
European improvement, not just US weakness

European equities | August 2025



Paul Doyle
Head of Large Cap European Equities

- **US growth has been downgraded and unemployment has risen, though less than in past slowdowns. Labour is tight due to early retirements and less immigration.**
- **The US faces stagflation risk due to labour constraints rather than weak demand.**
- **Europe has exited post-Covid stagflation, with inflation falling and interest rates easing, so economic performance has turned round.**
- **Small caps are outperforming for the first time in years, driven by falling inflation, domestic demand and Germany's €1 trillion stimulus**

The US

Growth expectations for the US at the start of 2025 were too ambitious. Global growth has been downgraded from 3% to 2.7%, but the US was marked down by 0.6 percentage points to 1.5%. This slowdown has not damaged the labour market: unemployment has risen, but by less than in previous slowdowns. Bulls say the US is more service-driven and less cyclical. They also say private sector leverage is well contained and lower than before the global financial crisis, with banks better capitalised and artificial intelligence (AI) transforming the economy.

Although the US consumer propelled the economy in recent years, real personal consumption is now slowing, and the housing market is weaker. Residential investment fell in Q1 2025 and is set to fall further in Q2. Inventories of new homes are the highest since 2009 and house prices are falling in 60% of US counties. Payroll data appears strong but gets revised down. Despite tariffs at 17% – the highest since the 1930s – the trade war has yet to be felt. Except for Japanese cars, retail prices have not risen, suggesting companies have absorbed some tariffs. The rest, however, have been borne by US consumers in higher prices. The New York Federal Reserve found a third of manufacturers and nearly half of service companies have passed on tariff costs and more will be passed on if they are permanent. This will squeeze real incomes.

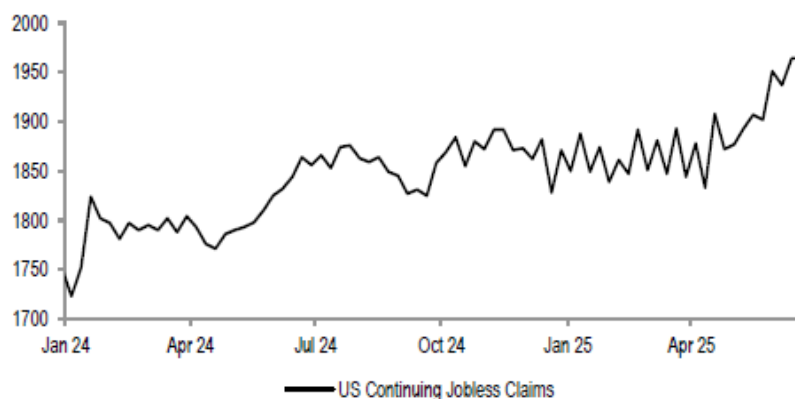
In June, US CPI was 2.7% year-on-year, up from 2.4% in May. The CPI swap market suggests inflation will be 3.4% in a year, driven higher by tariffs. Higher inflation impacts consumer confidence: though retail sales bounced in June, they are 0.5% lower than in December. The bounce in shares since April has eased financial conditions and will boost consumer demand, especially if rates are cut.

The 'One Big Beautiful' bill will increase the US deficit by 0.8% of GDP. That could mitigate the impact of tariffs, assuming the bond market does not revolt. Europe and China are loosening monetary and fiscal policy, which helps.

Although the tariff news has been digested, GDP continues to slow and inflation is expected to rise in H2. Unemployment fell in June, but continuing claims rose to a three-and-a-half-year high (Figure 1). The Conference Board's data on jobs, plentiful versus hard-to-get, has risen. Both correlate with unemployment, suggesting the trend is higher. Outside the public sector, healthcare and social care, payrolls only grew by 15,000 jobs. The payroll diffusion index dipped below 50, indicating more sectors are losing jobs than gaining them, while private sector hours worked are also falling.

