Europe's Revival? Curb Your Enthusiasm

- Russia, the U.S., and China pose challenges, but Europe's stagnation is largely self-inflicted.
- Without cheap energy, economic stagnation will persist.
- E.U. equities perform well on reform hopes, but political headwinds remain.
- The euro should weaken amid rate cuts, low inflation, and tariff risks.
- Middling reforms and persistent political risks favor German bunds.

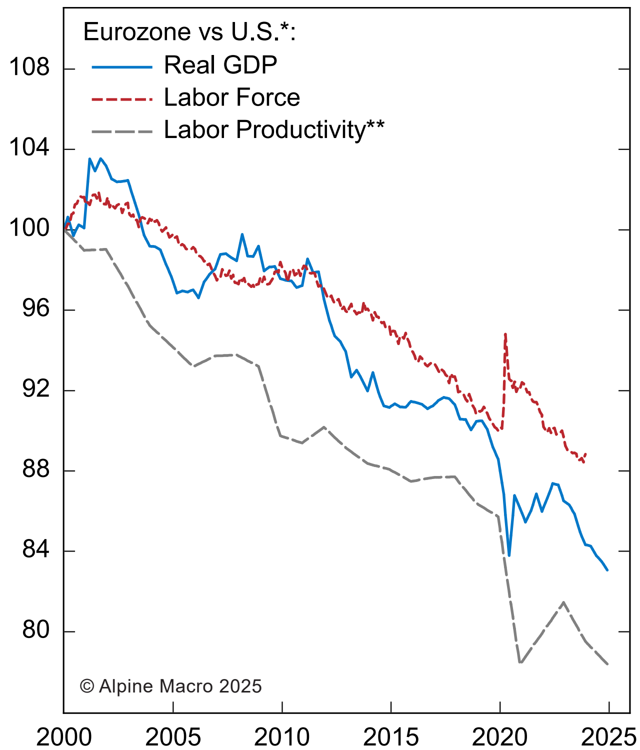
In This Report

Europe's economic malaise persists, with Germany likely in its third year of recession. Structural issues — aging workforce, high taxes, overregulation, and political barriers to reform — weigh on growth and productivity, compared to the U.S. (**Chart 1**).

Can this be reversed? Some policy-driven green shoots may emerge: Germany's elections, more market-friendly policies, and reforms in the wake of the Draghi report, such as a push for a capital markets union. However, reforms are likely to remain incremental and timid, unlikely to unlock stronger growth quickly.

Energy costs remain a major headwind, fueling deindustrialization, especially in Germany. Meanwhile, geopolitical risks mount — Russia's aggression, U.S. tensions, and rising competition with China.

Chart 1 Europe's Economic Decline Relative To The U.S.



*Rebased to Jan 2000=100
**Source: Conference Board

A Russia-Ukraine Peace Dividend?

The euro briefly rallied on news of a potential U.S.-brokered Russia-Ukraine peace deal. E.U. policymakers are angry at being sidelined and wary of Trump's overtures to Moscow, but a deal appears likely. Ukraine won't regain lost territory or join NATO — long evident, as Germany and other E.U. states opposed membership, and Ukraine lacks the military capability to retake its territories[1]. European voters also increasingly favor a settlement (Chart 2).

A deal would halt Ukraine's losses and allow it to regroup against future Russian threats. The outcome will likely be a truce or cold peace.

A peace dividend? Minimal at best. Sanctions on Russia will remain largely in place to avoid rewarding aggression, though some may ease post-deal. Reconstruction could help E.U. manufacturing orders.

