Ostrum ASSET MANAGEMENT

MyStratWeekly
Market views and strategy

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This document is intended for professional clients in accordance with MIFID

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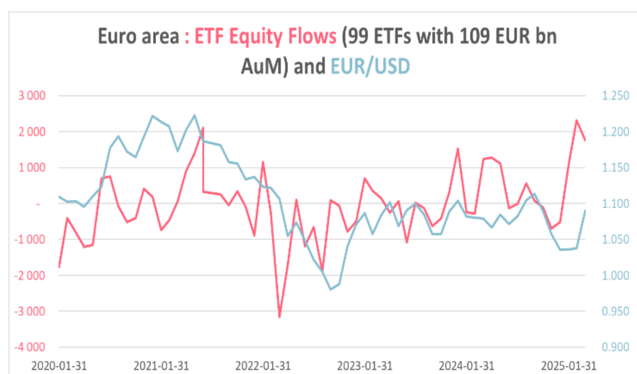
Topic of the week: Trump: A wake-up call for Europe
by Aline Goupil-Raguénès

- The abrupt shift of the United States regarding its allies in terms of NATO, Ukraine and their rapprochement with Russia threatens European security;
- This constitutes a wake-up call, forcing Europeans to act quickly to ensure their own defense;
- Germany has announced a reform of the debt brake and a large investment plan for infrastructure;
- The European Commission has proposed the ReArm Europe plan, which could mobilize up to 800 billion euros. It is primarily based on the member states, providing them with some flexibility, and includes a loan facility of 150 billion euros;
- This is an essential first step. Europe must equip itself to ensure its own defense. Other measures are forthcoming, such as potentially European defense bonds.

Market review: Escalation
by Axel Botte

- Donald Trump implements tariffs on steel and aluminum;
- United States: Consumer confidence plunges further;
- Spreads: Credit begins to feel the impact of high rates;
- Equities: U.S. markets decline, Europe down 1%.

Chart of the week



Net capital flows into the European equity market have increased significantly since the beginning of the year. This has been accompanied by a sharp decline in net flows into the U.S. equity market. This reflects investors' concerns about American growth, which is threatened by the consequences of rising tariffs, cuts in public sector jobs, and a shift in immigration policy. This contrasts with the large-scale measures announced by Germany and the European Commission aimed at significantly increasing spending on defense and infrastructure, which will support growth. The result has been an appreciation of the euro against the dollar.

Figure of the week

3,000

The price of gold reached over $3,000 per ounce for the first time during trading on Friday morning. The yellow metal is playing its role as a safe haven amid the trade war waged by the United States against all of its trading partners.
Source: Bloomberg

Topic of the week

Trump: A wake-up call for Europe

In light of the abrupt shift of the United States towards its allies regarding NATO, Ukraine, and its rapprochement with Russia, Europe must act quickly to ensure its own security and continue supporting Ukraine. The European Commission has proposed a plan of 800 billion euros, primarily relying on the expenditures of member states, and Germany has announced a reform of the debt brake concerning military spending, as well as a 500 billion euros infrastructure fund. This is only the first step. Europe must equip itself to ensure its own defense. Other measures are forthcoming, such as potentially European defense bonds.

A stark realization among Europeans that they must ensure their own security.