Figure 1: A recent high

US continuing claims



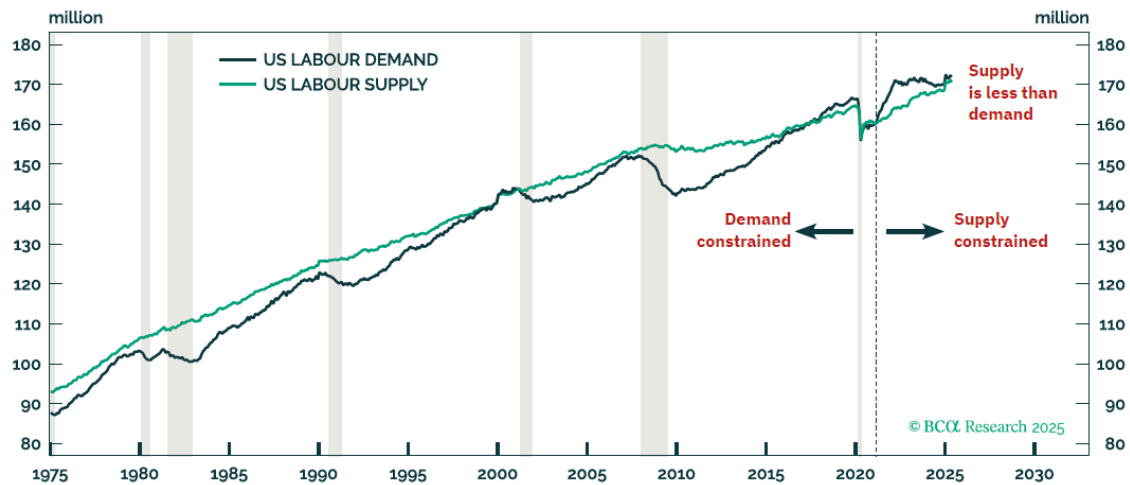
Source: Bloomberg Finance LP, as at July 2025/BCA Research, 2025

Usually when US unemployment rises by 80bps from its low, it signals a recession. This time it has taken two years to get this far, but no recession has arrived. A rise in unemployment accompanied by recession usually has two phases: first companies stop hiring, then they start firing. This time the second phase has not happened: companies are not yet firing, so initial unemployment claims are low. Employers know labour supply is constrained, thanks to the workers retiring early during Covid. Trump's clamp-down on immigration is rescuing the US from unemployment.

The downside is that this scenario can bring sticky inflation – or worse still stagflation – as growth slows while inflation stays at 2.5%-3%. Most economies are demand-constrained rather than supply-constrained, but not the US (Figure 2), which is short of 1.4 million workers. Retiree spending is not much different from that of employees but is funded by savings and pensions rather than wages. So demand remains high while labour supply falls.

Figure 2: The US has become Labour supply-constrained since Covid

US labour demand and supply (millions)



Source: US Bureau of Labor Statistics/BCA Research, 2025. Labour supply is the labour force, labour demand is jobs plus job openings plus unemployed on furlough. Shaded areas denote National Bureau of Economic Research-defined recessions.

Until recently the gap in labour supply was filled by immigrants and productivity growth. Now the US has cut illegal immigrants to zero and started to deport them, this could lead to a supply-driven recession. For that to happen, labour supply would need to shrink by more than productivity growth, which is 1.5%. As the US labour market is 170 million strong, this would equate to 2 million workers, or 200,000 a month. They will not deport on that scale, but falling participation rates or further retirements could induce this. A labour supply-economy will be inflationary or stagflationary.

It is right for the Fed to cut rates if the economy is slowing due to falling demand, since lower rates bolster demand. But lower rates are not the right medicine if the slowdown is due to stagnant supply in a supply-constrained economy. This is because rate cuts would stoke inflation without boosting supply. So rates and bond yields cannot fall much in the US.

Europe

Europe has benefited from front-running tariffs, and an increased trade surplus with the US. That tailwind is turning into a headwind, however, with German exports to the US plunging. Profit warnings from European companies have started due to the 15% appreciation of the euro against the dollar. This began during Q1 as investors revised growth expectations before the German election. The CDU/CSU election victory brought a €1 trillion stimulus coinciding with concerns about the US balance of payments and aggression on trade, which called into question foreigners' willingness to finance the US current account deficit.

