28 November 2024

Outlook 2025 (I): Politics as a risk factor

At the end of November, we have a good tradition of reviewing the past months and looking ahead to the New Year. Today we light the first candle on our Advent wreath of forecasts and look at the economic outlook for 2025. Before the Second Advent, we turn our attention to monetary policy and interest rates and shed light on which segments of the bond market offer the best prospects in the coming year. In the third part of our series, we look at the stock markets and forecast the development of the most important stock indices. Finally, just before Christmas, we summarize all the important statements in the fourth part of our annual outlook and suggest what we consider a suitable asset allocation. In view of the numerous geopolitical crises and political uncertainties, forecasts are always fraught with considerable uncertainty. The election of Donald Trump as the new US president in particular, but also the failure of the "traffic light" coalition in Berlin, mean that political issues are influencing the development of the economy and capital markets more than usual and, at the very least, the perceived forecasting uncertainty is even greater than usual. Nevertheless, we do not want to let this put us off, because forecasts are still necessary in order to be able to make decisions under uncertainty. We hope you enjoy reading our articles, which you will also be able to watch as videos on our YouTube channel in the coming weeks.

https://www.youtube.com/mmwarburgco

Review: 2024 is like 2023 was

From an economic perspective, 2024 was largely a repeat of 2023: the global economy grew by around three percent, once again at a moderate rate. On the positive side, a recession was avoided; on the negative side, growth was half a percentage point lower than in the pre-coronavirus period.

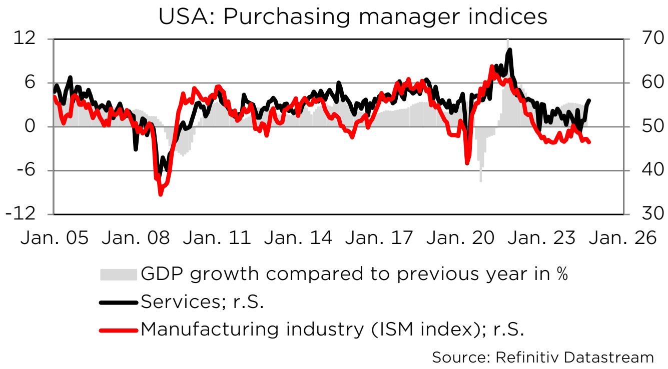
This is primarily due to the weaker economic momentum in the emerging markets. Among the major regions, Asia continues to grow faster than Eastern Europe and Latin America, but economic momentum has slowed in all regions in recent years. In Asia, the weaker growth is due in particular to China, where the growth rate has slowed significantly and continuously in recent years to just 4.5 percent this year. In China, the struggling real estate market and weak private consumption are weighing on development. Youth unemployment has risen sharply and the Chinese leadership's attempt to combat weak domestic demand by increasing exports has not worked. In contrast, India is developing into the new growth engine: in 2024, the Indian economy will grow again by almost seven percent, primarily because the young population is consuming a lot and the state is investing heavily in infrastructure.

The industrialized countries, on the other hand, are growing by just under two percent again this year. This is mainly due to the USA, where economic development once again surprised on the upside. In 2024, real US GDP will increase by 2.8 percent. Higher real incomes and positive wealth effects from higher share and property prices have once again supported private consumption, while companies have also invested a lot of money in new investments. The trend in the Eurozone and in Germany in particular was quite different and unfortunately negative. Instead of the slight upturn that had been hoped for, Germany remains in a state of economic lethargy. After a decline in real gross domestic product of 0.3 percent in 2023, the negative trend is continuing this year at -0.2 percent. The industry, which is stuck in its third year of recession, is responsible for the weak development. A lack of orders, high energy prices, excessive bureaucracy and declining competitiveness mean that companies are not investing, exporting less and massively reducing their production. It doesn't help that service companies are doing slightly better and private consumption is growing minimally again in 2024 thanks to rising real incomes.

So is Germany the sick man of the Eurozone? On the one hand, yes, because the Eurozone's largest economy has been struggling to grow since 2018. On the other hand, other countries in the Eurozone are also having problems with economic growth. These include France and Italy, but also Austria. Thanks to stronger growth in countries such as Spain, Portugal and Greece, the economic situation in the Eurozone as a whole is slightly better than in Germany, meaning that a growth rate of 0.7 percent will be achieved in 2024.

