

Fiscal conservatism and other global economic themes for 2025

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Key takeaways



Fiscal conservatism

Budget battles have contributed to government upheavals around the world, and the fiscal focus is growing.

Monetary policy

Central banks across the globe are attempting to manage current economic challenges and combat future headwinds.

Geopolitical risks

We're likely to see increased uncertainty and risks as wars continue, budget battles rage on, and democracies come under pressure.

Today marks my last Weekly Market Compass for 2024. But before we settle in for the holidays, I want to emphasize four key themes that I believe will drive global markets in 2025: A growing trend toward fiscal conservatism, the continued importance of monetary policy, increasing concerns about geopolitical risks, and technological innovation.

Theme 1: Fiscal conservatism

I believe fiscal conservatism will matter more in 2025. We've seen multiple recent examples of global markets being concerned about rising fiscal deficits:

- **France.** The no-confidence vote that ousted French Prime Minister Michel Barnier in early December was the result of a showdown over the French budget. The budget had previously been given a stamp of approval by the European Central Bank (ECB), but it met with disapproval from right-wing party leader Marine Le Pen. She objected to an increase in the electricity tax and wanted an increase in pension levels. French bond yields spiked in response to Barnier's ouster as well as the dysfunction related to not passing a 2025 budget in time, leading to the widest spread between the French 10-year government bond yield and the German 10-year government bond yield in more than a decade. (source: Bloomberg, as of December 13, 2024)
- **Germany.** The collapse of the German government in November was also the result of a budget battle. That battle caused German Chancellor Olaf Scholz to oust his finance minister, who represented a governing partner of Scholz's party. This effectively ended Germany's governing coalition, which had been in power since 2021. The current minority government cannot get a regular budget passed for 2025, so it must pass a supplementary budget. And on Dec. 16, Scholz lost a no-confidence vote – setting Germany up for snap elections in February and continued political uncertainty.
- **South Korea.** The short-lived martial law declaration by South Korean President Yoon Suk Yeol was partially the result of frustration over a budget battle with the opposition party. (Last week the opposition-controlled parliament passed its own budget, which cut government spending from Yoon's proposed budget.)
- **Brazil.** The recent drop in the Brazilian real was in response to disappointment around the rollout of spending cuts for 2025. Markets were unhappy with the lack of structural reforms as well as an expansion of income tax exemptions, which seemed unlikely to rein in Brazil's rising debt-to-GDP (gross domestic product) level.

We're likely to see more budget battles in 2025, including in the US, where the threat of bond vigilantism looms large and where policymakers of both parties are attempting to pursue their respective agendas while also reducing budget deficits. For example, incoming US Treasury Secretary Scott Bessent has set a goal of capping fiscal spending at 3% of GDP by 2028. As we head into the new year, it may be instructive for market watchers to brush up on the bipartisan National Commission on Fiscal Responsibility and Reform (known as the Simpson-Bowles Commission),

which made a valiant effort at fiscal reform but learned that almost every expenditure in the US federal budget was considered “off limits” by one party or another. Its proposals, however, were thoughtful and credible and hopefully will form the basis of renewed efforts to control and reform the federal budget and the budgeting process. The effort going forward needs to be a serious one in order to ensure credibility with markets and avoid bond vigilantes.

Theme 2: Monetary policy

I expect monetary policy to be an important driver of markets – stocks, bonds and currencies – in 2025. That’s because central banks are increasingly viewing themselves as primary care physicians. They’re treating current ailments but also providing prophylactics for anticipated future problems (and may be at risk of overprescribing). We got a taste of that recently with central banks attempting to manage current economic challenges and combat future headwinds through monetary policy actions.

Bank of Canada (BOC). Last week, the Bank of Canada decided to cut rates by 50 basis points, its fifth consecutive rate reduction since June. The BOC was clearly responding to signs of growing weakness in the labor market, as the November unemployment rate rose to 6.8%. (source: Statistics Canada, as of December 6, 2024) However, this was arguably also a preemptive move: The BOC is trying to protect the Canadian economy from the effects of more restrictive Canadian immigration policy in 2025, as well as the potential impact of US tariffs that may be levied against its goods. When announcing its decision, the BOC noted that “the possibility the incoming US administration will impose new tariffs on Canadian exports to the United States has increased uncertainty and clouded the economic outlook.”¹

Central Bank of Brazil. Brazil’s central bank hiked rates by 100 basis points last week in order to stabilize the real, which had been weakening on disappointment around the government’s spending cuts and income tax reform. The central bank indicated that there would be two more jumbo 100 basis point hikes by March. The Brazilian real rallied following the decision – but only briefly. It quickly gave back all its gains — and then some. In the midst of that selloff, the Central Bank of Brazil stepped in to conduct a spot auction on Friday, and it will no doubt continue to step in with different monetary policy tools as problems arise.

