MARCH 2025

What if Europe is shocked into action?

A US-Russia rapprochement has startled European officials. But we think the latest signs of a redrawing of the geopolitical landscape could be beneficial for markets if European Union policy makers are jolted into action to overhaul defence spending and boost competitiveness to stop the bloc from falling behind the US and China.

A shift in US policy towards the Russia-Ukraine war has further redrawn the geopolitical landscape and poses far-reaching implications for European policies and financial markets.

Gregor MA Hirt
Global CIO Multi Asset

Key takeaways

- Bigger European defence budgets and an increased focus on deregulation can stimulate economic growth in the near term and create opportunities for institutional investors.
- The ripple effect from higher military spending may benefit sectors beyond defence including cyber security, power and infrastructure. For European fixed income markets, the primary response to larger defence budgets may be tighter spreads.
- A Russia-Ukraine peace settlement would be beneficial for Europe: lowering risk premiums and boosting the euro. A potential fall in energy prices would aid businesses and consumers.

Navigating Rates

Three years on from the start of the conflict, US President Donald Trump has pushed for an end to the war and started bilateral peace talks with Russia. The US's warmer relations with Moscow initially startled Europe, which has – along with the US until now – maintained strong support for Ukraine.

An end to the conflict on the European Union's doorstep would be beneficial for the bloc's economy. However, the EU may also have to increasingly carve its own policy path.

Germany's chancellor-designate Friedrich Merz acknowledged the new reality after his recent election win, saying his priority was to strengthen Europe, step by step, to ensure it can achieve independence from the US.

Defence spending can bolster growth, but institutional investment will be needed

We see the prospect of a bolder and more independent EU leading to an increase in defence spending, potentially boosting economic growth.

Since late last year, NATO's European members have been considering a range of options to raise spending on defence from 2% to 3% of gross domestic product (GDP).

One possibility is a joint borrowing programme. Another option may be to relax EU fiscal rules to allow governments to increase defence spending.

Outside the EU, the UK has pledged to raise defence spending to 2.5% of national income by 2027 by cutting its aid budget.

Enhancing defence and safeguarding Ukraine could cost Europe's leading nations an additional USD 3.1 trillion over the next decade, according to Bloomberg Economics.

Some of the funding will need to come from institutional investors.

But for that to happen, sustainable finance legislation may need to be revised to tempt European investors who generally face more exclusions to their investment universe than their US counterparts. In a sign that the EU may be ready to help businesses, the European Commission has proposed relaxing regulations for firms on reporting the environmental impact of their activities in addition to supply chain due diligence rules.

Higher spending on defence can help support economic growth, even though defence spending has tended to generate lower returns for economies in the longer term compared to expenditure in other sectors. GDP could rise by 0.9% to 1.5% per year if governments raised annual defence spending to 3.5% of GDP and moved to buying home-grown weapons rather than those designed and mainly made in the US, according to analysis by the Kiel Institute.

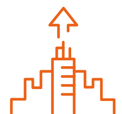
Ripple effect may benefit cyber security, power and infrastructure

Increased defence spending could provide a significant lift to a broad range of European stocks in the coming few years.

We expect a ripple effect from defence to other sectors such as cyber security, industrial goods, power grids, power generation and infrastructure (the latter may also benefit from the potential reconstruction of Ukraine). European small and mid cap companies could profit.

Within fixed income, the primary response to bigger defence budgets may be tighter spreads between the yield on bonds of periphery countries (for example, Portugal, Spain and Greece) relative to the core countries, namely France and Germany, as markets speculate about closer fiscal integration.

Prioritisation of growth and deregulation: a boon for European stocks



A renewed emphasis on accelerating economic growth may increase competition within the bloc, paving the way for the creation of so-called national champions within countries. The push may also open opportunities for private market investors.

A prioritisation of growth may also help to kick start productivity, giving Europe the chance to catch up with the US and China over the medium term. Productivity levels in Europe and the US were similar 20 years ago, but the gap has widened since in favour of the US. A sustained improvement in productivity would drive European stocks and earnings to potentially catch up with their US counterparts.

Finally, we expect a broader focus on deregulation. With the Trump administration moving to lower corporate regulations, Europe may need to reform some existing rules to remain competitive. Less red tape would be positive for companies and overall growth.

Potential Russia-Ukraine truce: the market impact

An end to the Russia-Ukraine conflict would be welcomed by European policy makers and cheered by financial markets, even if the settlement is suboptimal in the long term. We see four main ways a peace settlement may impact European markets:

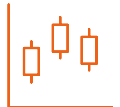
- **Boost from lower energy prices:** the EU has largely shunned Russian energy supply since the start of the conflict and any resumption of buying Russian gas would help to bring down high energy prices in Europe, aiding companies, particularly manufacturers and chemical producers, as well as consumers. A potential complication could be Mr Trump's threat to impose tariffs on the EU unless it buys more US liquified natural gas (LNG). US LNG is more costly than piped gas. A peace settlement could also open the way for an agreement between the US, Russia and Saudi Arabia to reduce global energy prices.