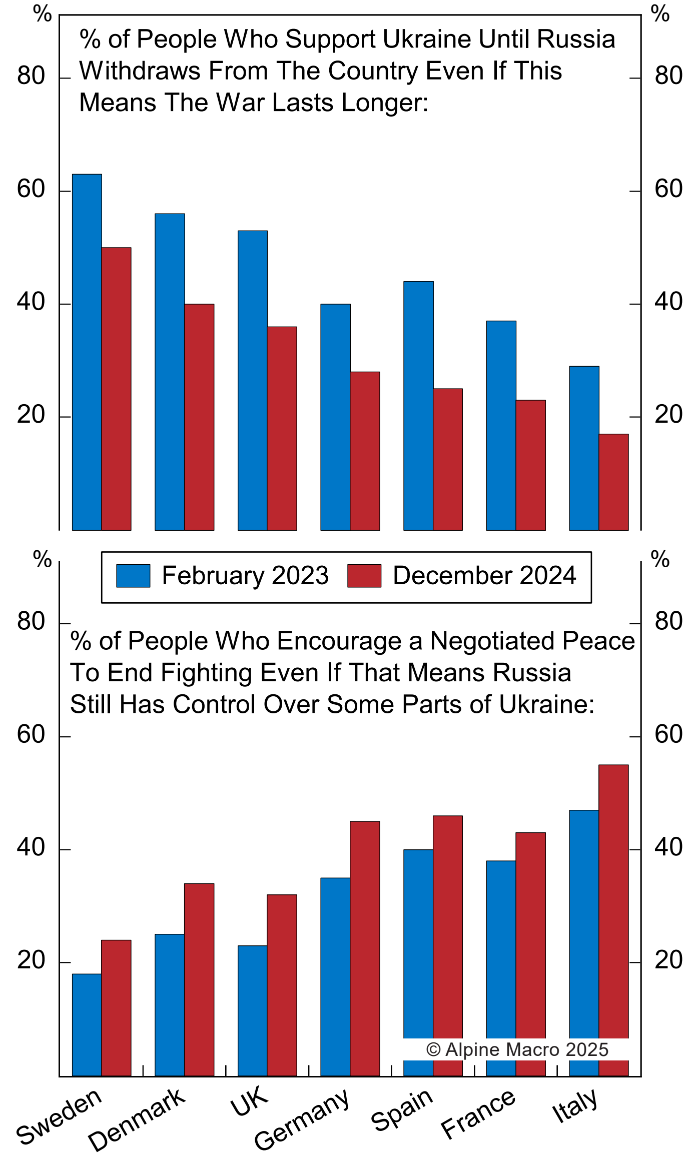
Cheaper oil is unlikely, as Russia already successfully skirted oil sanctions. Cheaper LNG Russian gas would be an economic boon to Europe, but the E.U. is reluctant to resume Russian gas imports, given fears of renewed strategic dependency on Moscow, and U.S. pressure to buy its LNG.

European fears of Russian aggression and U.S. abandonment are driving a push for rearmament, with likely German Chancellor Freidrich Merz advocating EUR 200bn in defense spending. Trump's policies further pressure Europe to bolster its military.

However, the Russian threat is likely overblown. Russia's costly, sluggish, inept Ukrainian campaign belies fears of a formidable aggressor. A militarily struggling Russia is unlikely to threaten a wealthier, better-armed NATO — especially given the nuclear umbrella. Thus, if the Ukraine war ends, the European threat perception and rearmament appetite could fade.

1 Alpine Macro *Geopolitical Strategy* "The Russia-Ukraine War: Lurching Toward An Uneasy Truce" (October 11, 2024).

Chart 2 More Europeans Favor A Settlement To The War In Ukraine



Source: YouGov.UK

The Coming Euro-American Split? Don't Hold Your Breath

The Euro-American relationship is increasingly strained, both economically and strategically. Trump has pushed Europe to stand on its own militarily, criticizing its reliance on U.S. security. His demand for European territorial concessions (e.g., Greenland) has alarmed NATO members.

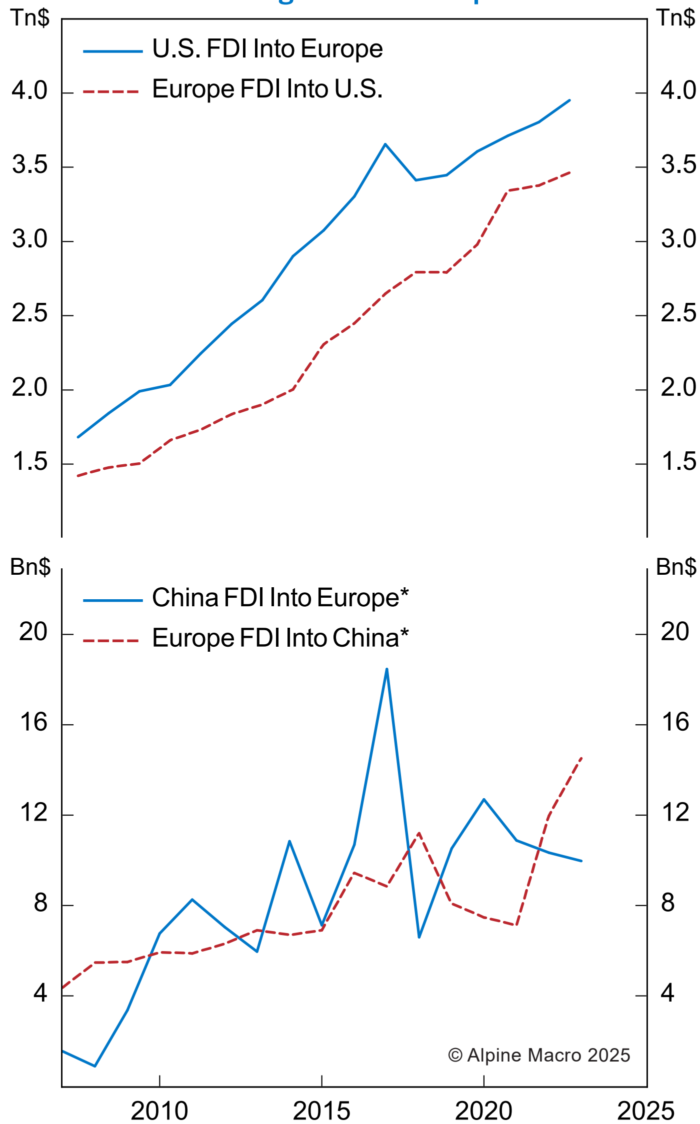
Ideological divides are widening. Vice President J.D. Vance's speech at the Munich Security Conference highlighted stark differences over civil liberties, free speech, and democracy. Meanwhile, Trump has condemned E.U. trade policies as "an atrocity," and has just threatened to impose 25% tariffs on the E.U.

