

Europe: towards an accelerated increase in defence spending

American interventionism in the conflict in Ukraine is upsetting the geopolitical balance. In the short term, it would above all encourage European governments to rapidly increase their military defence spending. Although some States are facing deteriorating public finances, the European Union nevertheless has tools and assets. The region has a completely contained public debt (90% of GDP for the euro zone, compared with more than 120% for the United States), as well as a large surplus of savings. This outlook for higher spending partly explains the continued very good performance of European equity markets, with defence stocks up more than 15% since the beginning of the year

Towards an increase in public spending. This week's announcement of negotiations between the United States and Russia over Ukraine and the threats of American disengagement from European security have potentially major geopolitical implications. But in the short term, they raise above all and more acutely the question of defence spending within EU countries, as well as its financing. Indeed, in this hardening context, it is very likely that governments will rapidly increase their defence spending, at least to the threshold of 2% of GDP per year, the threshold provided for by the NATO treaty. If France and the United Kingdom are already there, this would require an effort for economies such as Germany, Italy or Spain, of 0.5 points of GDP more per year. However, this effort comes in a context of deteriorating public finances following the Covid and energy crises post-War in Ukraine. In response, it is therefore quite likely that the European Commission will make choices such as i) a relaxation of fiscal rules, e.g. by excluding all or part of defence spending from the

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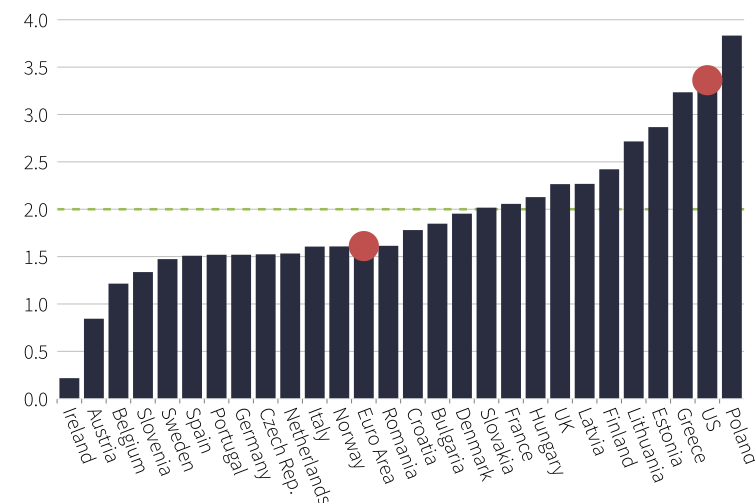
calculation of the public deficit, ii) a reallocation of unspent NGEU funds to defence spending or iii) agreeing between governments on a new dedicated EU borrowing plan.

The European Union has the means to cope. Although the public debt of some countries appears to be high, it is important to stress that at the aggregate level, the public debt of the euro area remains relatively contained (at 90% of GDP compared to more than 120% in the United States) and thus offers clear budgetary room for manoeuvre. Savings are another major asset that Europe has, with even an excess compared to its current investments. Indeed, Europe has significant external surpluses (around 4% of GDP), while the United States has a significant external deficit. These include Germany with a surplus of 6% of GDP, Spain with 3% and Italy with 1%. France's external balance is in balance. Thus, the solidity of the external accounts of the European economies remains an asset that should enable them to ensure the financing of new defence efforts without necessarily resorting to external debt and therefore without generating pressure on sovereign rates.

Equity markets supported by the prospect of higher spending. Despite the hardening geopolitical context, European equity markets continue to improve, with the Eurostoxx 600 rising by 3.5% in February and by 9% since the beginning of the year. Companies in the defence sector contribute to this very good performance, with a 9% increase since the beginning of the year. The markets believe that this defence effort will result in a sharp rebound in the order books of these companies. On the bond side, the prospect of more spending and therefore more issuance has resulted in a modest rise in rates, with the Bund rate rising to 2.5% and 3.3% for the OAT.

