A new European renaissance?

Market Performances (as of July 30, 2025 – 9:30 CET)

	CURRENT	CHANGE 1 WEEK	CHANGE YTD		CURRENT	CHANGE 1 WEEK	CHANGE YTD
MSCI USA Equity Index	6'092.37	1.00%	8.46%	Gold Ounce	3'327.25	-1.77%	26.78%
MSCI Canada Equity Index	3'537.50	0.73%	11.02%	Silver Ounce	38.06	-3.07%	31.69%
MSCI Eurozone Equity Index	1'741.65	0.50%	10.88%	Oil WTI Future	69.25	6.13%	-3.44%
MSCI Switzerland Equity Index	1'537.45	-0.98%	3.73%	EUR/USD	1.1564	-1.76%	11.69%
MSCI Germany Equity Index	216.00	-0.01%	17.68%	EUR/CHF	0.9306	0.26%	1.02%
MSCI Japan Equity Index	1'769.88	-0.89%	3.13%	USD/CHF	0.8045	-1.50%	-12.79%
MSCI Emerging Markets Equity Index	1'252.31	-1.02%	16.44%	USD/JPY	147.96	-0.98%	-6.24%
Yield 10Y US Treasuries	4.324	-0.06	-0.25	CAD/USD	0.7264	1.25%	-4.30%
Yield 10Y German Bund	2.686	0.05	0.32	USD/CNY	7.1764	-0.31%	-1.71%

Source: Bloomberg, Vontobel SFA

Europe in the spotlight

This year investors have refocused on Europe, creating a favorable shift in relative momentum of European equities versus the US after two decades of underperformance. The US and the EU reached a high-level trade deal this week with some detail still to be worked out and where some unclarities on the implications among EU member states remain. That being said, the tariff uncertainty is somewhat sidelined now and investors may refocus on the European growth story.

In economic policy, Europe especially Germany (and Poland), has responded to rising global geopolitical uncertainties with major investment plans across sectors such as defense and infrastructure. European politicians have become more outspoken about the need for Europe to reduce its external dependencies in security matters. This prioritization is creating positive momentum in the European political and economic landscape. Not just for the short-term, but also for the medium- to long- term.

Defense spending

On the 21st of March this year, Germany overhauled its "debt brake" and with it, years of limited borrowing capacity due to constitutional restrictions. After receiving the necessary two-thirds majority support for the constitutional change in the Bundestag, a revived approach to military reform has been approved. The economic impact is expected to be sizeable: a €500bn fund for infrastructure (encompassing rail, digitalization, innovation, education, research and climate) and unlimited borrowing for defense spending to bolster German and European defense efforts. Meanwhile in France, President Emmanuel Macron vowed to increase military and defense spending to 3.5% GDP, an increase of 1.5% over its current commitment, amounting to €30bn more each year.

The main outcome of the NATO summit on 24-25th of June in The Hague was an increased defense spending target of 3.5% of GDP, plus 1.5% on security-related spending. Some countries like Germany confirmed the target of 3.5% of GDP by 2029, but for the other three largest EU economies (France, Italy, Spain) high debt levels and/or high deficits may restrict the financing of the additional military spending, although relaxed EU fiscal rules will apply given the shift in priorities. For now, Spain has opted out of the increased spending targets.

Defense-related expenditure is expected to contribute to GDP growth in the near term and may have longer-term structural effects. After the catch-up phase, defense spending could potentially grow in line with trend GDP growth (approximately 3% nominal), though this remains subject to policy and economic developments. Yet, the market is currently pricing that such above-average growth will continue for the next 10 years.

Broader European growth initiatives

Another tailwind for Europe comes from the EU Savings and investments union initiative, which has broader implication for the development for the European capital markets and capital efficiency. This saw its first steps taken in the second quarter of this year, when the European Commission proposed measures to make the EU securitization framework simpler. This forms part of a broader plan on doubling of the securitization market (from €~550bn to €1.2tn), mobilize bank balance sheets faster, and help the funding of the region's ~€1tn annual investment needs.

The Savings and investments union's over-arching goal is to mobilize investments towards projects aimed at improving Europe's competitiveness via deepening its capital

markets – this is a project that will take multiple years, and the economic benefits are expected to only gradually become visible.