Likely German Chancellor Merz, a strong Atlanticist, has warned NATO "may soon be dead." Yet, the U.S. is unlikely to abandon the alliance, even as it pivots to Asia.

The E.U. would need to boost defense spending by 3% of GDP to be militarily independent - daunting given its economic and political constraints. So, while there are some echoes of the 1950s-60s Sino-Soviet split, a full geopolitical Euro-American fracture is unlikely.

Trade will be the bigger flashpoint. The U.S. is threatening tariffs, which would trigger reciprocal measures. The E.U. is countering with both sticks and carrots. The incentives may include buying U.S. LNG and military gear, lowering car tariffs, and negotiating on digital taxes and tech regulations. On the sticks side, Europe is preparing quite dramatic retaliatory measures, going beyond targeted counter-tariffs, to export controls and investment restrictions (e.g., E.U.'s Anti-Coercion Instrument).

Chart 3 Europe-U.S. Investment Levels Are Far Higher Than Europe-China



*Source: China Ministry of Commerce

Despite tensions and trepidations, an eventual deal is likely, given that what the E.U. offers is largely in line with Trump's demands. That said, given the latter's penchant for tense negotiations, an escalating trade conflict is quite possible, but unlikely to be sustained long-term, given the costs.

The E.U. has also offered to align China-related economic security policies with Washington, a key U.S. priority. While some European policymakers favor closer ties with China, deep economic interdependence makes a U.S.-Europe split improbable. Chart 3 illustrates the vast FDI flows between them, dwarfing Europe-China investments.

Bottom line: U.S.-E.U. tensions will rise, but the relationship will endure. Tariff-driven market volatility is likely, but a trade and investment deal remains the more probable outcome.

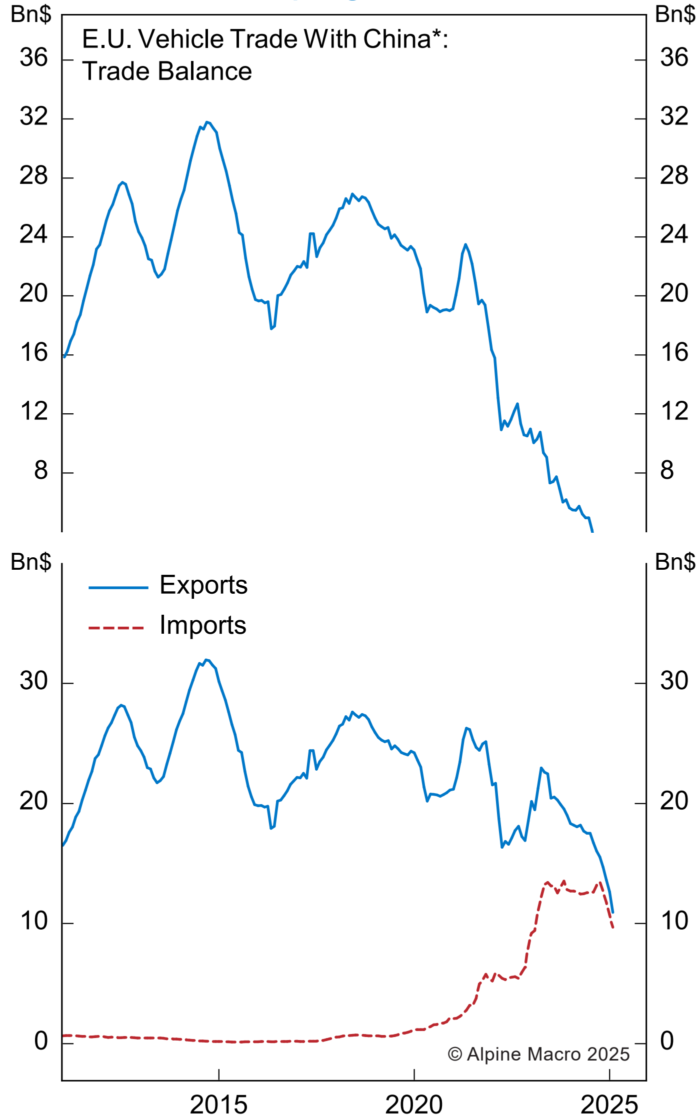
E.U.'s Problems With China: Underestimated?

The E.U. is aligning with the U.S. on "de-risking" trade with China due to shared strategic and economic concerns. China's support for Russia in Ukraine has soured European perceptions of Beijing.