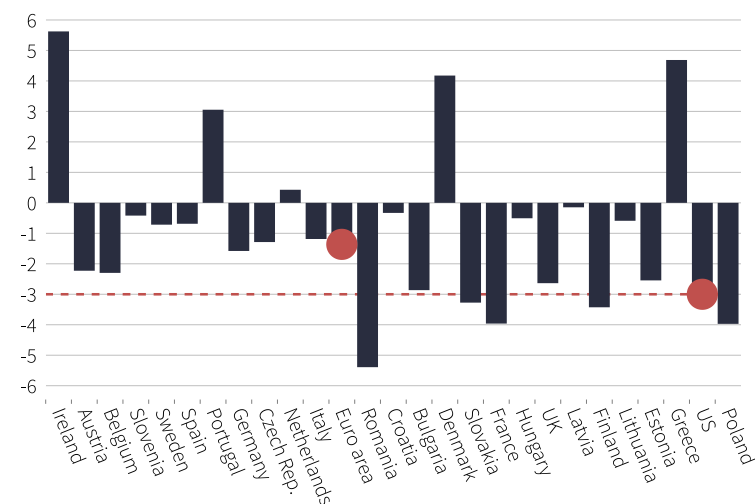
MILITARY DEFENSE EXPENDITURES

As % of GDP, 2023



GENERAL GOVERNMENT PRIMARY BALANCE

As % of GDP, excluding debt service, 2024



OUR MACRO COMMENTS

Events of the week

PMI activity index

The euro area Composite PMI remained stable at 50.2 in February, still in a slight expansion zone. Growth in activity was mainly driven by services (Services PMI at 50.7), although the pace of expansion is slowing. The manufacturing component remains in contraction territory, but is showing signs of improvement, with an index at its highest level since September 2024. In France, the PMI indices suggest a negative picture, with a sharp decline in the services index to 44 from January's level of 48. This decline should be moderated, as the PMI is historically a poor leading indicator of French growth. For the euro area, however, February's PMI data confirms our scenario of modest economic growth in the eurozone in the months ahead.

United Kingdom: inflation surprises on the upside

Inflation came as a clear upward surprise in January. Headline inflation rose to 3%, from 2.50% in December, while core inflation rose to 3.8%. While higher energy prices contributed to the upward surprise, several service components also posted rises more than 3%. These figures did not, however, significantly alter the Bank of England's expectations for market downturns, which remain at 2 rate cuts of 25bp by 2025.

THE WEEK IN DATA

| Country | Data | Actual | Last | Forecast |
|----------------|---------------------------|--------|-------|----------|
| United Kingdom | Unemployment rate January | 4,40% | 4,40% | 4,40% |
| | Inflation rate January | 3,00% | 2,50% | 2,80% |
| Japon | Inflation rate January | 4,00% | 3,60% | 4,00% |
| Euro area | Composite PMI January | 50,2 | 50,2 | 50 |
| Germany | Manufacturing PMI January | 46,1 | 45 | 45,1 |
| France | Composite PMI January | 44,5 | 47,6 | 47,2 |

Source: Macrobond, February 21, 2025. The colors in the 'Actual' column correspond to the difference from the forecast

KEY EVENTS NEXT WEEK



Monday

Germany Ifo Business Climate

Wednesday

Germany Gfk Consumer Confidence

Thursday

Spain Inflation Rate February
United States -Durable good orders MoM January
 -Initial jobless claims

Friday

France Inflation rate February
Germany Inflation rate February
United States PCE Price Index YoY January

Saturday

China Manufacturing PMI February

MARKET PERFORMANCES

Interbank rates

| % | 19/02/2025 | 21/01/2025 | 21/11/2024 | 01/01/2024 | 21/02/2024 |
|-------------------|------------|------------|------------|------------|------------|
| US SOFR | 4,349 | 4,35 | 4,73 | 5,34 | 5,32 |
| Euro area €ster | 2,665 | 2,92 | 3,17 | 3,88 | 3,91 |
| UK SONIA | 4,454 | 4,70 | 4,70 | 5,19 | 5,19 |
| Switzerland SARON | 0,444 | 0,45 | 0,96 | 1,70 | 1,69 |
| Japan TONAR | 0,477 | 0,23 | 0,23 | -0,04 | -0,01 |