Swiss National Bank (SNB). The SNB surprised markets with a larger-than-expected interest rate cut of 50 basis points last week. The policy rate fell from 1% to 0.5% — the lowest it has been since 2022. Although a rate cut was anticipated, few were expecting a jumbo cut. The SNB is laser-focused on weakening its strong currency and preventing future strength, clearly concerned about greater European Central Bank easing driving up the Swiss franc. It’s also likely concerned that uncertainty around the policies of the incoming Trump administration in the US could drive flows into “safe haven” currencies such as the Swiss franc. The SNB wouldn’t rule out negative interest rates if needed.

European Central Bank (ECB). The ECB lowered its key policy rate by 25 basis points last week. This was the fourth cut in 2024, and it seems like there is far more easing to come; ECB Governor Francois Villeroy de Galhau admitted that “we are collectively rather comfortable with the financial markets’ interest rate forecasts for next year.”² the ECB has the unique task of presiding over a monetary policy union that is not a fiscal union, which presents additional challenges.

I should stress that fiscal policy will also matter in 2025, especially when it comes from China. The Politburo announced last week that Chinese stimulus will be very significant, as we anticipated. The fiscal stimulus is likely to be comprehensive, including support for consumers, and will be accompanied by monetary stimulus with a bias towards lower interest rates. This is one of the swing factors we articulated in our outlook that we believe should be positive for global growth and markets.

Theme 3: Geopolitical risks

Geopolitical risks are likely to increase in 2025. We went into 2024 with a lot of uncertainty because there were so many major elections taking place. However, geopolitical uncertainties and risks haven't ended just because these elections are over. If anything, we are likely to see increased uncertainty and risks in 2025 as wars continue, budget battles rage on, and democracies come under pressure. We should be prepared for periodic flights to "safe haven" asset classes such as the US dollar and gold, as well as the continued popularity of cryptocurrencies in this environment.

Theme 4: Technological innovation

I would be remiss if I didn't include artificial intelligence (AI) as an important theme for 2025 – and of course well beyond. Today feels analogous to the late 1990s, when we saw investment in technological innovation lead to greater productivity.

While this theme deserves its own blog, I will simply mention that we are increasingly seeing different ways AI is making industries and the overall economy more productive. That includes improving the efficiency of the machinery used to drill and pump oil, as artificial intelligence has helped to optimize production processes. That also includes saving thousands of coding hours for companies through the use of AI coding co-pilots. I think of AI as a way to help improve profitability and efficiency, especially for smaller companies.

Looking ahead

This week we will get monetary policy decisions from the Federal Reserve (Fed), the Bank of England and the Bank of Japan.

- Markets expect the Fed will give us a hawkish 25 basis point cut this week – although I think it would be better to pause at this meeting. I believe the US economy is in better shape than expected and it would be good to have some "dry powder" in case of a real need for easing in the coming year.
- The Bank of England is likely to sit on its hands after cutting rates in August and November.
- The Bank of Japan (BOJ) is also likely to sit on its hands at this meeting, but we know there is room for tightening. That's because the Bank of Japan's Tankan December survey revealed that even small Japanese companies have not felt more stress in their financial positions in a meaningful way despite the two rounds of rate hikes that the BOJ conducted this year. That means there is room to normalize albeit gradually. It is unlikely to happen at this meeting but should happen in upcoming meetings.

This sets us up for an environment, as we articulated in the 2025 outlook, where the US dollar might strengthen relative to currencies such as the euro and Canadian dollar but remain relatively neutral or even weaken relative to the British pound and the Japanese yen.