Economically, Europe fears a China Shock 2.0 as Beijing's export-oriented manufacturing erodes E.U. exports, particularly in autos (Chart 4). To protect its industrial base, the E.U. has imposed countervailing duties on Chinese EVs (17.4%-37.6%) atop its existing 10% import tariff. European officials argue that Chinese subsidies allow EVs to undercut E.U. manufacturers by 40%, threatening an industry that employs 13.8 million people and carries major political stakes.

China has retaliated with selective counter-tariffs, and tensions persist. The E.U. is also pursuing an IP royalty case at the WTO, considering *de minimis* tariffs on cheap Chinese imports and investigating Chinese industrial subsidies.

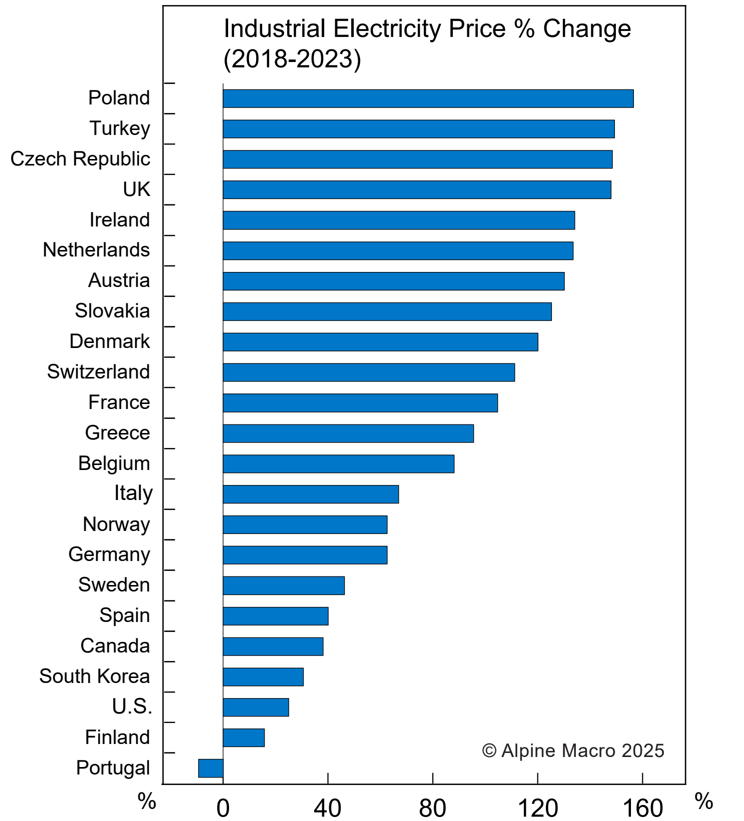
Chart 4 E.U.'s Vehicle Trade Surplus With China Is Collapsing



*Shown as 12-month moving sum; source: UNCOMTRADE

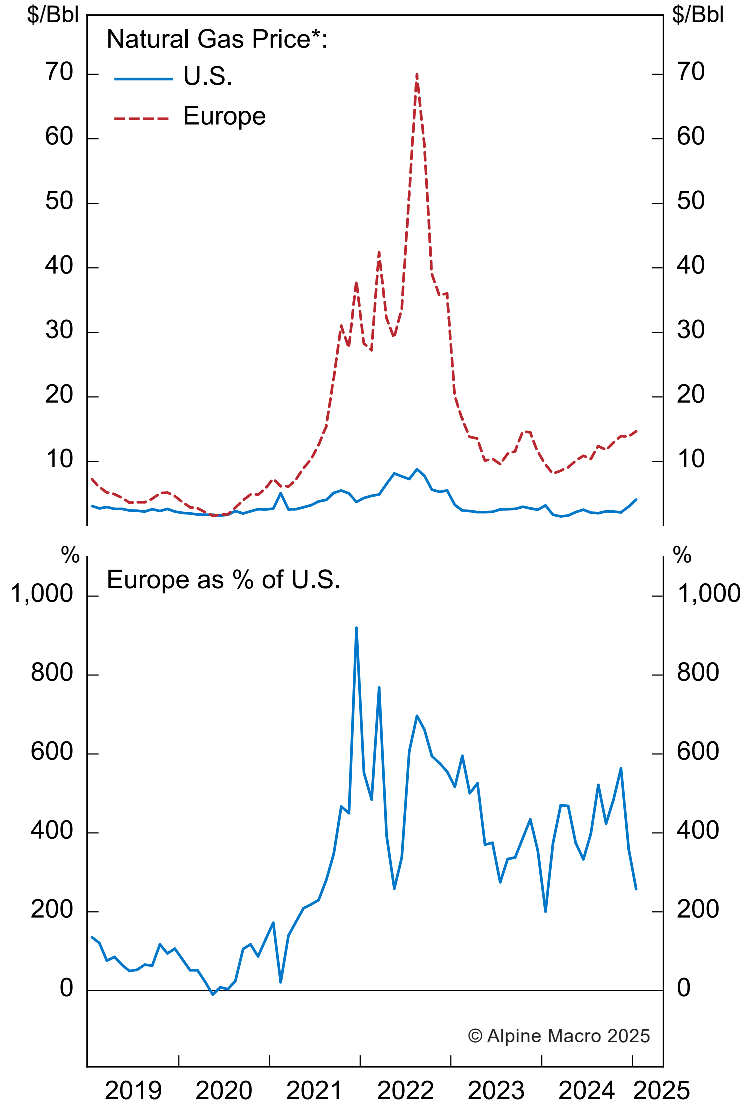
The E.U. also fears U.S.-China trade disputes will push discounted Chinese exports into Europe, further harming its manufacturing sector — yet another reason why the E.U. will increasingly coordinate with Washington on China-related restrictions on trade, foreign investment, and tech exports (e.g., the European Economic Security Strategy).

