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European equities: resilience amid global trade tariff turmoil

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- **US consumers and businesses are feeling the pressure from higher rates and tariffs, but core economic activity continues – data shows mixed signals not outright contraction**
- **While tariffs add friction to trade, they have prompted realignment and policy responses, creating near-term headwinds and longer-term opportunities**
- **In Europe, deeper integration, more focus on competitiveness and reduced internal trade barriers may make for stronger long-run equity performance**

The US

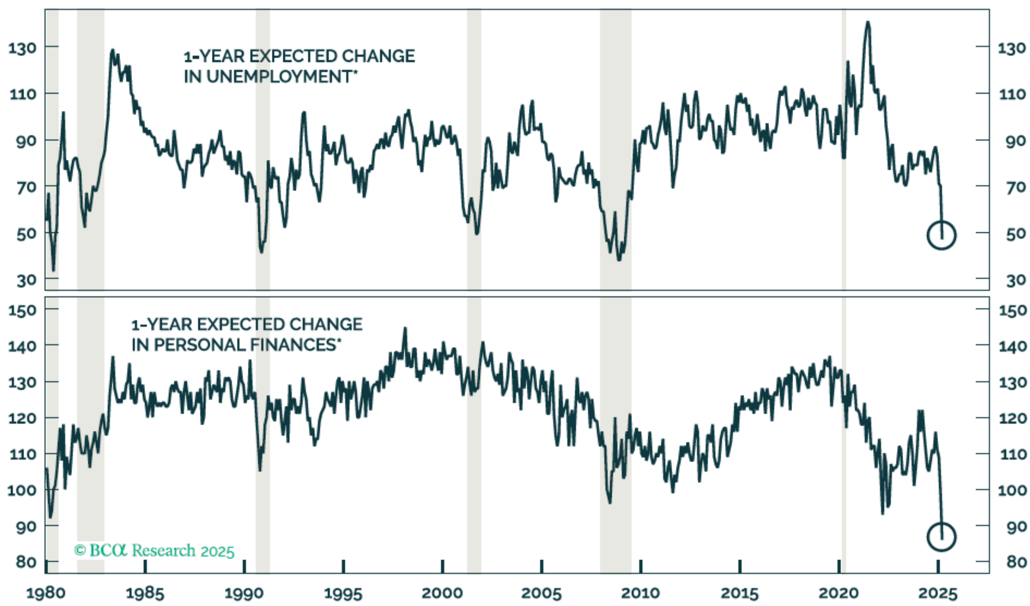
At the beginning of 2025 we were "all in" for markets. But the bond market bear steepening was a dangerous signal. The meaning became clear: the dollar, which typically benefits from disruptions to global trade, has fallen and the US equity market, usually more insulated from trade shocks than Europe, has underperformed. US tech stocks, which sell services not goods, so less at risk from tariffs, have been the worst. While President Trump's trade policies were the catalyst for the sell-off, the reason for the market moves were trends playing out before: valuation differences, divergent monetary and fiscal policy, a US slowdown and the cracking artificial intelligence (AI) narrative.

Valuation divergences are different compared with Trump's 2018 trade war. Following his 2024 election victory, expectations for US growth surged, and declined for the rest of the world. This drove US asset prices to new highs, thus vulnerable to disappointment. Deficit spending, which had given US assets a tailwind, is now reducing. Germany has now grasped that nettle and will increase its own deficit spending, giving Europe the advantage. The same is true for monetary policy: the European Central Bank cut rates by 200bps and can do more, while the US Federal

Reserve (Fed) is constrained by inflation, which has been pushed upwards by tariffs. It would take a major financial accident or recession to force Fed action.

Until now, US consumers were shielded from rate rises by savings accumulated during the pandemic, delaying a slowdown from 2023 until this year. However, bank deposits as a share of disposable income are back to pre-pandemic levels. For those on lower incomes, they are below where they were in 2019. Households are borrowing but find themselves in financial difficulty: 10 million Americans have overdue payments on student loans, after the five-year moratorium ended last September, while delinquency on credit cards and auto loans is at 2011 levels – when unemployment was double what it is today. Banks are tightening lending standards and raising rates on credit cards to record levels. Consumers are squeezed (Figure 1).

Figure 1: US consumers appear to be thoroughly rattled



Source: University of Michigan/BCA Research, 2025. Shading denotes National Bureau of Economic Research-designated recessions.

Even before tariffs, consumer spending was softening, with credit card and auto loan delinquencies at 14-year highs. CPI swap pricing shows inflation up to 3.5% by March, so household income will fall. Payrolls may have been strong in March, but they usually grow until a recession starts, and trade uncertainty will slow payroll growth. Job openings were 4.5% in February. Fed governor Waller said a further decline would boost unemployment. Openings posted by the largest employers fell in March and April.

