiety. European employment is also deteriorating, so the local consumer will not offset weakness from China. The employment component of the Composite PMI is below 50 and falling, and wage growth is slowing. This means real wage growth could evaporate by year-end, leading to reduced consumer spending and contracting GDP. However, consumer balance sheets are strong: private sector debt fell from 180% of GDP in 2021 to 154% by the end of 2024. Unlike during the Eurozone crisis, bank balance sheets are strong, giving no reason to shrink credit to households.

H2 should be more positive. Falling capacity utilisation and weakening price pressures mean the European Central Bank will be able to cut rates to 1%-1.5%. With strong private sector balance sheets and rate cuts to come, cutting below the neutral rate of inflation will stimulate demand and weaken the euro. Because Europe’s exports and manufacturing represent almost double the equivalent gross value added and employment than they do in the US, a trade war damages Europe more than the US. The euro usually weakens during phases like this, as it did during Trump’s first term (Figure 3). Flows into the US and a rising dollar raise the cost of capital, tightening global financial conditions.

Figure 3: Europe abhors uncertainty

Source: BCA Research/Baker Bloom and Davis, 2024

Once the headwinds abate, the outlook for European equities will improve. Europe has suffered poor profits and productivity, austerity, deleveraging, an energy shock and policy uncertainty. Whereas US borrowing cannot continue, in Europe bank deleveraging is over. There will be a gas glut in Europe because of spending on liquefied natural gas (LNG) import facilities. Policy could eventually move in opposite directions in the US and Europe; given low European equity valuations this could lead to outperformance. But first we have to get through low nominal growth, trade war fears and falling margins pressurising earnings – which could be a buying opportunity.

European equities have lagged the US by 280% since 2007. The region's problems are well-known: low productivity, low investment, lack of innovation and high energy prices. This has hurt profits, depressed capital expenditure and broken Germany's business model (cheap Russian energy fuelling exports to China). And despite the EU, Europe is still fragmented. The IMF estimates that non-tariff barriers across the EU are equivalent to a 44% tax on goods; the equivalent intra-state figure in the US is 15%. For services the cost is worse: 110%. So European companies struggle to find the economies of scale for capital expenditure and R&D. They are more dependent on bank finance than in the US where capital markets are deeper – 70% versus 26%. European banks are also more risk-averse, so Europe has a higher risk premium. In the run up to the global financial crisis, European equities outperformed the US by 60% (Figure 4). But the threat of a trade war is depressing European assets, so it is hard to imagine capital expenditure or R&D picking up. This is the harsh medicine Europe needs to simplify regulation, reduce market fragmentation and get closer to a capital markets union. A glut of LNG, replacing Europe's piped gas supply, will lower energy prices and release profits for reinvestment.

Figure 4: Back when Europe outperformed massively despite weaker productivity

Source: MSCI/BCA Research, 2025

In addition, China has become a major competitor for Europe, not just an export market. A decade ago, China's chemical exports were 15% those of Germany, now they are 40%. China became the world's largest car exporter in 2020; despite tariffs, China's electric vehicles cost 30% less than Europe's and have better software.

UK

In the UK, service sector inflation has been stubbornly at 3.9% while wage growth remains high. Falling job vacancies and inflation expectations mean wage growth will slow, which suggests the Bank of England will cut rates more than expected. Core inflation has overshot because of rents, but that seems to be moderating – private market rent growth has slowed from 11% to 2.2% in November 2024. The UK, which is not growing, has higher interest rates than the US where there is almost full employment. UK rates will fall a lot from here.

Conclusion

Sentiment has been bullish, with analysts expecting double-digit US earnings growth for 2025 and a 100bps expansion in record US margins. Going into 2024, Bloomberg estimated that half of all analysts expected a recession; now, almost no one does. GDP growth expectations were modest going into 2024, yet the economy grew almost 2.4%. Now expectations for growth in 2025 are running at more than 2%, which is open to disappointment. Earnings expectations are demanding. The US equity market valuation is out of kilter with real yields. Europe needs to weather the headwinds – low nominal growth, trade war fears and falling margins pressurising earnings – but the outlook for H2 and beyond is improving. This could present a buying opportunity In Europe and lead to renewed outperformance.

Unless specified, all data is Bloomberg, as at January 2025

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