Terrible Trifecta

Paris and Berlin in Crisis as Washington Takes Up Trump 2.0 Agenda

Bill Campbell | December 2024

Since the formation of the European Common Market in 1957 and its transformation into the European Union (EU) in 1993, France and Germany have formed the core of the European project. The continent's second-largest and largest economies, respectively, have entered fiscal and governing crises on the cusp of the U.S. under the second presidency of Donald Trump confronting the EU with strategic challenges on commercial, fiscal and defense fronts. I will survey the states of play in France and Germany, characterized by political limbo if not outright paralysis, in a context of internal economic anemia and fast-approaching yet still incipient challenges from the next administration in Washington.

France

The fall of the Barnier government comes as France faces a myriad of macroeconomic challenges – a ballooning budget deficit, a war in Ukraine, anemic growth prospects and a Trump presidency – all which demand decisive and competent policymaking.

Policy direction is suffering from a deeply fragmented Parliament with no outright majority in the National Assembly. This has created an unstable dynamic where the three major political blocs – President Emmanuel Macron's centrist party, the New Popular Front left-wing coalition and Marine Le Pen's far-right National Rally party – have struggled to find common ground to form a government and pass legislation. Given the very differing interests among these blocs, the likelihood of putting together a coalition that can address France's immediate macro and fiscal challenges looks difficult. Therefore, France is unlikely to make needed progress on the budget and fiscal reform, adding uncertainty for a recovery in growth, which remains fragile in the aftermath of war in Ukraine and an energy crisis.

President Macron has committed to seeing out his term, which ends in 2027, and his focus will be to appoint a government that can approve a budget. He appointed Francios Bayrou as France's new prime minister on Dec. 13. Bayrou is the leader of the Democratic Movement party and seen as a centrist, but he faces a difficult challenge to pass a 2025 budget given the recent political turmoil. It remains to be seen if the new government will attempt a similar fiscal adjustment to the one that brought down Prime Minister Michel Barnier. Any budget agreement that is reached in the short term might only prove to be a stopgap measure. Ms. Le Pen did state that "I can for sure vote for another censure motion," only compounding the volatile situation in France.

The political outlook is likely an unstable series of additional confidence votes and caretaker leadership until legislative elections can legally be held again in July. The French Constitution mandates a minimum of one year between elections. This will keep continued pressure on the fiscal outlook. During summer's parliamentary elections, untenable spending pledges were made. The New Popular Front ran on campaign promises of raising government spending by as much as 150 billion euros a year. The National Rally also promised substantial spending increases in excess of 30 billion euros a year. The outlook appears dim for any meaningful improvement in France's fiscal trajectory during 2025.

Views and opinions expressed herein are those of the individual portfolio manager and do not necessarily reflect the views of DoubleLine Capital LP, its affiliates or employees.

Given these recent developments, market participants are questioning the country's fiscal sustainability – spreads versus German bunds have risen to over 80 basis points from 50 basis points earlier this year, the deficit has ballooned to 6.1% of gross domestic product (GDP), and public debt has risen to 112% of GDP.

Higher borrowing costs impede the government's ability to invest and raise France's anemic growth profile – the International Monetary Fund estimates potential annual growth at a mere 1.3%. Critical areas of needed investment include infrastructure, such as energy, transport and digitalization, as well as education and healthcare. The public service sector faces persistent underfunding – the healthcare system faces supply and staffing shortages while school funding has also been a victim of austerity measures.

Business and investor confidence has deteriorated significantly this year. A November survey (by Ernst & Young) revealed that roughly half of the 200 international company bosses questioned had downsized or postponed their investment projects.

Germany

Germany faces similar governing crises. As in France, a budgetary impasse has given rise to parliamentary fragmentation. On Nov. 6, German Chancellor Olaf Scholz fired Finance Minister Christian Lindner due to Lindner's refusal to suspend the "debt break." (Scholz had sought to bypass this fiscal rule limiting budget deficits in Germany to enable a planned increase in defense spending.) The action collapsed the coalition government comprising Scholz's Social Democratic Party, Lindner's Free Democratic Party and the Green Party. The Bundestag (German parliament) voted on a confidence motion on Dec. 16, triggering a snap election to be held on Feb. 23. Following the passage of the no-confidence vote, Alice Weidel, co-chairwoman of Germany's second largest party, Alternative for Deutschland (AfD), castigated the "EU bureaucracy," stating "that the European Union in its current state is (not) an institution that is working well." Recent polling suggests that the Christian Democratic Union/Christian Social Union enjoys the support of around 30% of voters in Germany, and the AfD has around 20%. It does not appear likely that the AfD will win this election, but it does wield enough power to influence future German policy decisions.

Like France, Germany faces structural headwinds to growth, which will likely remain anemic. German growth is hampered by a poor demographic outlook, a loss of competitiveness in manufacturing due to increased competition from China and other emerging markets (most notably in the auto sector) and high energy costs from the Russia-Ukraine war. Business and consumer confidence remains weak due to high interest rates; weak domestic and foreign demand for manufactured goods; and geopolitical uncertainties, including President-elect Trump's return to the White House.