Chart 5 Europe Has Had The Highest Increases In Electricity Prices



Source: IEA and the UK Deparment For Energy Security And Net Zero

Chart 6 U.S. And European Gas Prices



*Source: World Bank

Bottom line: The E.U.-China economic relationship will likely worsen in 2025.

The E.U.'s Biggest Problem: Itself

The E.U.'s biggest challenges are largely self-inflicted. A core question remains: What is its growth model? Before the 2024 European Parliament elections, the E.U. aimed to become a renewable energy and tech superpower — unrealistic goals. Overregulation, especially in AI, has stifled innovation, for example, with nearly a third of billion-dollar startups (2008-2021) relocating abroad.

And renewable power is not cheap. Europe's biggest acute issue is arguably energy costs. Both electricity (**Chart 5**) and natural gas prices (**Chart 6**) remain significantly higher than in other major economies, hurting manufacturing and industrial sectors, especially in Germany. The Russia-Ukraine war exacerbated this, and stringent green mandates have worsened the problem.

Though the E.U. is slowly rolling back some decarbonization policies, it remains committed to the

Green New Deal. A BusinessEurope study projects that even by 2050, European energy prices will be 50% higher than in China or the U.S.[2]

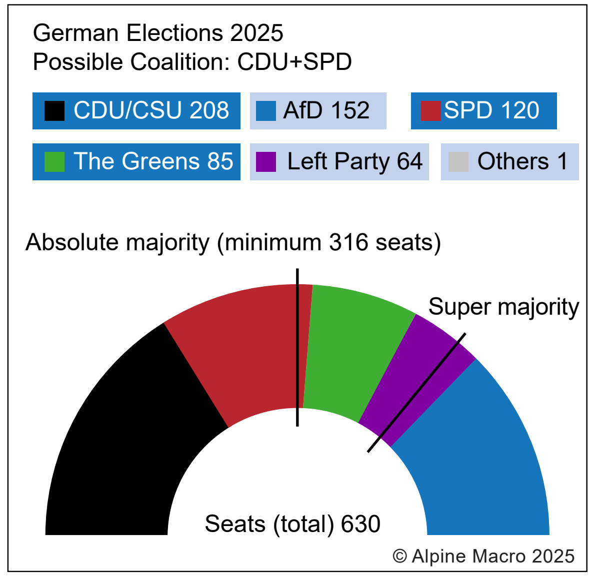
High energy costs are fueling deindustrialization, particularly in Germany. Auto production has fallen 30% since 2020 due to energy costs and Chinese competition. Europe faces a choice: prioritize reindustrialization, rearmament, and AI leadership — or stick to its renewables agenda. The trend is shifting to the former, but the decarbonization mantra persists.

One thing to watch is what will come of the Draghi report (Sep. 2024). It identifies expensive energy, overregulation, and weak business investment as key barriers to E.U. competitiveness. However, it continues to emphasize decarbonization and welfare state preservation, so its solutions are partially "more of the same." It calls for EUR 800bn/year in annual private sector investment (5% of GDP), but half is aimed at green energy and EVs, with the rest for high-tech and industrial policies — without clear funding sources.

On the more positive side, the report also pushes for a capital markets union to better utilize Europe's EUR 11.5tn in consumer savings, allowing for the creation of larger cross-border banks to boost investment. Past attempts at banking or capital market unions failed, but now-likely German Chancellor Merz supports these reforms, so there is a chance that some progress can finally be made, albeit slowly.

2 BusinessEurope "New Study Shows that Europe's Energy Price Gap Will Worsen Without Urgent Action" (July 4, 2024).

Chart 7 **Germany's Political Coalition Options, Post-Election**



Note: 2/3rds super-majority is needed for a constitutional change
Source: The Federal Returning Officer, preliminary official result (Latest: 02/24/2025)

There are some other green shoots. Election results in Germany, and upcoming contests in Poland, Norway, and the Czech Republic, may deliver more reform-oriented governments, raising hopes for a more competitive and investment-friendly E.U. economy.