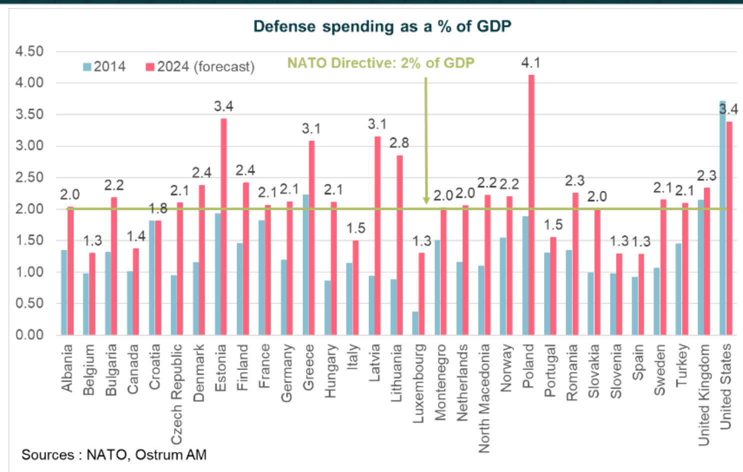
The intervention of American Vice President JD Vance at the Munich conference was a brutal wake-up call for Europeans, indicating that they could no longer rely on U.S. protection in matters of defense. They were subsequently stunned by discussions between Donald Trump and Vladimir Putin regarding a potential peace agreement, excluding Ukraine and Europe from the conversation. The shock reached its peak during the meeting in the Oval Office between President V. Zelensky on one side and Donald Trump and JD Vance on the other. Following this, the United States halted military aid to Ukraine, only to reinstate it last week after Ukraine accepted a ceasefire. The U.S. is no longer a reliable partner in any area (military, commercial, etc.). For the past 80 years, Europe has relied on the United States to ensure its security. The likely withdrawal of Americans from NATO and the continuation of support for Ukraine necessitate a massive increase in European military spending. This is all the more urgent given that some intelligence agencies have indicated that a Russian attack on a NATO member country is likely in the coming years. Europe is therefore at a crossroads and must act urgently.

Necessity to significantly increase military spending

Military spending will need to significantly increase. It has already risen considerably in countries geographically close to Russia.

European defense spending has significantly increased since 2014, the year of Russia's annexation of Crimea, and has notably surged since 2022 following Russia's unjustified attack on Ukraine. While these expenditures were often well below the NATO-recommended level of 2% of GDP (except for Greece, the United Kingdom, and France), many countries are expected to reach this threshold by 2024, with some exceeding it significantly, as shown in the graph below. Countries closest geographically to Russia have increased their military spending the most to address this threat. For instance, Poland allocates 4.1% of its GDP to defense, the highest level among NATO countries (compared to 3.4% for the United States), followed by Estonia at 3.4%, Latvia at 3.1%, and Lithuania at 2.8%.

Countries such as France, Germany, and the United Kingdom aim to increase military spending to between 3% and 3.5% of GDP. To meet this challenge, significant announcements have been made in recent days by Germany and then by the European Commission.



The 180-degree turn of Germany

The likely future German Chancellor announces a "Whatever it takes" moment for Germany.

Germany made a 180-degree turn in just a few days. Barely had the results of the early legislative election been announced (on February 23) and negotiations begun to form a coalition, the likely future Chancellor Friedrich Merz of the conservative CDU party announced, on the evening of March 4, an agreement between the CDU/CSU and the SPD to significantly increase public spending and investment. This effectively ends the excessive fiscal caution that has weighed on German growth. These measures were presented by F. Merz as a moment akin to Mario Draghi's "Whatever it takes," which proved decisive for the eurozone in overcoming the sovereign debt crisis.

As we noted in a previous MyStratWeekly[1], measures were necessary to increase public investment, which is the lowest among G7 countries, negatively impacting both German growth and that of the eurozone. The results of the legislative elections and statements from D. Trump accelerated the pace. The CDU/CSU and the SPD announced an agreement consisting of two components: a reform of the debt brake and a special investment fund for infrastructure amounting to 500 billion euros. After negotiations with the Green Party, adjustments were made to reach an agreement with them.

Reform of the debt brake

Reform of the debt brake for military spending beyond 1% of GDP.

Military spending above the threshold of 1% of GDP will not be subject to the debt brake. For other expenditures, the budgetary rule remains: the federal government cannot increase its debt beyond 0.35% of GDP per year. After negotiations with the Greens, the expenditures not subject to the debt brake above 1% of GDP have been expanded to include civil protection, intelligence services, aid to Ukraine, and information technology.

The federal states (Länder) are allowed to increase their debt within the framework of the debt brake.

The federal states (Länder) will be allowed to increase their debt by 0.35% of GDP per year, just like the federal government (which they were not allowed to do before).

A commission will be established to formulate a proposal aimed at modernizing the debt brake

German elections: The necessary reform of the debt brake - https://www.ostrum.com/sites/default/files/1-ostrum-mediatheque/mystratweekly/2025/02%20fevrier/18-02-2025/2025-02-17%20EN_OSTRUM_MyStratWeekly.pdf

to allow for more long-term investments. The legislation is expected to be completed by the end of 2025.