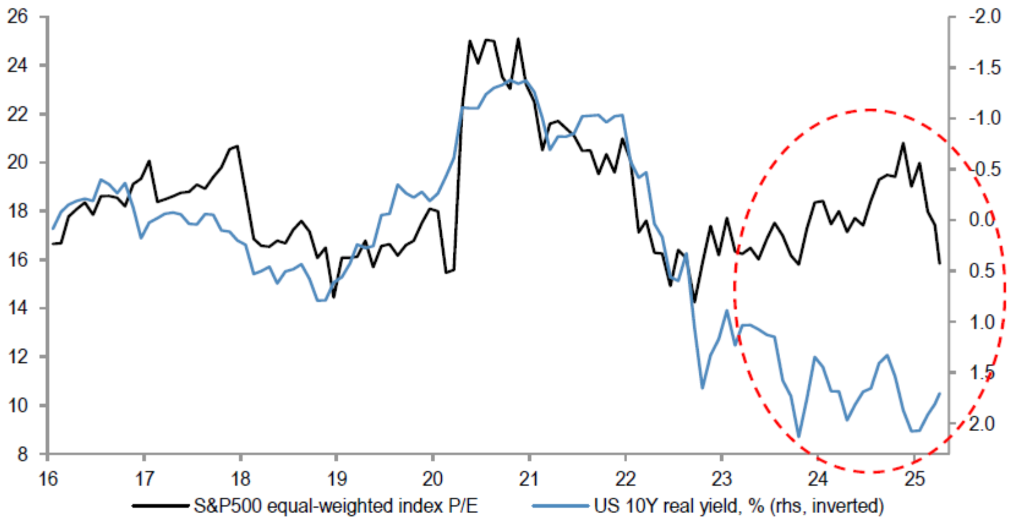
Although lower tariffs have been agreed between the US and China, albeit just for 90 days, the blanket 10% rate lifts tariffs to their highest since the 1930s. Business uncertainty from these trade and tariff policies, together with the weaker consumer sentiment, now make a recession more likely. Preliminary data from the University of Michigan's consumer sentiment survey show one-year forward inflation expectations at 5%, and six- to 10-year expectations at 4%. This is not what the Fed wants to hear. Personal consumption has accounted for 80% of US growth since 2020, and since 2022 US imports have exploded. But in 2024 consumer spending began to slow. The Atlanta Fed's Q1 2025 GDPNow tracker was flat, a trend echoed in consumer sentiment surveys. Tariff uncertainty and the equity sell-off is hardly going to make consumers bullish, reinforcing the stagflation threat.

Trade policies were the catalyst for the equity slump, but uncertainty also creates angst for business heads. The National Federation of Independent Business (NFIB) survey of small businesses shows only 13% plan more capital expenditure, while expenditure plan data from the regional Fed surveys are also slumping. The Citi Economic Surprise Index has been weakening and the Philadelphia Fed survey of new orders has seen its largest ever two-month drop. While the March S&P PMI was robust, expectations for future orders fell to the lowest in two years. Expectations of unemployment have risen and holiday plans are being ditched. Vacancies in offices are at a record high. Commercial property delinquencies are rising for offices and hotels (and apartments) and manufacturing construction has rolled over. The labour market is no longer tight, prime-age employees are being laid off and housing has gone from shortage to glut. New homes for sale have risen to the highest level since 2009, slowing residential investment.

AI was meant to revolutionise productivity, but this was cast into doubt by Chinese rivals to US hegemony, such as DeepSeek. Software investment gave the US an economic moat, but investors question if that will continue with AI, which is much more competitive: no single player can dominate, unlike with US technology after the global financial crisis. This means some capital expenditure will be wasted. Demand for data centres in China is cooling and Microsoft has cut investments.

Bond yields usually fall during recessions, but inflation makes it difficult to ease. Inflation lagged the 2% target from the global financial crisis (GFC) through to the pandemic. Since then CPI has been over target so the Fed is hamstrung. Foreign investors now hold 30% of T-bills but the tariffs make them wary. The budget deficit has been 6%-7% for a few years, despite full employment; it needs to be 3% to stabilise debt-to-GDP. This is unlikely given planned tax cuts, and a recession would only exacerbate the deficit.

Figure 2: S&P 500 equal weighted index P/E versus US real yield



Source: IBES, April 2025

In terms of equities, US valuations are nowhere near the trough. They reached a forward price/earnings of 13.5x at the low-point of the pandemic and less than 9x at the low point of the GFC. US equities are currently on a PE of 20x, which assumes double-digit earnings growth this year (Figure 2). Recessions, which usually shave 20% off US earnings (30% off European earnings) usually start when economies are vulnerable and a shock occurs. A trade war constitutes such a shock: tariffs will raise prices as incomes fall, and inflation will curtail the ability to cut rates. Because of lagged inflation in the past decade, the personal consumption expenditures (PCE) deflator in Trump's first term was 6% below where it should have been had inflation been 2% following the GFC. Inflation now is 1.2% above trend. The Fed cannot let inflation expectations un-anchor. Given that 80% of global trade is in primary, intermediate and capital goods, tariffs will boost input costs and lower profits, raising costs overall. Worries about tariffs have worsened the equity/bond sell-off, tightening financial conditions.