Germany's election will likely produce a CDU/CSU-led coalition with the Social Democrats. Expect some deregulation, corporate tax cuts, and if the Greens are not in the government, a push for cheaper energy (natural gas, possibly nuclear). However, Social Democrat opposition to welfare cuts will limit the scope for reforms.

A key question is whether Germany will modify its constitutional debt brake to allow more fiscal spending — a potential major boost for GDP growth and markets. A Merz-led coalition would lack the two-thirds majority needed for this constitutional

Chart 8 Low Legitimacy And Low Growth = Radical/Populist Challenges

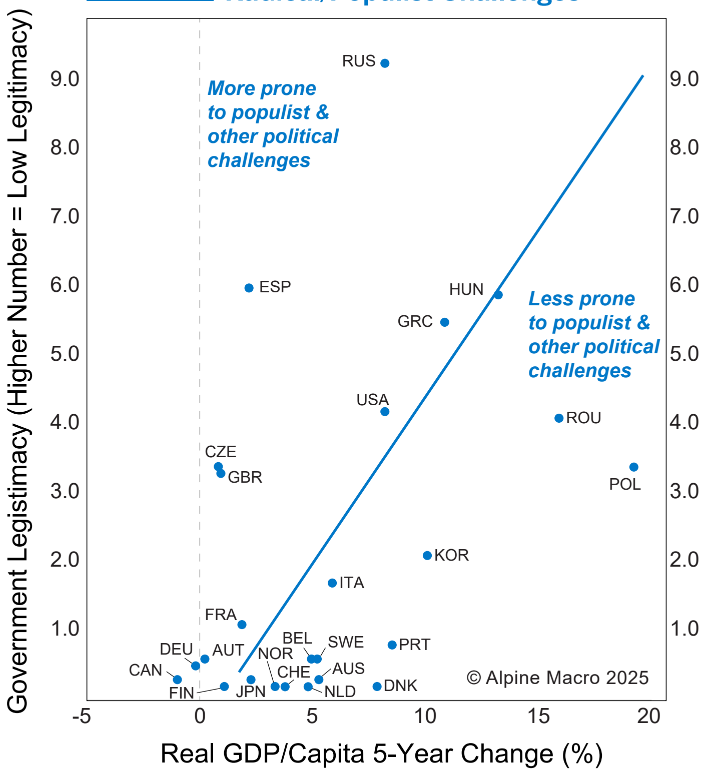
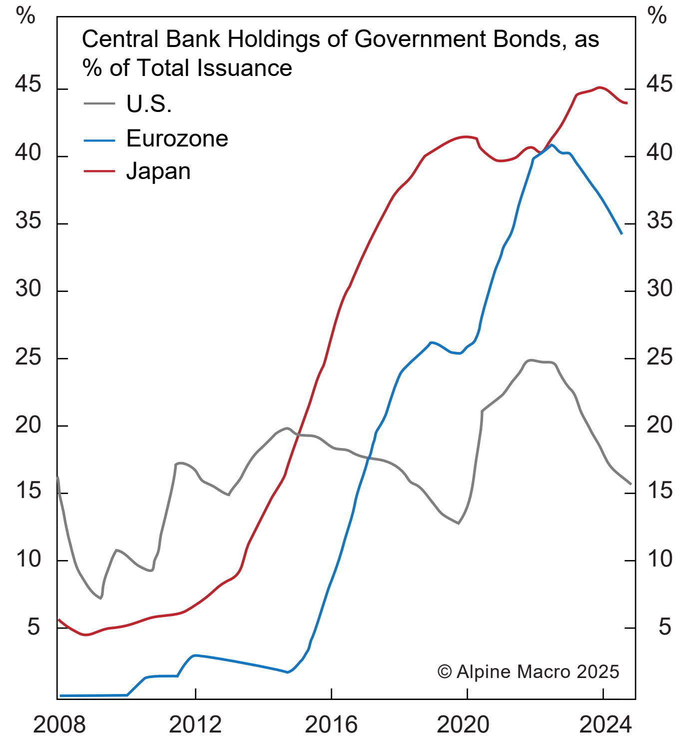


Chart 9 Central Banks' Holdings Of Government Bonds



Source: Haver Analytics

change (**Chart 7**). Even with Green Party support, it would require votes from the far-left Left Party, a politically costly move (i.e., the far-right AfD remains excluded from any deals). Merz also won't lift the debt brake unless the money goes to investments and not to social spending, clashing with left-wing parties. Lifting or modifying the debt brake will thus remain uncertain, and if it happens, will take time (possibly into 2026). A surprise scenario: the current lame-duck Parliament preemptively lifts the brake in the next 1-2 months – plausible, but this faces major legal and political hurdles.

Germany's election also underscores Europe's broader dilemma: deeper federalization or a looser "Europe of nations"? Historically, federalization dominated, but the rise of right-wing nationalist parties makes that path increasingly difficult.