Special investment fund for infrastructure of 500 billion euros

Investment fund for infrastructure of 500 billion euros (11% of GDP) over 12 years.

A special investment fund for infrastructure will be established. This off-budget fund will amount to 500 billion euros (11% of GDP) over 12 years (initially announced for 10 years).

100 billion euros will be allocated to the federal states (Länder) and municipalities.

100 billion euros will be dedicated to the special fund for climate and transformation.

The investments will focus on civil protection and defense, hospitals, energy infrastructure, education, childhood, research and development, and digital technology.

Necessity of a two-thirds majority vote in Parliament

The reform of the debt brake and the investment fund for infrastructure must be voted on by Parliament with a two-thirds majority. Given the significant rise of the far-right (AfD) and the entry of the far-left party Die Linke into Parliament, it will be much more challenging to pass these measures in the new Parliament, which is set to convene from March 25. This is why F. Merz is seeking a vote by the outgoing Parliament, where the CDU/CSU, SPD, and Greens hold the majority. The vote in the upper house (Bundestag) will take place on March 18, and the vote in the lower house (Bundesrat), which includes the 16 federal states (Länder), will occur on March 21.

Impact on Growth

The impact on growth is expected to be significant starting in 2026.

Public spending and investments in defense and infrastructure are set to significantly increase in Germany over the coming years, which will benefit growth. The effects are not expected to be felt until 2026, given that in the defense sector, Europe currently sources the majority of its supplies from the United States. This is not likely to change quickly due to constraints on production capacities. The same applies to infrastructure investments, which, by their nature, will take time to be implemented and to impact growth. There is a lag effect between the planning of investments, their approval, allocation, and implementation. The impact is expected to be significant starting in 2026. According to the German economic institute DIW, the impact on growth is projected to average over 2% per year over the next 10 years. The impact on inflation is expected to be more moderate: an average increase of 0.5 percentage points per year.

The ReArm Europe plan of the European Commission

Activation of the national safeguard clause of the Stability and Growth Pact for defense spending.

On March 5, the European Commission announced the ReArm Europe plan. It consists of five parts.

The first part is the activation of the national safeguard clause of the Stability and Growth Pact for military expenditures. This aims to provide countries with the flexibility to significantly increase their military spending without triggering an excessive deficit procedure. For example, the European Commission indicates that if countries increase military spending by an average

of 1.5% of GDP, it could create 650 billion euros of leeway over four years.

Creation of a loan facility of 150 billion euros: SAFE.

The second part is the creation of a new instrument: a loan facility of 150 billion euros intended for investments in defense, called SAFE (Security Action for Europe). This facility will finance joint purchases in defense, particularly military equipment intended for Ukraine. The European Commission cited examples such as joint purchases in air and missile defense, artillery systems, missiles, and drones, as well as anti-drone systems, along with needs in the areas of cybersecurity and military mobility.

The third part concerns the European budget and the use of unused funds, such as those from the cohesion fund, to finance countries that wish to participate.

The fourth part focuses on mobilizing private capital by accelerating the Union of Savings and Investment, while the fifth aims to provide the European Investment Bank with more flexibility to finance defense.

According to the European Commission, ReArm Europe could mobilize 800 billion euros.

Three remarks:

ReArm Europe is primarily based on the member states.

This plan primarily relies on an increase in military spending by member states (with 650 billion euros given as an example). However, some of them have very limited budgetary leeway, such as Italy and France, which inevitably raises the question of how this will be financed.

These countries will be able to request the SAFE loan facility for defense investments (see the Rearm Europe plan). This will be advantageous for countries whose interest rates are higher than the European Union rate, such as France, Italy, Spain, Belgium, Greece, and Portugal. France is considering soliciting private capital by engaging insurers and banks. Discussions are currently underway on this matter.

Other sources of funding will need to be found: towards an increase in European bond issuances.

Other sources of funding will need to be found to enable countries with limited budgetary leeway to increase their military spending and thus contribute to ensuring the security of all of Europe. This could involve an increase in the issuance of European bonds, similar to the NextGeneration EU initiative.

The European Parliament is urging the EU to do more

Members of the European Parliament welcomed the European Commission's ReArm Europe plan while urging EU to do more. They are calling for urgent action to ensure its own security. Given the massive investments that need to be made, they are asking the EU to quickly find innovative financing solutions, such as European defense bonds.