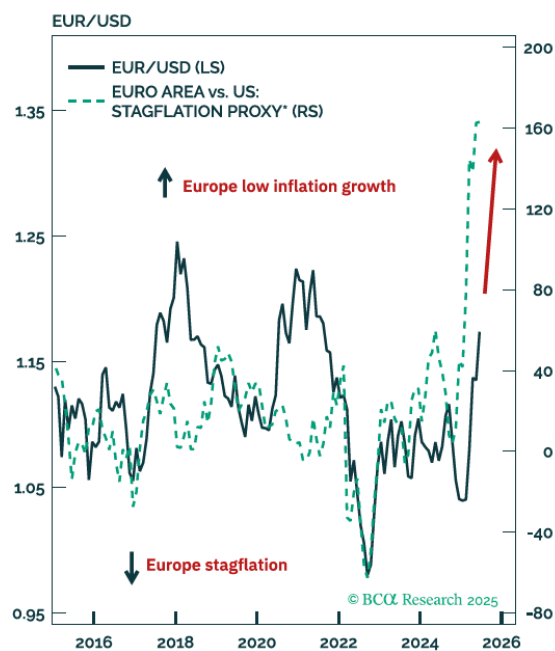
The direction of travel for the euro/US dollar is up. While the US runs a 4.6% current account deficit, the eurozone runs a 2.3% surplus. This gap was not a problem for the dollar while foreigners piled into the US. The US deficit has been the mirror image of the capital account surplus, which pushed up the dollar and funded domestic demand, worsening the deficit. The capital account surplus is under threat as investors find other homes for their money, which will push down the dollar.

US liabilities to foreigners exceed US foreign assets, and funding this requires capital inflows. Europe's net international investment moved from -27% at the start of the eurozone crisis to +8% at the end of 2024. Policy uncertainty in the US will raise volatility and risk premia, which is now happening in Europe. European capital markets are second only to the US for their depth, so a weaker US dollar boosts the euro.

But this is not just about dollar weakness: it is about European improvement. Europe has finally exited post-pandemic stagflation: inflation is falling, as are interest rates, leading to a turnaround in economic performance. Europe can deal with 15% tariffs with the US – if they stick.

Figure 3: Favourable economic regime shift

Euro vs US dollar and stagflation proxy



Source: BCA Research, July 2025. *Difference between ZEW survey growth and inflation expectations

Europe was badly hit by the energy crisis at the start of the Ukraine war, which hurt economic growth, productivity and corporate earnings. Lost Russian gas led to investment in regasification infrastructure, now on stream. This means energy and electricity prices will fall, boosting capital expenditure, increasing corporate margins and alleviating Europe's energy cost disadvantage versus the US. Germany's move away from austerity will also help, further bolstered if the European Commission commits to eurozone defence spending (NATO countries in Europe have agreed to spend 5% of GDP on defence from 2035, up from 2%).

Austerity in Europe crushed demand, asset turnover and returns on capital. This is one reason why productivity has been so poor since the financial crisis. Deeper integration, in defence, energy or capital markets, will bolster growth and increase productivity. While the US suffers persistent inflation and an impaired fiscal impulse, the debt situation in Europe is improving. In the periphery, private sector debt has dropped from 178% of GDP at the start of the eurozone crisis in 2011 to 103%. This is where it was when the euro was launched in 2002, and an end to deleveraging should mean domestic demand can recover. Unit labour costs have narrowed between core and peripheral Europe. The latter's current account deficits have disappeared,

reducing pressure on the euro, so sovereign spreads can narrow. European equities outperformed the US in Q1 but gave part of this back as euro strength hit earnings.

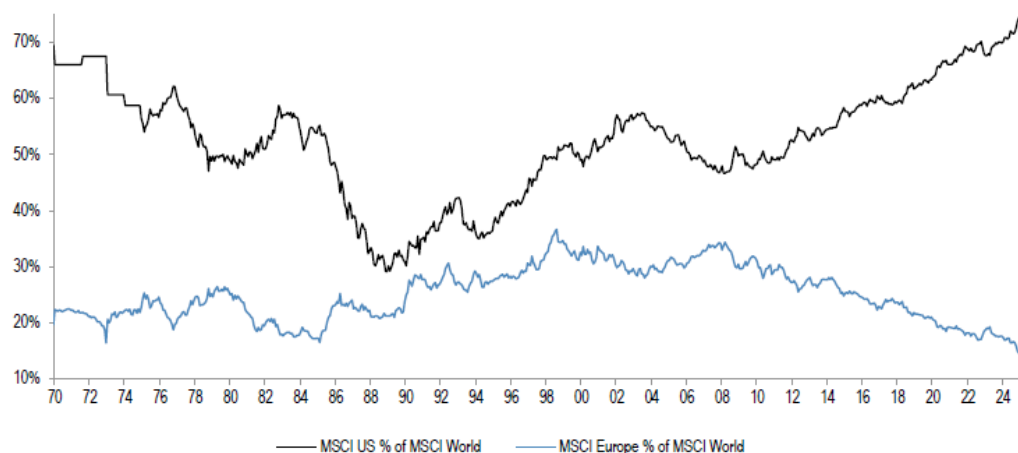
The European Central Bank (ECB) kept rates steady in July and the consensus expects only one more cut. But inflation continues to fall, heading towards 2%, with the strong euro pushing import prices lower. China's overcapacity means they are exporting deflation, while the 15% tariff on European exports to the US will weigh on capital expenditure and pricing. So we might get two more cuts.