- **Risk premiums may ease in European markets:** a truce would bolster investor sentiment and lower the risk premium of potential future escalation. We estimate the market impact of a truce could be a 10% gain for the EURO STOXX 50 and potentially two to three times more for exposed Eastern European markets like Poland (although some of the upside may already be priced in).

- **Higher European bond yields may persist:** recent developments have reinforced the expectation that debt issuance will need to rise as European countries bear the financial burden of a long-term peace agreement. Since the prospect of an end to hostilities arose after a call between Mr Trump and Russian President Vladimir Putin on 12 February, 10-year German and French government bonds have both risen. With increased defence spending, we expect higher yields to persist in an environment of increased volatility and a decoupling of major yield curves. One positive is that with closer European cooperation, spreads between French and German sovereign bonds could stabilise somewhat. The outlook for yields may change if lower gas prices materialise, giving the European Central Bank more leeway to cut interest rates.

- **The euro may (partially) emerge from the US dollar's shadow:** the FX market has been focused on the dollar in the aftermath of Mr Trump's election. But the prospect of a peace settlement, together with the recent outperformance of European equities, has signalled greater optimism of a European cyclical recovery and policy change. We think the changing outlook could lead to upward momentum for the euro versus the Swiss franc and reduced downward pressure on the euro against the dollar. Valuation factors certainly support an appreciation of the euro. However, volatility might increase compared to last year, especially as the euro's prospects may be dampened by Europe's persistent structural weakness and the risk of fresh tariffs.

A more proactive Europe is a positive for markets



Even if a peace settlement fails to emerge immediately, we think the lasting impact from the US's policy shift might be a more proactive EU as officials are jolted into action to overhaul defence spending and other policies to stop the bloc from falling behind the US and China. For investors, we think that can only be positive.

The document is for use by qualified Institutional Investors (or Professional/Sophisticated/Qualified Investors as such term may apply in local jurisdictions).

This document or information contained or incorporated in this document have been prepared for informational purposes only without regard to the investment objectives, financial situation, or means of any particular person or entity. The details are not to be construed as a recommendation or an offer or invitation to trade any securities or collective investment schemes nor should any details form the basis of, or be relied upon in connection with, any contract or commitment on the part of any person to proceed with any transaction.

Any form of publication, duplication, extraction, transmission and passing on of the contents of this document is impermissible and unauthorised. No account has been taken of any person's investment objectives, financial situation or particular needs when preparing this content of this document. The content of this document does not constitute an offer to buy or sell, or a solicitation or incitement of offer to buy or sell, any particular security, strategy, investment product or services nor does this constitute investment advice or recommendation.

The views and opinions expressed in this document or information contained or incorporated in this document, which are subject to change without notice, are those of Allianz Global Investors at the time of publication. While we believe that the information is correct at the date of this material, no warranty of representation is given to this effect and no responsibility can be accepted by us to any intermediaries or end users for any action taken on the basis of this information. Some of the information contained herein including any expression of opinion or forecast has been obtained from or is based on sources believed by us to be reliable as at the date it is made, but is not guaranteed and we do not warrant nor do we accept liability as to adequacy, accuracy, reliability or completeness of such information. The information is given on the understanding that any person who acts upon it or otherwise changes his or her position in reliance thereon does so entirely at his or her own risk without liability on our part. There is no guarantee that any investment strategies and processes discussed herein will be effective under all market conditions and investors should evaluate their ability to invest for a long-term based on their individual risk profile especially during periods of downturn in the market.

Investment involves risks, in particular, risks associated with investment in emerging and less developed markets. Any past performance, prediction, projection or forecast is not indicative of future performance. Investors should not make any assumptions on the future on the basis of performance information in this document. The value of an investment and the income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested.

Investing in fixed income instruments (if applicable) may expose investors to various risks, including but not limited to creditworthiness, interest rate, liquidity and restricted flexibility risks. Changes to the economic environment and market conditions may affect these risks, resulting in an adverse effect to the value of the investment. During periods of rising nominal interest rates, the values of fixed income instruments (including short positions with respect to fixed income instruments) are generally expected to decline. Conversely, during periods of declining interest rates, the values are generally expected to rise. Liquidity risk may possibly delay or prevent account withdrawals or redemptions.

February 2025

LDS-250069

ADM-W4284505