10Y Government rates

| % | 20/02/2025 | 21/01/2025 | 21/11/2024 | 01/01/2024 | 21/02/2024 |
|---------------|------------|------------|------------|------------|------------|
| US Treasuries | 4,50 | 4,57 | 4,43 | 3,88 | 4,32 |
| France OAT | 3,22 | 3,27 | 3,09 | 2,55 | 2,91 |
| Germany Bund | 2,53 | 2,48 | 2,31 | 2,02 | 2,43 |
| Italy BTP | 3,61 | 3,59 | 3,56 | 3,70 | 3,93 |
| Spain Bonos | 3,20 | 3,14 | 3,03 | 2,98 | 3,35 |
| Switzerland | 0,54 | 0,37 | 0,41 | 0,66 | 0,83 |
| UK Gilts | 4,61 | 4,57 | 4,43 | 3,60 | 4,16 |
| Japan JGB | 1,42 | 1,19 | 1,06 | 0,62 | 0,73 |

Credit

| % | 20/02/2025 | 21/01/2025 | 21/11/2024 | 01/01/2024 | 21/02/2024 |
|------------------|------------|------------|------------|------------|------------|
| United States IG | 5,28 | 5,33 | 5,25 | 5,06 | 5,40 |
| United States HY | 7,20 | 7,23 | 7,23 | 7,59 | 7,90 |
| Europe IG | 3,42 | 3,52 | 3,49 | 3,72 | 4,04 |
| Europe HY | 5,46 | 5,81 | 5,80 | 6,80 | 6,68 |
| Emerging FX | 6,26 | 6,38 | 6,30 | 6,77 | 7,02 |

Equity indices

| 20/02/2025 vs | -1w | -1m | -3m | 01/01/2024 | -1y |
|-------------------|-------|--------|-------|------------|---------|
| World | -0,16 | 1,596 | 3,66 | 24,93 | 19,967 |
| United States | -0,12 | 0,846 | 2,55 | 28,95 | 23,210 |
| Euro area | -0,62 | 5,136 | 12,89 | 20,61 | 16,639 |
| France | -0,73 | 4,267 | 12,40 | 10,79 | 8,004 |
| Germany | -0,79 | 6,184 | 15,37 | 29,61 | 27,491 |
| United Kingdom | -0,67 | 1,493 | 6,11 | 15,25 | 15,237 |
| Japan | -0,86 | 0,755 | 2,16 | 18,19 | 6,041 |
| Emerging | 0,64 | 3,853 | 4,85 | 17,94 | 16,680 |
| China USD | -0,36 | 13,608 | 13,92 | 34,20 | 42,274 |
| India USD | 1,15 | -3,117 | -7,20 | 4,93 | -0,613 |
| Latin America USD | -0,09 | 9,821 | 4,72 | -15,51 | -12,045 |

Foreign exchange rates

| | 20/02/2025 | 21/01/2025 | 21/11/2024 | 01/01/2024 | 21/02/2024 |
|---------|------------|------------|------------|------------|------------|
| EUR/USD | 1,05 | 1,04 | 1,05 | 1,11 | 1,08 |
| GBP/USD | 1,26 | 1,23 | 1,26 | 1,27 | 1,26 |
| EUR/CHF | 0,94 | 0,94 | 0,93 | 0,93 | 0,95 |
| USD/JPY | 149,54 | 155,34 | 154,42 | 141,03 | 150,28 |
| USD/CNY | 7,28 | 7,31 | 7,24 | 7,08 | 7,19 |

Commodity prices

| | 20/02/2025 | 21/01/2025 | 21/11/2024 | 01/01/2024 | 21/02/2024 |
|------------------------|------------|------------|------------|------------|------------|
| Brent, USD/BL | 77 | 79 | 74 | 77 | 83 |
| Copper, USD/Metric ton | 9 515 | 9 067 | 8 946 | 8 476 | 8 472 |
| Gold, USD/Troy oz | 2 939 | 2 745 | 2 670 | 2 063 | 2 026 |
| Silver, USD/Troy oz | 33 | 30 | 31 | 24 | 23 |
| Palladium, USD/Troy oz | 985 | 944 | 1 028 | 1 136 | 973 |
| Platinum, USD/Troy oz | 976 | 947 | 960 | 1 000 | 902 |

Source : Bloomberg on 21 February 2025, 1W = 1 week change, 3M = 3 month change, 12M = 12 month change, YTD = year to date change, Equities; total return in local currency. Government bonds = 10 year returns. Figures are rounded.

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