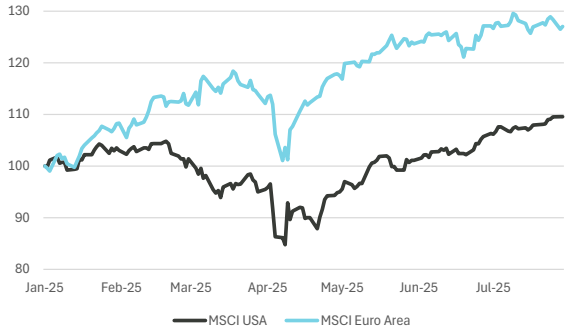
Yet, launching the right reforms for capital markets, alongside the new fiscal stimulus out of Germany, could help attract foreign capital. Initial developments suggest some movement toward this outcome, although it is too early to draw definitive conclusions. Mobilizing private capital for European infrastructure continues to be a focus area among policymakers and may remain relevant over the coming years depending on implementation progress. As a result, this could gradually over the longer term support an increase of market cap to GDP / debt issued to GDP / securitization as a % of GDP from the current low levels. There is plenty of scope for a catch-up, although it will probably not come close to the US as the world`s main financial market, at least not in the near term.

Rising investor interest in Europe

For financial analysts and investors, the European policy shift represents a rare convergence of macro transformation and micro-opportunity. At the macro level, increased public investment could provide a countercyclical buffer to potential externally driven headwinds, while deepening euro-area capital markets through expanded sovereign and EU-level debt issuance. It also provides a combination of shorter- and longer- term policy, which has the potential to support overall economic growth for a longer period, including down to the broader economy. At the micro level, European defense contractors stand to benefit from years of elevated spending, with growing backlogs, pan-European procurement, and a new wave of industrial policy support.

Measured in US dollars, the Euro Area equity index has outperformed other key regional indices year-to-date, based on available data (Chart 1).

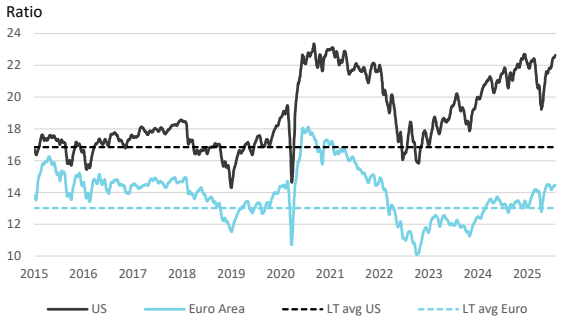
Chart 1: Country equity performance (MSCI, measured in USD, start of 2025 = 100)



Source: Bloomberg, Vontobel SFA, July 29th, 2025

The strong year-to-date European performance has come with high dispersion between single stocks, with a primary focus on individual stocks that could directly benefit from the government spending. With investors anticipating the positive impact on longer term earnings, it has propelled infrastructure and defense sector valuations to high levels. However, the market overall is by far not as expensive as the US market, and quite close to its own historical levels (chart 2).

Chart 2: US and European equity price-earnings ratio (based on forward earnings)



Source: Bloomberg, Vontobel SFA, July 29th, 2025

The rise of the euro elicited a mix of euro-pride and concern among economists. It also happens at a juncture where investors, especially those with US dollar concentrated portfolios, are looking for more diversification and searching for opportunities outside of the US. With the rising interest of investors in Europe, the euro currency has benefited, with a notable appreciation versus the US dollar. This was not only the result of a more positive European investment outlook but also of negative US dollar sentiment. The EUR/USD pair has risen to above 1.17 and with that it reached a 4 year high (Chart 3).

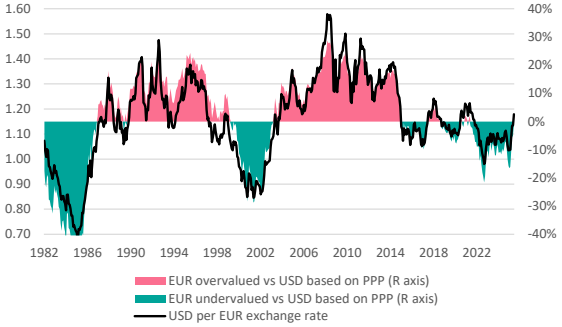
Chart 3: Euro/dollar exchange rate (in USD)



Source: Bloomberg, Vontobel SFA, July 29th, 2025

Given that the euro was, on a purchasing power basis, undervalued, the currency is still not expensive even after the most recent moves. History has shown that the euro can also become significantly overvalued versus the greenback, and it is therefore not clear whether the tailwind to the euro will stop at fair value. Should investor interest persist and current trends in US dollar sentiment continue, the euro may experience further support. However, currency movements are influenced by a wider range of factors.