The European Commission will publish a white paper on the future of European defense on March 19, which will serve as the basis for the European Council meeting scheduled for March 20 and 21, 2025.

Strong tensions on yields and good performance of spreads

German yields rose by 30 basis points between March 4 and 5 in anticipation of a significant increase in German issuances.

These tensions have spread to a similar extent on the yields of other countries in the eurozone.

The announcement of a significant upcoming increase in public spending in Germany on defense and infrastructure has generated strong tensions on German yields due to the anticipation of higher emissions from the government to finance them. The 10-year German yield increased by 30 basis points, between March 4 and March 5, reaching 2.79%, and settled at 2.88% on March 14. This reflects a term premium.

The tensions on German yields have impacted the yields of other eurozone countries in similar proportions, resulting in stable spreads against Germany, maintaining at a low level. The tensions on the Portuguese spread reflected a change in bond benchmarks that coincided with concerns related to a vote of confidence against the government and the holding of early legislative elections, which are scheduled for May 18.

Peripheral spreads are expected to narrow due to lower issuances compared to Germany and the continued improvement of their public finances.

The announcements made by Germany regarding the reform of the debt brake and the extensive infrastructure plan represent a significant shift from Germany's fiscal caution. Most other countries have much more limited leeway and are expected to increase their spending only to a lesser extent. This should lead to a tightening of spreads, particularly peripheral spreads. These countries benefit from the continued improvement of their public finances, as evidenced by Moody's recent upgrade of Greece's sovereign debt rating to Baa3, with a stable outlook last Friday. It was the only rating agency to rate Greek debt as low-quality investment grade. In contrast, the French spread is expected to remain under pressure. The divided National Assembly limits the government's ability to reduce the public deficit, which is the highest among eurozone countries.

Conclusion

The abrupt shift of the United States towards its allies, its likely withdrawal from NATO, and its rapprochement with Russia constitute a wake-up call for Europe, forcing it to react swiftly. This is the only positive aspect of Donald Trump's return to the White House. Europe has often taken decisive measures when it was backed into a corner. The arrival of Friedrich Merz at the helm of Germany should facilitate this, as he is quickly pushing for changes in Germany in response to threats to European security. The reform of the debt brake and the extensive infrastructure plan will boost German growth and that of the eurozone starting in 2026. The European Commission's ReArm Europe plan is a first step towards European defense, which should be followed by other instruments, including the potential issuance of European defense bonds.

Aline Goupil-Raguénès

Market review

Escalation

The unpredictability of Donald Trump's actions weighs heavily on stocks, despite a late-week rebound attempt. Interest rates remain elevated in Europe, and credit spreads are beginning to reflect the heightened risk environment. Gold, the ultimate safe haven, is on the rise.

Donald Trump shows no inclination to pursue anything other than a deadly escalation of tariffs. It appears the U.S. administration has learned little from the post-COVID experience regarding the critical importance of supply chain reliability. The implementation of tariffs on steel and aluminum has once again pressured equity markets. Furthermore, despite the Bund stabilizing around 2.90%, the competition from high rates is creating early tensions in credit spreads, particularly in the high-yield sector. The dollar has rebounded under the threat of new 200% tariffs on European wines. In this context, consumer confidence has plunged in March, according to the University of Michigan survey. Inflation expectations are at their highest (4.9% for one year). The decline in CPI inflation (2.8% in February) is attributed to falling airfares and leisure costs, which are responding to consumer caution. In the Eurozone, industrial production improved in January (+0.8%), but the economic outlook remains fragile. German inflation has been revised down to 2.6% in February, which could signal a downward adjustment for Eurozone inflation. The ECB remains inclined to ease its policy, anticipating a decline in wage inflation and, consequently, a moderation in service prices.