USA: In Trump we trust

Political developments have the potential to have a major impact on the economy and capital markets in 2025. In the US, Donald Trump's clear election victory is likely to be seen as a mandate to implement his political agenda swiftly and extensively. For example, the corporate tax rate is to be reduced from 21 to 15 percent. This will significantly improve the international competitiveness of US companies. The new US government is also focusing on deregulation and cutting red tape. The economy should benefit from this, meaning that the US should continue to grow faster than most other economies in the group of industrialized countries in 2025. We expect real gross domestic product to increase by around 2.5 percent, although this forecast is subject to upside risks ¬ growth could therefore be even stronger than we currently expect. Growth will continue to be driven by private consumption and corporate investment. While small and medium-sized enterprises have lost out to large companies in recent years, their prospects are brightening considerably under a Trump administration.



At the same time, Trump announced the introduction of tariffs. During the election campaign, he spoke out in favour of a general import tariff of 10 to 20 percent, and even 60 percent for Chinese products. Cars produced in Mexico could be subject to an import duty of 200 percent. In the meantime, Trump has specified initial measures that he intends to adopt immediately after his inauguration: all products from Mexico and Canada are to be subject to a 25 percent tariff so that these two countries can take action against drug smuggling and illegal immigration into the USA. Chinese imports are to be subject to an additional duty of ten percent because China supplies chemicals to Mexico that are used there for drug production.

Tariffs are similar to consumption taxes, as they are usually added to the sales price and therefore make imported products more expensive. In this respect, tariffs could lead to a higher inflation rate in the USA. However, it is difficult to predict the possible extent of this from today's perspective, especially as it is not yet clear when the tariffs will be introduced and how high they will actually be, and higher prices also have a steering effect. If demand for more expensive foreign goods declines because the price elasticity of demand is minus one, the general price level will not be affected by the tariffs. Without tariffs, the PCE inflation rate observed by the US Federal Reserve is likely to fall to below two percent on average in the coming year; even with tariffs, the Federal Reserve's two percent target could be achieved. By contrast, the core PCE inflation rate excluding energy and food prices is likely to average just under 2.5 percent for the year. As the real key interest rate in the US remains very high and therefore restrictive, the US Federal Reserve will therefore continue to cut interest rates until the end of 2025.

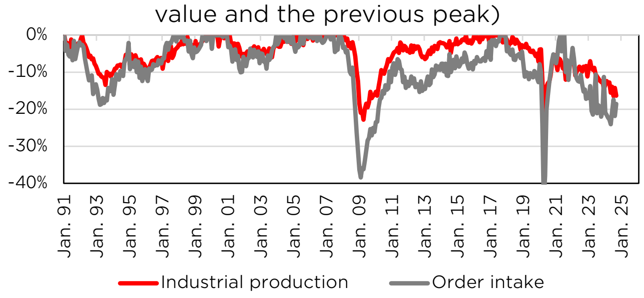
Germany: Sluggish growth continues

The structural problems of the German economy will be exacerbated by the expected protectionist trade policy of the USA. This is because the USA is our most important export market. Last year, the German trade surplus amounted to 63 billion euros, which corresponds to 1.5 percent of nominal gross domestic product. This year, the surplus is likely to be around 70 billion euros. The most important export goods are cars, pharmaceutical products and machinery. These would be hit hard by a US import tariff. We therefore assume that exports to the US will be lower in 2025 and that the bilateral trade surplus will fall. The extent of this decline will of course depend on the trade policy countermeasures expected from the EU.

The current domestic political situation in Germany is also having a negative impact on growth prospects. Although many greeted the end of the "traffic light" coalition with relief, the political uncertainties will not immediately disappear with the federal elections, which are expected to take place on February 23. On the contrary: the formation of a new federal government is likely to be complicated and take a long time. There will probably be a new "GroKo" or a three-party alliance, but there could be political gridlock until next summer, paralyzing the country and the economy. It is uncertain whether and how quickly urgently needed reforms to improve Germany's competitiveness will be adopted afterwards. A tax reform that reduces corporate taxes in Germany from around 30 percent to a competitive level and the necessary funds for investment in infrastructure and armaments are unthinkable without a reform of the debt brake. However, this requires a two-thirds majority in the Bundestag and Bundesrat.

All in all, German economic output is likely to decline again slightly in 2025; we expect real GDP to fall by 0.2 percent. Although private consumption will increase again slightly next year thanks to rising real wages (+0.4 percent), growth will remain below average due to consumer uncertainty. The savings rate, on the other hand, remains high. The structural weakness of German industry (industrial production and incoming orders are almost 20 percent below the highs of mid-2018) and the deteriorating outlook for global trade are likely to lead to declining investments (equipment -2.8 percent, buildings -1.1 percent) and exports (-2.3 percent). There is a threat of a fifth consecutive decline in construction investment. There is a growing risk that the recession in industry will spread to the service sector, which has been growing slightly to date.