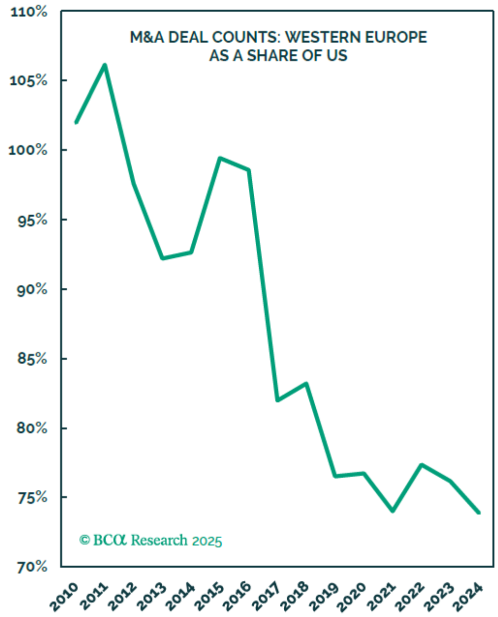
A recession in the US is unlikely to be deep, because private sector imbalances are not what they were during the GFC. They are more serious in the public sector: government debt costs have ballooned since Trump's first term. Reducing the deficit will be difficult politically, and impossible if automatic stabilisers need to counteract a recession. Hiring under the Biden administration, which was three times the usual level, is reversing. Of the 4.5 million jobs created in the past couple of years, 70% were in the public sector, compared with a long-term average of 28%.

The wild card could be a Chinese stimulus. Land sales are weak, so property market problems persist. Housing starts are down 70% from 2021, and only the secondary market shows signs of life. But industrial production, investment and retail sales are stronger this year; buying ahead of US tariffs might explain this. Chinese exports to the US rose 13.6% last year; Los Angeles container volumes were up 17% in H2. US tariffs will hurt, but half of Chinese exports go to other emerging markets. China ran a record trade surplus in 2024 and their share of manufacturing value-added has risen from 10% to 30% over 20 years, so a trade war will hurt. EM equities have underperformed despite a bounce in China.

Europe

Barriers to M&A in Europe have made it difficult for companies to overcome the dominance enjoyed by US peers. In 2010, deals in Europe exceeded those in the US, but today they lag by 25% (Figure 3). This needs to change if European companies are to have scale. Even if US tariffs on European goods have halved from the proposed 20%, at 10% they are nine times what they were at the start of the year. Car exports still suffer a 25% tariff.

Figure 3: M&A activity has decreased in Europe relative to the US



Source: Institute for Mergers, Acquisitions and Alliances / BCA Research, 2025

Penal tariffs on China put Europe's third largest trading partner under pressure, which means Chinese goods destined for the US market get dumped in Europe, bringing deflation – even before financial conditions tightened with a stronger euro, which is 10% up against the dollar since December. During the 2018 trade war, the euro and bond yields fell. Not this time. The European Central Bank (ECB) has scope to cut rates. Only Germany can raise public debt, but in the face of a shock the ECB Transmission Protection Instrument can limit spreads.

The structural case for Europe is improving in the face of the crisis unleashed by Trump. Dealing with it will drive Europe closer together, tackling the competitiveness issue outlined by Mario Draghi last year. Europe needs to integrate to address long-term demographics. An ageing population worsens the ratio of employees to retirees. Immigration is problematic, not just politically – educational achievement and labour force participation, even for second generation immigrants, is lower than for non-immigrants (though the UK scores better).

Conclusion

With Mark Carney elected in Canada, the priority will be for a North American trade deal, delaying a European deal until Q3 when damage will have been done. Chinese dumping in Europe will exacerbate deflation and retaliation by Europe would make it worse. Germany's stimulus will help: recent changes will add 1% to annual growth. But the output gap in Europe is large and the tariff shock will increase it. With deflation coming from China, the ECB could even consider QE.

If the US is now unpredictable, Europe must deepen other trade ties – particularly with the UK and Switzerland. Non-tariff barriers between European countries, equivalent to a 44% tariff on goods and 110% on services, are targets. This will not save Europe short term, but it will make the case for European equities stronger: structural reforms, deeper single market integration and renewed monetary and fiscal support.

If a US recession comes, there is downside. European companies have spent 15 years orienting towards the US, with 30% of their assets now based there. A mild recession would cut European earnings by 20%-30%, and for cyclicals more like 30%-40%. At more than 17%, the US is Europe's largest export destination. Exports are half Europe's GDP versus 11% in the US. And there are 23 million eurozone manufacturing jobs versus only 13 million in the US. So a trade war will hurt.

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

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