

European stock markets surge as US stock market sags

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Key takeaways



German spending

Plans to increase defense and infrastructure spending offers compelling economic benefits for Germany's lagging manufacturing sector.

US spending cuts

The US seems to be dramatically reducing spending through its Department of Government Efficiency (DOGE) effort.

Recession odds

The Atlanta Fed GDPNow indicator is showing an alarming pullback in US economic growth for the first quarter, now expected to be -2.8%.

We've seen a big change in market performance thus far in 2025. The MSCI USA Index, which returned 23.4% last year, has gained just 1.22% so far this year.¹ Conversely, European indexes have seen strong relative returns so far this year after modest gains last year.¹ For example, the MSCI France Index, which actually had a negative return last year, has posted a double-digit gain so far this year.¹ So what's behind this trend? As I've mentioned before, there have been four key drivers of European equity outperformance:

- Monetary policy in the eurozone is expected to be more accommodative than monetary policy in the US going forward.
- As indicated by the Citi Economic Surprise Indexes, there has been positive economic surprise in the eurozone and negative economic surprise in the US.
- Earnings momentum, while negative, has been improving in the eurozone while earnings momentum in the US hasn't.
- Valuations are relatively low in the eurozone but very high — essentially priced for perfection or close to perfection — in the US.

Germany plans substantial increase in defense and infrastructure spending

Adding to these four factors, Germany made a momentous announcement last week — one that marks an extremely important shift in the world from both a political and economic standpoint. Incoming Chancellor Friedrich Merz announced plans to increase defense and infrastructure spending substantially. This is a 180-degree change for a country that has been laser-focused on maintaining fiscal prudence — to the detriment of its economy in recent years. But that's no longer the case.

The new German governing coalition plans to dramatically alter the country's cap on deficit spending in order to spend up to €1 trillion on defense and infrastructure over the coming decade.² While this is being done in reaction to US policies, it offers compelling economic benefits for Germany, addressing key issues facing its economy. German manufacturing has been in the doldrums for the last several years. Last year, I received dozens of questions from skeptical clients asking if Germany would ever see a restoration of its former strength in manufacturing. But few envisioned how quickly relations between the US and Europe would deteriorate and how quickly Germany and other European nations would respond.

And it's not just Germany; many European nations have been catalyzed by the US shift away from its longstanding allies. This week, European Union (EU) leaders are expected to hold emergency talks on Thursday to decide upon ways to lift EU-level fiscal constraints in order to quickly increase their military budgets. European countries are acting rapidly and dramatically, and markets understand this is an important shift — the most seismic development since German reunification. I think it's no coincidence that Mr. Merz used the language "whatever it takes," channeling his inner Mario Draghi. Not surprisingly, last week, the yield on the 10-year German bund rose as high as 30 basis points — the largest jump since 1990.¹

US is prioritizing government spending cuts

Meanwhile, the US seems to be dramatically reducing spending through its Department of Government Efficiency (DOGE) effort. While markets seem focused on tariffs, I believe dramatic government spending cuts are the bigger threat to the US economy. While the US certainly needs to trim spending to reduce the fiscal deficit, I think very few anticipated that cuts would be so swift and aggressive. This can be very problematic for the US economy because every lost job and every dollar of reduced spending has implications for the overall economy.

I think of it as a potent “reverse multiplier effect” — removing a dollar of government spending has ripple effects, reducing spending throughout the economy. The amount of the impact depends on the kind of government spending that’s being cut. Cutting areas of government spending that have higher multiplier effects — for example, transfer payments to low-income households — will have a more negative impact on the economy than cutting areas of government spending with lower multiplier effects. Transfer payments have a higher multiplier effect because low-income households are more likely to spend every dollar they receive rather than save some of it. In other words, all else being equal, cutting payments to low-income households should have a bigger impact on the US economy than, for example, cutting taxes for higher-income households that are more likely to save part of that money. We need to pay close attention closely to where the cuts are occurring, not just that cuts are being made.

Probability of a US recession has risen

So, the switch in Europe/US stock market performance is likely to be amplified by the switch in fiscal impulse. And that switch in fiscal impulse has substantially increased the probability of a US recession this year.

The Atlanta Fed GDPNow indicator is showing an alarming pullback in US economic growth for the first quarter, now expected to be -2.8% (although it will certainly be revised many more times before the end of the quarter).³

Government spending cuts are already having an impact on employment. Challenger, Gray & Christmas announced last week that job cuts from US employers increased 245% in February to 172,017 — the highest level since July 2020 when America was in throes of the COVID-19 shutdown.⁴

And we shouldn’t overlook the feedback from the Federal Reserve Beige Book released last week:⁵

“Contacts noted sharply higher uncertainty around the outlook, with a wait-and-see stance echoed widely. Reduced labor supply as a result of stricter immigration policy, increased costs from tariffs, and decreased government spending were cited as headwinds for economic activity, while potential deregulation and corporate tax cuts were seen as tailwinds.”

“Contacts in manufacturing, ranging from petrochemical products to office equipment, expressed concerns over the potential impact of looming trade policy changes.”

“Some contacts in the sector also expressed nervousness around the impact of potential tariffs on the price of lumber and other materials.”

“A few contacts were hesitant to hire because of uncertainty about how federal government policy changes could affect the economy.”