Wage growth is slowing – the ECB wage tracker has fallen from 5.6% to 1.6%. Labour market slack is increasing, and the euro has risen 15% from its low against the dollar this year. Brent crude is below \$70 per barrel (its lowest since 2021 in euro terms), and the gas price has fallen (to the equivalent of €30-€40 per MWh). Across Europe, import prices are falling, meaning deflation is the risk.

Fiscal policy will not rescue Europe until next year, even with Germany's commitments to increase defence and infrastructure spending. With equities having traded sideways and bond yields up 60bps in Germany and 50bps in France this year, financial conditions have tightened. But the bifurcation between European and US assets has become extreme (Figure 4).

Figure 4: Extreme bifurcation

MSCI US and Europe share of MSCI World



Source: Datastream, July 2025/BCA Research, 2025

European small caps began to outperform this year, following three years of terrible performance (Figure 5). This is not just because growth in Europe has picked up, it is also due to falling inflation. High inflation damages smaller company margins, because unlike their larger peers they cannot pass on rising costs to customers. The transmission effect on margins operates with a lag, which means small cap margins will continue to rise even as inflation has stabilised. Small caps also perform in a procyclical way. They derive more revenues from domestic markets than large caps, so have recovered along with manufacturing PMI. Sector biases also explain small cap performance: banks are one of the biggest sectors in large cap so outperformed as rates rose. Now rates are falling, the reverse should be true.

Germany dominates the small cap index at more than 29%, versus 22.7% in large cap. It is no coincidence that small caps started to outperform as German election and stimulus package occurred.

Figure 5: Ready to resume the climb?

Euro area small caps versus large caps equity prices



Source: MSCI, July 2025/BCA Research, 2025

China and the rest of the world

China continues to prioritise manufacturing production capacity at the expense of deflation, focusing on industrial and technological innovation. It now ranks 11th in the Global Innovation Index. Property investment has collapsed, but manufacturing has continued to rise. China could address overcapacity by scaling back manufacturing investment, but that would come at a price of layoffs, which for political reasons they will not contemplate. Emerging markets could do better from here, especially with a weaker US dollar.

The bottom line

With markets at or near all-time highs, here are some concluding thoughts.

The US low-end consumer is under pressure given student loan delinquency, credit card and auto loan quality. The housing market is in decline: multi-family and single-family units are both down around 25% from their peak, but residential construction employment is only down 0.6%. With inventories rising, we are at a tipping point.

Tariffs have not yet impacted margins but are about to, so earnings will be hurt. Consumption, two-thirds of the economy, has stalled with spending lower than in December – this is unusual when the economy is expanding (albeit slower than last year). Consumption usually leads

investment, so it remains to be seen if the slowdown causes businesses to pull back on investment and start firing workers.

As Congress signs off a new debt ceiling, the Treasury will raise the General Account from \$350 billion to \$850 billion, sucking \$500 billion of liquidity from the system over the next few months and reversing the recent \$500 billion injection.

Meanwhile, Europe's outlook is improving thanks to falling inflation, a strong euro, and structural reforms. Energy costs are dropping, boosting margins and investment, while Germany's stimulus and deeper EU integration support this growth potential. The eurozone's trade surplus and improving debt dynamics contrast with US fiscal instability, making Europe increasingly attractive for investors.

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



Important Information

For use by professional clients and/or equivalent investor types in your jurisdiction (not to be used with or passed on to retail clients). For marketing purposes.

