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Amidst concerns surrounding Europe, some signs of optimism

Everything seems to be going wrong for the European economy...

Germany was once the jewel of the European economy, but not anymore. In 2024, its economy experienced a contraction largely due to challenges within its industrial sector. The rising cost of energy put significant pressure on manufacturers and industrial operations across the country, leading to reduced profit margins and, in some cases, a scaling back of production. Additionally, the automotive sector, a crucial pillar of the German economy, has faced difficulties, with declining car sales due to a change in consumer preferences and a shift towards electric vehicles. These factors weakened the demand for German manufactured cars and contributed to a stagnating economy, with the industrial sector unable to bounce back as quickly as hoped. The economic downturn in Europe has been further exacerbated by a period of uncertainty in the market, largely driven by the unexpected snap elections in France in July 2024. This created political instability and did not allow the Eurozone to implement policy changes and reforms that could have provided economic relief, leaving the market at a standstill.

But political instability is not the only challenge for Europe: as the Mario Draghi report¹ clearly explains, the region suffers from a lagging productivity and lack of innovation with many European countries failing to keep pace with technological advancements. This lack of innovation in key sectors has negatively impacted growth rates of the region compared to other global economies, making it difficult for Europe to compete in an increasingly competitive global marketplace.

Furthermore, for more than a decade we have been witnessing a growing wave of nationalist sentiment, which has been building since the Great Financial Crisis in 2008, threatening the cohesion of the European Union and fueling discussions of possible exits from the Union. For example, following the 2016 Brexit referendum, there were also talks of a "Grexit" (Greece leaving the EU) during the country's debt crisis as well as a "Frexit" (France possibly leaving the EU), a particularly popular topic in the country's 2017 election. All this has shaken the foundations of a stable and solid European Union.

While Europe faces serious internal challenges, additional threats are looming from outside. The US has continued to threaten several of its trading partners with increased tariffs, with duties on Canada and Mexico expected to take effect in early April 2025, and

¹ Mario Draghi, [The Future of European Competitiveness](#), 2024

the more recent announcement of a proposed 25% tariff on European Union products.

All these factors—political instability, lagging productivity, rising nationalism, trade tensions, and a fragmented EU—have created a challenging economic environment. As a result, the European equity markets have consistently underperformed in recent years, with investors wary of the lack of stability and long-term growth prospects.

...and yet, European equities have started the year strong, even outperforming the US.

The equity market in Europe has made a surprisingly strong start to 2025, showing resilience despite the challenges of the past year. In the first two months, the European market posted a performance of around 10%², outperforming the US. Most importantly, this performance was not driven by a specific sector but was rather broad-based, suggesting that investor confidence is being restored in the overall health of the European economy, rather than reliant on a few high-performing sectors.

Despite concerns, while investors aren't sanguine, they seem to show some optimism. The following factors may provide further reason for that sentiment:

The recent elections in Germany could result in a centrist coalition. This coalition would need to address domestic challenges, such as economic growth and energy security, to create a strong political firewall against the far-right's appeal.

Moreover, while current political developments do not seem promising, a resolution in the Ukraine/Russia conflict could lead to more affordable energy, particularly natural gas. This has been a major source of economic strain due to the ongoing war. Additionally, the revitalisation of agriculture in the region could positively affect food prices and the broader agricultural sector, benefiting both European economies and global supply chains.

Interest rates in Europe are expected to decrease faster than in the US, which could provide a significant boost to the European economy. This could lead to increased M&A activity, positively impacting job creation, productivity, and market competitiveness in the region.

Another potential driver for growth in Europe could be the relaxation of regulatory frameworks surrounding artificial intelligence (AI) which could unlock its potential to transform sectors such as healthcare, manufacturing, and financial services and drive economic growth.

In addition, an increase in defense spending, a significant topic in the region, could also boost economic growth by driving investments in infrastructure, technology, and personnel. This, in turn, would create job opportunities within the sector and stimulate demand for goods and services across related industries.

Lastly, the valuations of European companies are more attractive than those in the US. European stocks have generally been trading at lower price-to-earnings (P/E) ratios, making them more appealing to value investors looking for undervalued assets with strong growth potential. This could lead to increased foreign investment in European equities, providing an additional boost to the region's financial markets.

All these factors - political stability in Germany, the potential resolution of the Ukraine conflict, lower interest rates, a more competitive AI landscape, increased defense spending, and attractive valuations—could create a favourable environment for economic growth and investment in Europe over the coming years.

We remain cautious for now, as the geopolitical and market environment continues to be uncertain. However, we will keep monitoring the situation. We will increase allocations when we see that the market is moving ahead sustainably, beyond the initial gains driven by improved expectations.

² STOXX Europe 600

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