“Business and group travel volumes fell notably, with one hospitality contact in Southern California reporting a number of business trip cancellations from groups impacted by recent changes to federal government funding.”

Will this trend continue?

While the odds of a recession have greatly increased, we don't have enough information to know whether or not the US economy will go into recession. Much will depend on the extent of government spending cuts going forward. Recession is not a fait accompli — yet.

Having said that, I think European stock market outperformance versus US stocks is likely to continue this year. I believe a key driver going forward will be the change in fiscal impulse for the markets' respective economies. We'll stay tuned.

Looking ahead

The Bank of Canada will meet this week and decide on whether to cut interest rates again. Current US government funding ends on March 14 and must be extended by a politically fractured US Congress, which could result in a government shutdown — and of course short-term uncertainty and volatility. Also, we'll closely follow European leaders' efforts to increase deficit spending to pay for increased defense expenditures. We'll also get US CPI data, although I dare say inflation has become a secondary concern at this point given the growth scare going on in the US.

Stay calm, stay diversified, and keep your investment time horizon in mind as you follow headlines that can be unnerving and stomach-churning.

Dates to watch

Date	Report	What it tells us
Mar 10	Japan Leading Economic Indicators	Gauges the economic outlook for Japan based on data reports such as consumer sentiment and job offers.
	Eurozone Sentix Index	Tracks sentiment among eurozone investors.
	Germany Industrial Production	Indicates the economic health of the industrial sector.
	Japan Gross Domestic Product	Measures a region's economic activity.
Mar 11	Australia NAB Business Confidence	Rates the current level of business conditions in Australia.
	US NFIB Small Business Optimism Index	Indicates the health of small businesses in the US.
	Brazil Industrial Output	Indicates the economic health of the industrial sector.

Dates to watch

Date	Report	What it tells us
Mar 12	US Consumer Price Index	Tracks the path of inflation.
	Brazil Inflation	Indicates the economic health of the industrial sector.
	Bank of Canada Monetary Policy Decision	Reveals the latest decision on the path of interest rates.
Mar 13	Eurozone Industrial Production	Indicates the economic health of the industrial sector.
	United States Producer Price Index	Measures the change in prices paid to producers of goods and services.
Mar 14	UK Industrial Output	Measures total value of goods produced by an economy's industrial sector over a specific period.
	UK Gross Domestic Product	Measures a region's economic activity.
	University of Michigan Survey of US Consumers	Provides indexes of consumer sentiment and inflation expectations.

Notes

¹Source: MSCI, as of March 7, 2025. MSCI Spain Index 18.13% return, MSCI Italy Index 13.97% return, MSCI Germany Index 13.40% return, MSCI France Index 10.26% return, and MSCI United Kingdom Index 8.39% return. Index performance based on price returns (excluding dividends and interest.)

²Source: Euractiv, "Germany poised to commit €1 trillion for defence and infrastructure in stunning reversal," March 4, 2025.

³Source: Atlanta Fed GDPNow, as of March 3, 2025.

⁴Source: Challenger, Gray & Christmas, Challenger Report, March 6, 2025.

⁵Source: Federal Reserve Beige Book, March 5, 2025.

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.

Diversification does not guarantee a profit or eliminate the risk of loss.

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.

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

The risks of investing in securities of foreign issuers can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The performance of an investment concentrated in issuers of a certain region or country, such as North America and Europe, is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified investments.

Many countries in the European Union are susceptible to high economic risks associated with high levels of debt, notably due to investments in sovereign debts of European countries such as Greece, Italy, and Spain.

The MSCI USA Index measures the performance of the large- and mid-cap segments of the US market.

The MSCI France Index measures the performance of the large and mid-cap segments of the French market.

The MSCI Spain Index is designed to measure the performance of the large and mid-cap segments of the Spanish market.

The MSCI Italy Index is designed to measure the performance of the large and mid-cap segments of the Italian market.

The MSCI Germany Index is designed to measure the performance of the large and mid-cap segments of the German market.

The MSCI United Kingdom Index is designed to measure the performance of the large and mid-cap segments of the UK market.

The Summary of Commentary on Current Economic Conditions by Federal Reserve District (the Beige Book) is published eight times per year. Each Federal Reserve Bank gathers anecdotal information on current economic conditions in its district, and the Beige Book summarizes this information by district and sector.

A bund is a debt security issued by the German federal government. It is the German equivalent of a US Treasury bond.

The Consumer Price Index (CPI) measures the change in consumer prices and is a commonly cited measure of inflation.

The Citi Economic Surprise indexes are quantitative measures of economic news, defined as weighted historical standard deviations of data surprises; a positive reading of the Economic Surprise Index suggests that economic releases have on balance been beating consensus.

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.

The Federal Reserve Bank of Atlanta's GDPNow forecasting model provides a "nowcast" of the official GDP estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the US Bureau of Economic Analysis.

The GDPNow Indicator seeks to forecast the growth rate of US real gross domestic product before the official estimates are released by the government.

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

The multiplier effect measures how much a change in fiscal policy affects income levels in the country due to the new policy's effect on spending, consumption, and investment levels in the economy.

Relative return refers to the return an asset achieves over a certain period of time compared with another measure or benchmark.

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

The opinions referenced above are those of the author as of **March 11, 2025**. 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.