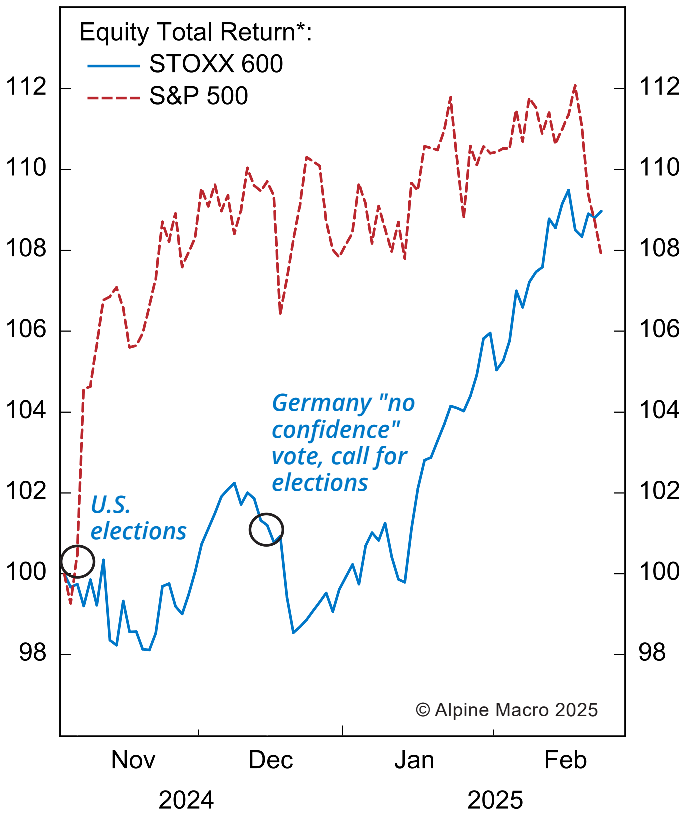
Given this dynamic, a fiscal or joint military union is unlikely, and even a capital markets union faces resistance, as most states — including Germany — refuse to cede power to Brussels. With economic stagnation and weakening government legitimacy, more populist, decentralization-focused leaders are likely to emerge (**Chart 8**), further complicating deeper integration[3].

Without a fiscal union, the Eurozone risks "Japa-nification" — low growth, high debt, and aging demographics, forcing the ECB to prop up sovereign debt, mirroring BoJ policies (**Chart 9**) which would weigh on growth[4].

3 Alpine Macro *Geopolitical Strategy* "Populism Does Not Really Matter" (August 29, 2024).

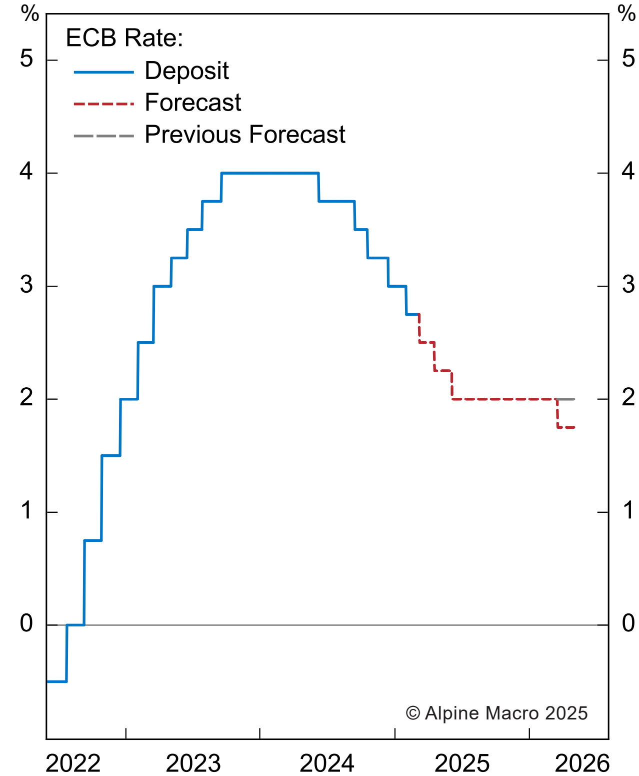
4 Brookings "Structural Drivers of Eurozone Underperformance" (December 20, 2024).

Chart 10 E.U. Stocks Have Performed Well Recently



*In EUR terms; Series are reabsed to Nov 2024=100

Chart 11 ECB Rates May Fall Further Than Previously Foreseen



Source: Bloomberg Survey of Economists, Feb 7-13, 2025

Bottom line: Europe remains structurally stuck with gradualist, muddle-through policies, and it is hard to see a more dynamic growth model.