In financial markets, following last week’s Bund crash to around 2.90%, yields are stabilizing at these high levels. The news of an agreement between the SPD and the Greens on infrastructure spending briefly reignited tensions on the 10-year before the release of U.S. consumer confidence reversed the trend. The curve's steepening continues, particularly on the 10-30-year segment, with no adverse effects on sovereign spreads for now. The 10-year OAT has tightened to below 70 bps ahead of Fitch’s decision (unchanged). Additionally, issuance premiums of around 8 bps on the 15- and 30-year GGBs have attracted unprecedented demand. The syndication of a 10-year EU bond has seen strong interest, especially as a futures contract on supranational debt may soon be launched. In the U.S., the T-note hovers around 4.30%, influenced by positive CPI surprises and political uncertainty. The trend toward steepening is less pronounced than in the Eurozone. In the credit market, participants appear to be becoming more selective, with performances becoming more heterogeneous. The €8 billion weekly issuance is slightly less well-subscribed than in recent weeks. Spreads on euro investment-grade bonds widened by about 5 bps over the week. European high yield has experienced a first week of buybacks (+20 bps on BB-B ratings). The market is vulnerable to a reversal of technical factors given the valuation levels. European credit spreads (both IG and HY) are widening significantly less than their dollar equivalents, but the interest rate effect tempers the analysis.

In equity markets, the correction continues in the United States. The implied volatility of the S&P 500 has reached a peak above 29%. Europe is outperforming Wall Street during the market downturn. Banks are benefiting from higher long-term rates, while defensive and telecommunications stocks are also performing well.

Axel Botte

Main market indicators

G4 Government Bonds	17-Mar-25	1wk (bp)	1m (bp)	2025 (bp)
EUR Bunds 2y	2.19%	-3	+5	+10
EUR Bunds 10y	2.82%	-1	+33	+46
EUR Bunds 2s10s	63.4 bp	+2	+29	+35
USD Treasuries 2y	4.01%	+13	-25	-23
USD Treasuries 10y	4.28%	+7	-20	-29
USD Treasuries 2s10s	26.5 bp	-6	+5	-6
GBP Gilt 10y	4.66%	+1	+13	+9
JPY JGB 10y	1.51%	-6	+21	+23
€ Sovereign Spreads (10y)	17-Mar-25	1wk (bp)	1m (bp)	2025 (bp)
France	68 bp	-3	-6	-15
Italy	103 bp	-10	-10	-12
Spain	62 bp	-3	-2	-7
Inflation Break-evens (10y)	17-Mar-25	1wk (bp)	1m (bp)	2025 (bp)
EUR 10y Inflation Swap	2.09%	+3	+11	+16
USD 10y Inflation Swap	2.44%	+1	-16	-3
GBP 10y Inflation Swap	3.41%	-4	-14	-12
EUR Credit Indices	17-Mar-25	1wk (bp)	1m (bp)	2025 (bp)
EUR Corporate Credit OAS	92 bp	+7	+3	-10
EUR Agencies OAS	49 bp	+1	-4	-13
EUR Securitized - Covered OAS	44 bp	+1	-6	-12
EUR Pan-European High Yield OAS	325 bp	+25	+29	+7
EUR/USD CDS Indices 5y	17-Mar-25	1wk (bp)	1m (bp)	2025 (bp)
iTraxx IG	56 bp	+0	+5	-1
iTraxx Crossover	307 bp	+3	+28	-7
CDX IG	55 bp	+1	+8	+5
CDX High Yield	348 bp	+10	+56	+36
Emerging Markets	17-Mar-25	1wk (bp)	1m (bp)	2025 (bp)
JPM EMBI Global Div. Spread	331 bp	+3	+18	+6
Currencies	17-Mar-25	1wk (%)	1m (%)	2025 (%)
EUR/USD	$1.091	0.665	4.025	5.3
GBP/USD	$1.297	0.738	2.764	3.7
USD/JPY	JPY 148	-0.775	2.082	5.9
Commodity Futures	17-Mar-25	-1wk ($)	-1m ($)	2025 (%)
Crude Brent	$71.4	$2.2	-$3.5	-3.3
Gold	$2 992.0	$103.3	$95.5	14.0
Equity Market Indices	17-Mar-25	-1wk (%)	-1m (%)	2025 (%)
S&P 500	5 639	-2.27	-7.78	-4.1
EuroStoxx 50	5 417	0.56	-1.86	10.6
CAC 40	8 053	0.06	-1.67	9.1
Nikkei 225	37 397	0.99	-4.77	-6.3
Shanghai Composite	3 426	1.78	3.06	2.2
VIX - Implied Volatility Index	22.15	-20.50	44.11	27.7

Source: Bloomberg, Ostrum AM

Additional notes

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