Dates to watch

Date	Report	What it tells us
Dec. 16	Eurozone preliminary Purchasing Managers' Indexes	Indicates the economic health of the manufacturing and services sectors.
	UK preliminary Purchasing Managers' Indexes	Indicates the economic health of the manufacturing and services sectors.
	Eurozone wage growth	Measures the change in hourly wages.
	Eurozone Labor Cost Index	Measures the change in the cost of labor for employers.
	US preliminary Purchasing Managers' Indexes	Indicates the economic health of the manufacturing and services sectors.
Dec. 17	UK Unemployment Rate	Indicates the health of the job market.
	German ZEW Economic Sentiment	Measures economic sentiment in Germany for the next six months.
	Canada Consumer Price Index	Tracks the path of inflation.
	US Industrial Production	Indicates the economic health of the industrial sector.
	US Retail Sales	Indicates the health of the retail sector.
Dec. 18	UK Consumer Price Index	Tracks the path of inflation.
	UK Producer Price Index	Measures the change in prices paid to producers of goods and services
	Federal Open Market Committee Monetary Policy Decision	Reveals the latest decision on the path of interest rates.
	Eurozone Consumer Price Index	Tracks the path of inflation.
	Bank of Japan Monetary Policy Decision	Reveals the latest decision on the path of interest rates.
	US Building Permits	Indicates the health of the construction industry.
	US Housing Starts	Indicates the health of the housing market.
Dec. 19	GfK German Consumer Climate	Measures the level of consumer confidence in economic activity in Germany.
	Bank of England Monetary Policy Decision	Reveals the latest decision on the path of interest rates.
	US Gross Domestic Product	Measures a region's economic activity
	US Existing Home Sales	Indicates the health of the housing market.

Dates to watch

Date	Report	What it tells us
Dec. 19	Bank of Mexico Monetary Policy Decision	Reveals the latest decision on the path of interest rates.
Dec. 20	UK Retail Sales	Indicates the health of the retail sector.
	US Personal Consumption Expenditures Price Index	Tracks the path of inflation.
	Reserve Bank of India Monetary Policy Committee Meeting Minutes	Gives further insight into the central bank's decision-making process.
	US Personal Income	Measures income from all sources, including wages and salaries, as well as government social benefits.
	Canada Retail Sales	Indicates the health of the retail sector.
	University of Michigan Survey of Consumers	Provides indexes of consumer sentiment and inflation expectations.
	Eurozone Consumer Confidence	Tracks sentiment among eurozone consumers.

Notes

¹Source: Bank of Canada press release, Dec. 11, 2024

²Source: Reuters, "ECB governors back more rate cuts if inflation settles at goal," Dec. 13, 2024

Important information

All investing involves risk, including the risk of loss.

Past performance does not guarantee future results.

Investments cannot be made directly in an index.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Fixed income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Investments in companies located or operating in Greater China are subject to the following risks: nationalization, expropriation, or confiscation of property, difficulty in obtaining and/or enforcing judgments, alteration or discontinuation of economic reforms, military conflicts, and China's dependency on the economies of other Asian countries, many of which are developing countries.

Cryptocurrencies are considered a highly speculative investment due to their lack of guaranteed value and limited track record. Because of their digital nature, they pose risk from hackers, malware, fraud, and operational glitches. Cryptocurrencies are not legal tender and are operated by a decentralized authority, unlike government-issued currencies. Cryptocurrency exchanges and cryptocurrency accounts are not backed or insured by any type of federal or government program or bank.

Cryptocurrencies are digital currencies that use cryptography for security and are not controlled by a central authority, such as a central bank.

Fluctuations in the price of gold and precious metals may affect the profitability of companies in the gold and precious metals sector. Changes in the political or economic conditions of countries where companies in the gold and precious metals sector are located may have a direct effect on the price of gold and precious metals.

Gross domestic product (GDP) is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

Inflation is the rate at which the general price level for goods and services is increasing.

A policy rate is the rate used by central banks to implement or signal their monetary policy stance.

A politburo is the principal policymaking committee of a communist party.

Safe havens are investments that are expected to hold or increase their value in volatile markets.

Spread represents the difference between two values or asset returns.

The Tankan survey is a quarterly assessment of business conditions in Japan from the Central Bank of Japan.

Tightening monetary policy includes actions by a central bank to curb inflation.

A basis point is one-hundredth of a percentage point.

Bond vigilantes is a name given to bond investors who sell bonds in protest against a monetary or fiscal policy they fear is inflationary.

Monetary easing refers to the lowering of interest rates and deposit ratios by central banks.

The opinions referenced above are those of the author as of **Dec. 16, 2024**. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.