

IS EUROPE AT SEA?

REVIEW OF THE WEEK
3 MARCH 2025

SEISMIC GEOPOLITICAL CHANGES ARE WRENCHING THE POST-WAR GLOBAL ORDER, STRAINING THE TRANSATLANTIC PARTNERSHIP AND UPENDING SUPPLY CHAINS. INVESTORS ARE RECALCULATING FURIOUSLY, PUTTING FINANCIAL MARKETS IN FLUX AS WELL.

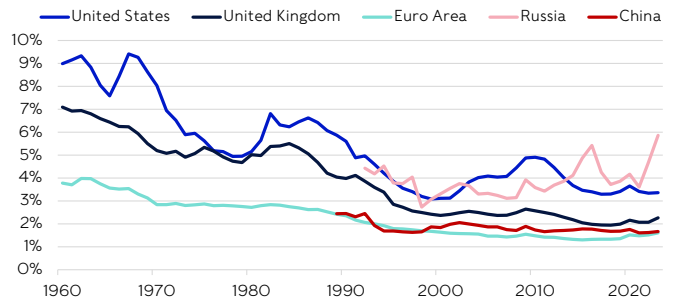
A disastrous Oval Office press conference that was supposed to reset jagged relations between US President Donald Trump and Ukrainian President Volodymyr Zelenskyy has instead pushed them further apart.

A meeting that was supposed to be a PR stunt ahead of signing a compromised form of the security-for-minerals deal originally offered by Trump degenerated into a shouting match and the Ukrainian delegation being ejected before signing. Zelenskyy says he would still sign the agreement if invited back, but there's been no suggestion so far that he will be. The US-led attempt to craft a ceasefire directly with Russia while sidelining Ukraine apparently remains in the works.

As Zelenskyy noted in the White House before the sparks flew, Russia has a habit of invading its neighbours and ignoring internationally recognised ceasefires and treaties. To ensure Ukraine's security – or, perhaps closer to the point, the security of all nations on the eastern flank of the Eurozone who are wary of Russia – strong defensive ties must be set in stone. Until now, the US has underwritten that security for the NATO alliance. Under Trump that defensive pact, once the closest to a concrete certainty you could get in geopolitics, is no longer a given.

Trump has lambasted the rest of NATO for its lack of military spending, arguing that Europe has failed to meet its target to spend at least 2% of GDP on defence. He's fighting the last war, however, as European nations have been increasing defence budgets for years. Whether that's driven because of Russia's invasion of Ukraine, the approach of Trump 2.0, or both, 23 members were estimated have spent more than 2% of their GDP on military outlays last year. Regardless, Trump wants NATO members to go further: he has said he wants 5%.

DEFENCE SPENDING (% GDP)



Source: World Bank, Stockholm International Peace Research Institute; data to 2023

UK Prime Minister Keir Starmer responded by raiding the foreign aid budget to transfer to military spending. By 2027, that would leave foreign aid at roughly 0.3%, down from 0.5%, and the defence budget at 2.6%. Europe has reacted as well, with leaders meeting to discuss how to ensure collective security in a new world where the US is no longer a reliable ally. France has called for all Europe to hit 3% defence spending. One of the deals the German government-in-waiting is hammering out to cement its coalition is funding for hundreds of billions of euros in defence and infrastructure spending. There are reports that this could amount to €400 billion for defence and €500bn for infrastructure over a decade. Deutsche Bank says such an amount would be roughly equivalent to all the investment in east Germany since reunification. Combined, that €900bn is a fifth of the nation's GDP or roughly 2% a year when spread over a decade. If Germany follows through, it would be a fiscal regime shift of historic proportions.

Uncertainty increases investor concerns

This potential for big increases in European defence spending has driven the mother of all rallies in defence companies, both here and on the Continent. This has been bubbling away for a while, yet defence stocks surged on Monday: at the time of writing, many were up by double-digits for the day. An index of European aerospace and defence contractors was up more than 30% year to date.

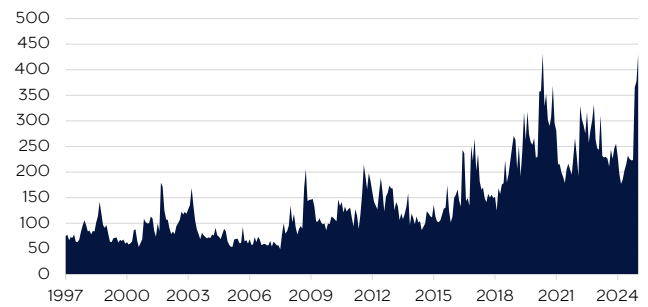
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That compares with a roughly 10% slide in US defence businesses since they peaked with Trump's inauguration.

As European and Canadian defence spending has increased as a proportion of GDP in recent years, US military spending has remained roughly flat at 3.4%, down from the most recent peak of roughly 5% in 2010. With entrepreneur Elon Musk's Department of Government Efficiency aiming to slash poor-value Pentagon contracts, how will America's defence spending stack up in the coming years? A recently leaked memo shows that Defense Secretary Pete Hegseth plans 8% annual cuts in the Pentagon's budget for the next five years. While Europe rearms, is the US – despite all the noise – doing just the opposite?

At the outset, Trump 2.0 was widely expected to be beneficial to US companies and detrimental to stocks in the rest of the world. While it's hurt Japanese companies, those in Europe and the UK have actually fared well so far. The geopolitical uncertainty that Trump has sparked has hit all-time highs according to the Baker, Bloom & Davis measure that goes back to the 1990s. The last reading was published at the end of January, and it's fair to assume that February's score will be even higher. This uncertainty has wiped out the investor optimism that accompanied Trump's election. The AAI US Investor Sentiment survey shows a greater proportion of investors are 'bearish', or concerned about the future, than at any time since the invasion of Ukraine, the Great Financial Crisis and the 1990 recession.

GLOBAL POLICY UNCERTAINTY SKYROCKETS UNDER TRUMP



Source: FactSet, Baker, Bloom & Davis; Global Economic Policy Uncertainty Index

The response has been a steady fall in the yield of the 'safe-haven' US 10-year treasury bond (i.e. its price has risen as investors buy more) while stocks, which are riskier, have slipped back slightly. Uncertainty is one of investors' greatest enemies because, unlike 'risk', it's hard to quantify. Uncertain policies lead you into different environments where your risk calculations may no longer stack up. It also means a very wide range of potential outcomes – both good and bad. This is why times of great change bring great opportunities, along with great risks. You can't have one without the other.

If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing review@rathbones.com. We'd love to hear from you.

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