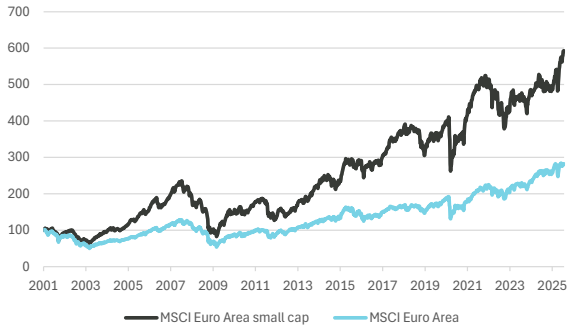
Chart 4: Euro area valuation versus US dollar



Source: Bloomberg, Vontobel SFA, June 2025

Implications for investors
So far this year the European equity market rally has been concentrated on sectors or even single names and any longer-term improvement will be expected to have broader effects on the European markets. Especially Small- & Mid- cap stocks may benefit, as they are more domestically oriented while the European large caps have more global exposure. Given the size and complexity of the spending plan, in combination with deregulation and broader functioning of the European economy, the effects will also be more European wide, spreading outside of just the defense sector. Historically, the MSCI Euro Area small cap index has significantly outperformed the broader MSCI Euro Area index (chart 5).

Chart 5: MSCI Euro Area small cap versus broader index (indexed, start 2001 = 100, net total return)



Source: Bloomberg, Vontobel SFA, July 29th, 2025

However, since the post COVID-19 rally, European small caps have struggled and underperformed the broader index (chart 6). Since the start of the year, small caps have seen an improvement in performance momentum but are relatively still significantly below the performance peak relative to the broader index that was reached in 2021.

Chart 6: Relative performance MSCI Euro Area small cap versus MSCI Euro Area (start 2001 = 1)

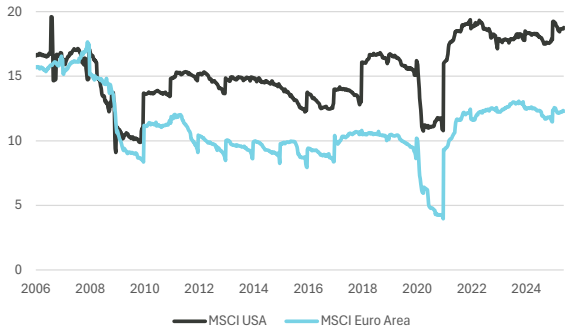


Source: Bloomberg, Vontobel SFA, July 29th, 2025

Sustained improvement in profitability metrics such as Return on Equity may enhance the long-term outlook for European companies, although structural reforms and market conditions will play a crucial role. Chart 7 shows that the eurozone ROE has lagged the US since the GFC.

Constraints in the European regulatory frameworks (labor rules and competition laws) may have inhibited capital formation which in turn has reduced the earnings potential compared to other regions. Success in Europe over the longer term depends on these improving, but as history has shown, crises tend to be required to bring European politics together and move things forward.

Chart 7: Return on Equity (in %)



Source: Bloomberg, Vontobel SFA, July 29th, 2025

Conclusion
Last weekend a high-level trade deal was announced between the EU and the US, with some detail still to be worked out and where some unclarities on the implications among EU member states remain. That being said, trade tariff uncertainty is somewhat sidelined now and investors may refocus on the European growth outlook. European equities have performed strongly this year and outperformed the other large regions with a total return in USD of nearly 30%. This outperformance has happened against a background of an improved European growth outlook, financed by government borrowing together with intended/expected structural reforms and supported by monetary policy easing. The performance has been skewed to sectors like defense and some individual companies. Overall, the valuation (based on P/E ratios) of the broader index remains close to the long-term average and much cheaper than, for instance, US equities. The euro currency has benefited as well. Given the sizeable fiscal stimulus and the potential of structural reform, there is the potential of this spreading to the broader economy and to enhanced long-term growth. This could be beneficial for small companies, where performance has lagged the last years, with their higher exposure to the domestic and regional economies. Going forward, European success will depend on the delivery on structural reform, implementation of the intended sizeable fiscal spending and the pass through into corporate earnings.

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