Germany: Industrial production and new orders (difference between the current value and the previous peak)



Source: Refinitiv Datastream

The ongoing economic weakness will also have a negative impact on the labor market. We expect the annual average number of unemployed to rise from 2.8 million to 3.0 million. The worsening situation on the labor market means that the upcoming wage agreements will be significantly more moderate than in the past three years, as the issue of job security is becoming a priority for the trade unions. This is another reason why the average annual inflation rate in 2025 will be below two percent for the first time since 2020.

Eurozone: Just above zero

Despite the election of Donald Trump and the difficult political situation not only in Germany but also in other countries, most economic forecasts for the Eurozone in 2025 are characterized by cautious optimism. For example, the European Commission is forecasting gross domestic product growth of 0.9 percent in 2025, compared to 0.8 percent in 2024. We do not agree with this forecast: We expect economic growth to be just above the zero line at 0.2 percent.

This is because, in addition to Germany, France and Italy are also experiencing very difficult economic conditions. In France, the purchasing managers' indices for both the manufacturing industry and the service sector are well below the 50-point mark and even lower than in Germany. In addition, the country is governed by a minority government and it is not clear how long it will be able to stay in office.

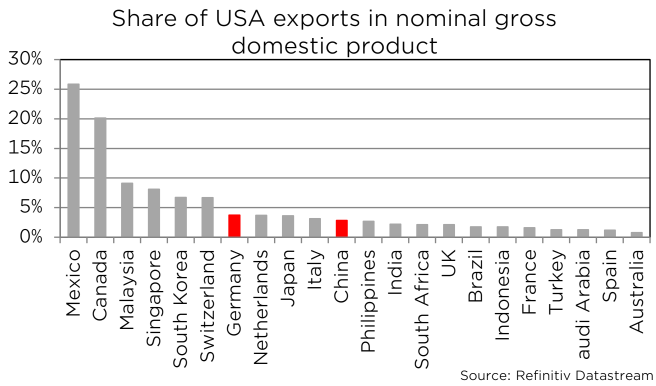
The high levels of public debt in France (112 percent of GDP) and Italy (138 percent) are forcing both countries to adopt a more restrictive fiscal policy in order to prevent budget deficits from spiraling out of control. The

French government is planning tax increases and spending cuts, which will have a negative impact on companies' willingness to invest. However, private consumption also offers little scope for positive surprises. At the same time, the entire Eurozone is vulnerable to higher US tariffs, as Germany is not the only country with a high trade surplus with the US. However, as neither Germany nor France will have governments capable of taking action when Trump takes office in January 2025, US tariffs could be introduced without major political resistance from the Eurozone. It can therefore be assumed that both exports and investments will come under pressure in 2025.

Due to the weak economy, companies in the Eurozone have little scope to pass on prices. This suggests that the inflation rate will fall to below two percent on average in the coming year. Ten of the twenty Eurozone countries already have an inflation rate of two percent or less. For the overall inflation rate to fall further, the still very high rate of price increases for services in particular must fall. This has remained virtually unchanged at four percent month after month for around a year. However, the gradual cooling of the labor market should ensure that wage pressure gradually eases and thus services prices rise less sharply. This will enable the European Central Bank to lower interest rates further in the coming year towards the neutral interest rate of around two percent.

Global economy: More protectionism slows growth

A potential trade war triggered by US President Trump would not only have a negative impact on growth prospects in Germany and the Eurozone, but also in all countries that export to the US to any significant extent. This represents a considerable burden for the global economy in the coming year. Among the industrialized countries, Canada and Switzerland are particularly affected, but also the Netherlands and Japan, for example. However, not only the industrialized countries, but also the emerging markets could be negatively affected by trade restrictions, possibly even more so.



Among the emerging markets, the focus will be on China in particular, which Trump already had on his mind during his first term in office. The consequences could be even more dramatic for Mexico, whose exports to the US account for a good 25 percent of Mexican GDP. So if Trump is serious about his announcements (which we assume he will be), we believe that the IMF's growth forecast for the global economy published in October 2024 is too optimistic. Instead of around three percent again, global economic growth could be significantly lower in 2025. Especially as the former growth engine of the global economy, China, is still struggling with considerable structural problems. The unresolved problems on the real estate market and, above all, the negative demographic trend could dampen growth more than expected in 2025 and subsequent years. The United Nations assumes that the Chinese population will shrink from the current 1.4 billion people to 1.3 billion by 2050. By 2100, the Chinese population is even expected to almost halve to just under 800 million people. This is likely to have a dramatic impact on China's future economic growth, as private consumption and investment will also fall as the population shrinks. However, this is (fortunately) not yet an issue for economic growth in 2025.

