RBC BlueBay
Asset Management

Market Commentary

Europe feeling ghosted by its former best friend

But could this result in deeper integration?

Key points:

- US pushes for Ukraine peace, exposing EU's military reliance on Washington, prompting urgent defencespending discussions.
- UK's fiscal constraints challenge defence budget increases, risking political fallout for Labour leaders amid a public dependent on government support.
- Japan's Q4 growth spurs BoJ towards continued monetary policy normalization, with potential rate hikes expected as JGB yields rise and yen strengthens.
- EU's joint defence funding could signal deeper integration, potentially benefiting regional spreads, but German elections may show a surge in populist sentiment.

21 February 2025 (London) – A US push towards a Ukraine peace deal with Russia has left Europe scrambling to respond during the past week. Broadly speaking, it speaks volumes in terms of the EU's military insignificance that the bloc doesn't even merit representation in the same room when talks are held.

With European capitals already left indignant by Washington's attitude towards them in the wake of last week's inflammatory speech by Vice President Vance, there is a rapid realisation that the former status quo and assumed world order has shifted, and Europe needs to respond with some urgency.

This has piqued the desire to materially increase defence spending across the region, with a push to agree that this be funded at an EU level, outside of national budgets and pre-existing fiscal rules.

However, reaching an agreement to increase spending is only part of the issue. The reality is that the EU has very limited defence industry capacity. Any plans will take years, not months, to put the EU in a position whereby it is able to defend itself without ongoing US support.

In the shorter term, the EU will also have to spend money on US weaponry, as well as building its own defence sector.

At least it seems that ESG opposition relating to this space seems to be getting brushed aside. Arguably, it seems to have dawned on investors and stakeholders that nothing is a sustainable investment if you aren't able to underwrite your own security.

In many respects, this push to raise defence spending should not really take markets too much by surprise given how much this has been discussed in recent months. Yet, it seems that the implications of the new reality in Washington are only still beginning to hit home, with commentators still reacting to incoming news.

From an economic standpoint, increased defence spending infers higher government debt levels, and this will be a factor holding up bond yields in quarters to come. Indeed, European fixed income yields have underperformed on the back of these concerns over the past week.

However, in the year ahead, we doubt that there will be much of a fiscal multiplier to boost growth from increased defence spending, especially if the EU is forced into importing the arms it needs.

In this context, it is hard to become much more constructive on the European growth outlook and we continue to see the ECB cutting rates to 2% in the coming 6 months.

Further easing could still be warranted should looming US tariffs further depress the growth outlook.

From this standpoint, we see conflicting drivers pushing yields in opposing directions, and we don't have a particularly strong view on European yields at this time. That said, we would see 10-year Bunds as starting to look cheap around 2.7%.

Meanwhile, in the UK, the lack of fiscal space puts the Labour government in an unenviable position.

Although the UK defence budget is above some other EU nations, it still needs to increase, noting that the British Army remains considerably under-strength in terms of manpower, versus strategic targets.

Yet, having to raise taxes or cut benefits will be politically unpopular and could end up costing Reeves and Starmer their jobs, given likely resentment from within their own Party ranks.

The furore around removing the winter fuel allowance for pensioners who were not dependent on other benefits this past winter, showed how difficult cutting spending has become, in a UK society that has become increasingly addicted to state handouts.

As it stands, we would assess that the UK is already at risk of breaching its OBR rules on the budget and this assessment itself is heavily dependent on eye wateringly optimistic projections for rapid productivity growth.

Consequently, this leaves the government with little room for manoeuvre, or scope to massage the calculations to paint a rosier picture.

Meanwhile, with wage growth and inflation moving higher, stagflationary risks lurk not far below the surface in the UK.

Growth remains non-existent and it is hard to see any cause to become more optimistic on the outlook. This being the case, we retain a downbeat assessment on UK gilts and the pound.

Meanwhile, the skies look much brighter in Japan. Stronger Q4 growth will have been well received by the Bank of Japan (BoJ) and helps cement the case for ongoing monetary policy normalisation.

We continue to see the next move to 0.75% cash rates in July, but there is a risk that this could come sooner, with the other BoJ meetings in Q2, also becoming considered as live events.

This being the case, JGB yields have continued to climb and as they have done so, we have continued to pare long held JGB shorts.

To give some context to the move we have now witnessed in Japan fixed income, JGBs as an asset class have now delivered a negative total return over the past 10-year period.

This said, we think there will be more domestic support for yields above 1.50% and in our estimation, the compelling trade in Japan is now to own the yen, rather than to be short in JGBs.

For a change, it has felt like US markets have taken more of a backseat over the past week. With the trading week itself shortened by President’s Day, there is a sense of consolidation in price action.

There is no reason to project any Fed cuts or hikes in the near term and this leaves 2-year yields anchored for now, at levels close to 4.3%, where cash rates sit.

The dollar has had something of a period of consolidation, since the greenback firmed ahead of the Presidential inauguration and equity markets have also traded sideways over the past couple of weeks, lacking a fresh catalyst to drive price action.

These conditions have been broadly supportive for credit products, though tight spreads limit the scope for corporate bonds to rally in a material way.

Short JGB positions have continued to be a positive driver of returns over the past several weeks.

In recent days a long position in Euro fixed income versus the US has detracted from returns. However, sovereign credit has benefited with Romania spreads narrowing on increased Ukraine peace hopes.

In addition, one might infer that a decision to jointly fund an increase in defence spending from the EU budget can be viewed as a step in the direction of closer Euro integration.

In this sense the Trump Administration may help drive the EU member states closer together and if this were the case, then this can benefit spreads across the region.

That said, German elections this weekend are expected to show populism on the march. In particular, it will be interesting to see if 'shy' AFD voters end up driving the vote share for the far right meaningfully above 20%.

Looking ahead

It is something of a cliché to state that we are living in uncertain times. However, geopolitical events are upending many long-held norms and there is a sense that this may end up having a pretty profound impact, not just on the world around us, but in financial markets too.

From this standpoint, we continue to position relatively conservatively and would push back on perceived complacency, where it may appear to exist.

Turning to Ukraine specifically, it strikes us that the US/Russia deal won't automatically mean the end to war in Ukraine, if Kyiv sees this as a bad peace, without security guarantees attached. In this case, it may determine that it makes sense to keep fighting and actually double down on its war effort.

Similarly, if a peace deal leads to a cessation of hostilities, there is no guarantee that a ceasefire will hold for long before confrontation starts again.

Moreover, if Russia ends up with a total victory in Ukraine, there is a growing sense that Putin may not stop there. The implications for Europe are frightening to contemplate, and it is not lost on well informed commentators that Russia's military output is now outstripping that of the rest of Europe put together.

Furthermore, the risk of a tidal wave of Ukrainian refugees will surely push tolerance around immigration beyond breaking point in a number of countries. This may push the continent in a more populist, more nationalist and right-wing direction.

Trump and Vance may look at Europe and cite the enemy within, and hope that these trends in place will help also cure the continent of the 'woke mind virus' the Administration is also waging war on in Washington DC.

But surely empowering Putin and other such strongmen can't be the right way to go, and hopefully the US will remember that its interests have been well served for the past 70 years by the existing world order……

Notes to Editors
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