This document is intended for informational purposes only and should not be considered representative of any particular investment. This should not be considered an offer or solicitation to buy or sell any securities or other financial instruments, or to provide investment advice or services. Investing involves risk including the risk of loss of principal. Your capital is at risk. Market risk may affect a single issuer, sector of the economy, industry or the market as a whole. The value of investments is not guaranteed, and therefore an investor may not get back the amount invested. International investing involves certain risks and volatility due to potential political, economic or currency fluctuations and different financial and accounting standards. The securities included herein are for illustrative purposes only, subject to change and should not be construed as a recommendation to buy or sell. Securities discussed may or may not prove profitable. The views expressed are as of the date given, may change as market or other conditions change and may differ from views expressed by other Columbia Threadneedle Investments (Columbia Threadneedle) associates or affiliates. Actual investments or investment decisions made by Columbia Threadneedle and its affiliates, whether for its own account or on behalf of clients, may not necessarily reflect the views expressed. This information is not intended to provide investment advice and does not take into consideration individual investor circumstances. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon and risk tolerance. Asset classes described may not be suitable for all investors. Past performance does not guarantee future results, and no forecast should be considered a guarantee either. Information and opinions provided by third parties have been obtained from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. This document and its contents have not been reviewed by any regulatory authority.

In Australia: Issued by Threadneedle Investments Singapore (Pte.) Limited ["TIS"], ARBN 600 027 414. TIS is exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 (Cth) and relies on Class Order 03/1102 in respect of the financial services it provides to wholesale clients in Australia. This document should only be distributed in Australia to "wholesale clients" as defined in Section 761G of the Corporations Act. TIS is regulated in Singapore (Registration number: 201101559W) by the Monetary Authority of Singapore under the Securities and Futures Act (Chapter 289), which differ from Australian laws.

In Singapore: Issued by Threadneedle Investments Singapore (Pte.) Limited, 3 Killiney Road, #07-07, Winsland House 1, Singapore 239519, which is regulated in Singapore by the Monetary Authority of Singapore under the Securities and Futures Act (Chapter 289). Registration number: 201101559W. This advertisement has not been reviewed by the Monetary Authority of Singapore.

In Hong Kong: Issued by Threadneedle Portfolio Services Hong Kong Limited 天利投資管理香港有限公司. Unit 3004, Two Exchange Square, 8 Connaught Place, Hong Kong, which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 regulated activities (CE:AQA779). Registered in Hong Kong under the Companies Ordinance (Chapter 622), No. 1173058.

In Japan: Issued by Columbia Threadneedle Investments Japan Co., Ltd. Financial Instruments Business Operator, The Director-General of Kanto Local Finance Bureau (FIBO) No.3281, and a member of Japan Investment Advisers Association and Type II Financial Instruments Firms Association.

In the UK: Issued by Threadneedle Asset Management Limited, No. 573204 and/or Columbia Threadneedle Management Limited, No. 517895, both registered in England and Wales and authorised and regulated in the UK by the Financial Conduct Authority.

In the EEA: Issued by Threadneedle Management Luxembourg S.A., registered with the Registre de Commerce et des Sociétés (Luxembourg), No. B 110242 and/or Columbia Threadneedle Netherlands B.V., regulated by the Dutch Authority for the Financial Markets (AFM), registered No. 08068841.

In Switzerland: Issued by Threadneedle Portfolio Services AG, Registered address: Claridenstrasse 41, 8002 Zurich, Switzerland.

In the Middle East: This document is distributed by Columbia Threadneedle Investments (ME) Limited, which is regulated by the Dubai Financial Services Authority (DFSA). The information in

this document is not intended as financial advice and is only intended for persons with appropriate investment knowledge who meet the regulatory criteria to be classified as a Professional Client or Market Counterparty and no other person should act upon it. This document and its contents and any other information or opinions subsequently supplied or given to you are strictly confidential and for the sole use of those attending the presentation. It may not be reproduced in any form or passed on to any third party without the express written permission of CTIME. By accepting delivery of this presentation, you agree that it is not to be copied or reproduced in whole or in part and that you will not disclose its contents to any other person.

This document may be made available to you by an affiliated company which is part of the Columbia Threadneedle Investments group of companies: Columbia Threadneedle Management Limited in the UK; Columbia Threadneedle Netherlands B.V., regulated by the Dutch Authority for the Financial Markets (AFM), registered No. 08068841.

Columbia Threadneedle Investments is the global brand name of the Columbia and Threadneedle group of companies.

columbiathreadneedle.com

8.25 | CTEA-8330638.1