Our conclusion for the economic outlook 2025 is: from an economic perspective and with a view to Donald Trump's second term in office, expect the worst but hope for the best. We are excited to see what surprises the next few months will bring.

Carsten Klude

Market data

Stock marktes	As of 29.11.2024 09:07	Change versus 22.11.2024 -1 week	28.10.2024 -1 month	28.08.2024 -3 months	28.11.2023 -1 year	29.12.2023 YTD
Dow Jones	44722	1,0%	5,5%	8,8%	26,3%	18,7%
S&P 500	6028	1,0%	3,5%	7,8%	32,3%	26,4%
Nasdaq	19060	0,3%	2,7%	8,6%	33,5%	27,0%
DAX	19426	0,5%	-0,5%	3,4%	21,5%	16,0%
MDAX	26226	0,2%	-4,1%	4,0%	0,8%	-3,4%
TecDAX	3397	0,8%	-0,7%	1,1%	8,4%	1,8%
EuroStoxx 50	4759	-0,6%	-4,2%	-3,1%	9,4%	5,2%
Stoxx 50	4295	-0,5%	-3,5%	-4,9%	8,9%	4,9%
SMI (Swiss Market Index)	11710	-0,1%	-4,3%	-5,2%	8,8%	5,1%
Nikkei 225	38208	-0,2%	-1,0%	-0,4%	14,4%	14,2%
Brasilien BOVESPA	124610	-3,5%	-5,0%	-9,3%	-1,5%	-7,1%
Indien BSE 30	79820	0,9%	-0,2%	-2,4%	20,6%	10,5%
China CSI 300	3917	1,3%	-1,2%	19,2%	11,3%	14,1%
MSCI Welt	3789	0,6%	2,0%	4,4%	25,8%	19,6%
MSCI Emerging Markets	1080	-0,7%	-5,1%	-1,6%	9,6%	5,5%
Bond markets						
Bund-Future	134,37	126	135	28	244	-285
Bobl-Future	119,66	57	61	191	242	38
Schatz-Future	106,97	-2	6	72	174	42
3 Monats Euribor	2,91	-11	-14	-59	-104	-100
3M Euribor Future, Dec 2024	2,82	7	7	-19	-19	52
3 Monats $ Libor	4,60	-3	-10	-61	-87	-80
Fed Funds Future, Dec 2024	4,52	-1	0	1	12	68
10 year US Treasuries	4,22	-20	-5	38	-13	35
10 year Bunds	2,11	-14	-18	-9	-35	11
10 year JGB	1,04	-3	10	14	28	42
10 year Swiss Government	0,28	-7	-16	-16	-64	-42
US Treas 10Y Performance	604,32	1,4%	0,5%	-2,2%	4,8%	0,6%
Bund 10Y Performance	574,94	1,1%	1,6%	1,7%	5,7%	1,7%
REX Performance Index	456,19	0,3%	0,8%	1,2%	4,5%	1,9%
IBOXX AA, €	2,90	-8	-8	-27	-75	-17
IBOXX BBB, €	3,36	-8	-10	-32	-107	-39
ML US High Yield	7,38	-5	-1	-10	-123	-41
Commodities						
MG Base Metal Index	413,14	0,1%	-4,1%	-1,2%	9,2%	5,7%
Crude oil Brent	72,71	-3,0%	1,0%	-8,0%	-11,0%	-6,4%
Gold	2660,15	-1,7%	-3,0%	6,1%	30,7%	28,8%
Silver	30,07	-3,7%	-10,8%	2,4%	20,3%	24,0%
Aluminium	2572,47	-0,9%	-1,5%	4,3%	18,4%	9,7%
Copper	8884,35	0,4%	-5,5%	-2,7%	5,9%	5,0%
Iron ore	102,17	0,2%	-1,9%	3,7%	-21,6%	-25,1%
Freight rates Baltic Dry Index	1419	-7,7%	2,7%	-19,1%	-40,7%	-32,2%
Currencies						
EUR/ USD	1,0572	1,5%	-2,3%	-4,9%	-3,4%	-4,3%
EUR/ GBP	0,8315	0,0%	-0,2%	-1,3%	-4,0%	-4,0%
EUR/ JPY	158,70	-1,3%	-3,9%	-1,2%	-2,5%	1,5%
EUR/ CHF	0,9317	0,5%	-0,5%	-0,6%	-3,4%	0,6%
USD/ CNY	7,2302	-0,3%	1,5%	1,4%	1,2%	1,8%
USD/ JPY	151,55	-2,1%	-1,1%	4,8%	2,8%	7,4%
USD/ GBP	0,79	-1,4%	2,1%	4,0%	-0,2%	0,3%

Source: Refinitiv Datastream

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