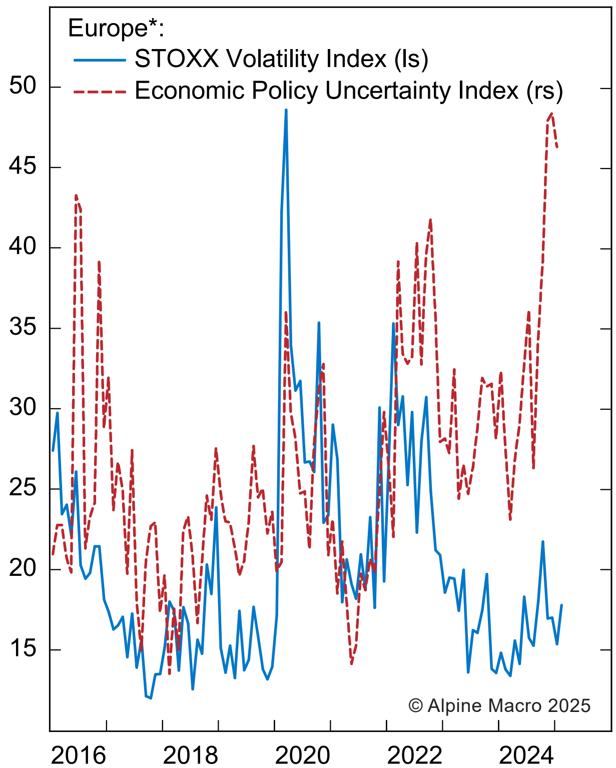
Some Implications

E.U. equities have outperformed recently, driven by German election optimism and relative softness in U.S. stocks (**Chart 10**). Investors see U.S. headwinds — tariffs, AI-driven disruptions, plausible inflation, and consumer weakness risks — while expecting lower ECB rates, a Russia-Ukraine peace dividend, and fiscal loosening in Germany to support European stocks.

However, the E.U. equity rally may fade. Of its drivers, only ECB rate cuts are very likely (**Chart 11**). A trade war with the U.S. will probably be contained but will pose risks. The Ukraine peace dividend will be small and delayed, and German reforms may disappoint. Rising E.U.-China trade tensions could also weigh on market sentiment. E.U. policymaking could also pose a risk: **Chart 12** shows how European equity volatility has been rather low despite rising policy uncertainty.

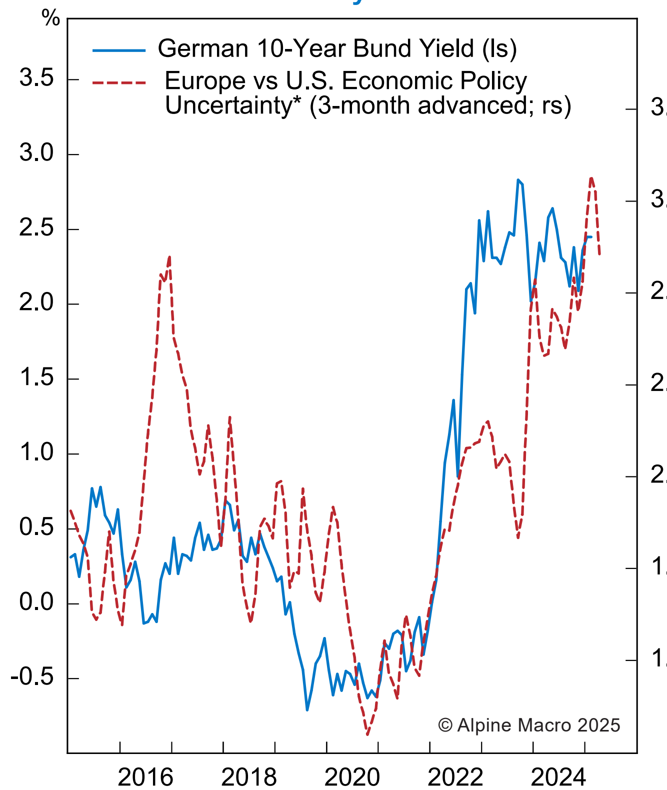
Some sectors will have policy tailwinds. Aerospace & Defense has surged due to military spending, and more military spending is likely, but with the Russia war cooling, outperformance may be peaking. Financials could gain from capital markets union progress (or hopes thereof), though ECB rate cuts could squeeze margins.

Chart 12 Will Europe's Economic Policy Uncertainty Lead To Market Volatility?



*Shown as 1-month moving average

Chart 13 Relative European Policy Uncertainty And Bund Yields



*Shown as 3-month moving average.

The euro is likely to drift toward USD parity, driven by lower interest rates and cyclical factors, outweighing geopolitical concerns. U.S. tariffs could further weaken the euro.

German bunds remain attractive, especially if Germany's debt brake stays intact and fiscal expansion stalls. Potential French elections/political instability could further drive investors to safe-haven assets. **Chart 13** shows bunds' relationship to relative E.U. vs. U.S. policy uncertainty, underscoring Europe's higher economic risks and the safe-haven appeal of German debt.

Dan Alamariu
Chief Geopolitical Strategist

A Unique Mind On The Markets