The political turmoil in France and Germany could not come at a worse time. President-elect Trump is vowing to take an aggressive stance toward Europe on trade and foreign policy. He is looking to impose a baseline or universal tariff of 10% to 20% on all imports from EU countries. In addition, he has threatened multiple tariff actions, on one occasion a 100% tariff on imported vehicles, on another a tariff of up to 25% on European cars, up from the current 2.5%, to counter the EU's 10% tariff on U.S. cars and tariffs on other key European export sectors such as machinery, chemicals and manufactured goods. Furthermore, President-elect Trump has warned that Europe will "pay a big price" if it doesn't buy enough American goods.

President-elect Trump has also threatened the U.S. security guarantee for Europe, demanding that European nations spend a mandated 5% of GDP on defense. In regard to the U.S. defending NATO nations, President-elect Trump has threatened to consider withdrawing from NATO if allies fail to meet the 5% defense-expenditure minimum. He has floated the idea that nations who do not meet their spending targets could receive reduced U.S. security guarantees. These threats need to be taken seriously, and in fact, were one of the major reasons for German Chancellor Scholz sacking his finance minister.

Europe will need to mount a unified response in confronting the threats from the incoming Trump administration. One step toward this was the announcement of the EU discussing plans for a 500 billion euro fund to pay for common defense projects and defense procurements. Another step in this direction was the recent "Mercosur" trade agreement reached on Dec. 6 among negotiators for the EU and four Mercosur countries – Argentina, Brazil, Paraguay and Uruguay. Unfortunately, France opposes this trade deal, making ratification anything but straight forward. Ratification requires approval by at least 15 of the EU's 27-member-states as well as the European Parliament. If European leaders cannot find a way to find common ground to address their domestic and European-wide issues, they likely will be headed toward a difficult 2025 with the incoming Trump administration, whose plans promise to add headwinds to a strained growth outlook for the continent.

Terrible Trifecta

Paris and Berlin in Crisis as Washington Takes Up Trump 2.0 Agenda

As we look to 2025, challenges to the global economy from the change in U.S. leadership will likely be felt very quickly, but how long these headwinds persist will come down to this question: Will President-elect Trump choose to be more transactional or structural in his approach to global trade? In his first term, his trade deals focused on stronger labor protections, enhanced intellectual property rights and better market access and procurement for U.S. agriculture (with an emphasis on soybeans). To be sure, the resulting trade deals were complex agreements and contained many other provisions, but the highlights were to provide increased protections to U.S. industries and boost U.S. exports. During the campaign for his second term, President-elect Trump focused more on returning manufacturing back to America, an idea that has been repeated by his proposed Commerce Secretary Howard Lutnick and Trade Representative Jamieson Greer. This new policy stance would be much more impactful on global growth, as U.S. companies would need to bring their manufacturing back to the United States. Such a development would fundamentally change the way global supply chains and trade work today. In addition, tariffs and trade restrictions would likely remain in place much longer, creating a more durable headwind to growth in countries that are targeted.

The question for markets is, which of these two potential trade policies will the incoming administration pursue? If negotiations and dealmaking follow the pattern of the prior Trump administration, the process might be less drawn out and more transactional in nature. Washington under the 47th president could give trading partners such as France and Germany actionable items to agree on, and deals could appear attainable in a reasonable time frame. On the other hand, if the incoming administration chooses to take a harsher line to focus on repatriating manufacturing, this would limit the potential areas of negotiation and agreement between the United States and other countries. The implications of this more structural strategy would be more profound and would likely result in longer-lasting headwinds to global growth and global markets.

Investment Stance

Trade uncertainties under a Trump presidency further weigh on France and Germany's growth profiles. Universal tariffs of 10% to 20% could severely damage demand for France's pharmaceutical and aerospace exports and further weaken the German auto industry. France's Airbus might be particularly hard hit as the Trump administration protects and promotes national champions, like Boeing.

Ultimately, domestic political turmoil and external trade risks appear unlikely to be resolved in the near term for France and Germany. I expect the fiscal risk premium to persist in keeping French government bond spreads elevated, and with a weakening growth outlook, we will see continued downward pressure on the euro. The European Central Bank (ECB) is currently facing pressure to lower policy rates to counteract the anemic growth outlook, and the market is expecting cuts throughout 2025. Given our expectation that the euro will continue to weaken, the ECB will face a difficult decision between supporting the currency by slowing the pace of rate cuts or supporting growth with those cuts. Our outlook for European assets remains challenged, as the political solutions needed to help address the external threats will be difficult to meet. We will keep a close eye on developments in the U.S. and Europe. ■

Terrible Trifecta

Paris and Berlin in Crisis as Washington Takes Up Trump 2.0 Agenda

William Campbell
Portfolio Manager, Global Sovereign Debt

Mr. Campbell joined DoubleLine in 2013. He is a Portfolio Manager for the DoubleLine Global Bond Strategy and is a permanent member of the Fixed Income Asset Allocation Committee. He covers Developed Markets, Central & Eastern Europe, Middle East and Africa (CEEMEA), and China. Prior to DoubleLine, Mr. Campbell worked for Peridiem Global Investors as a Global Fixed Income Research Analyst and Portfolio Manager. Previous to that, he was with Nuveen Investment Management Company, first as a Quantitative Analyst in their Risk Management and Portfolio Construction Group, then as a Vice President in their Taxable Fixed Income Group. Mr. Campbell also worked at John Hancock Financial as an Investment Analyst. He holds a B.S. in Business Economics and International Business, as well as a B.A. in English, from Pennsylvania State University. Mr. Campbell holds an M.A. in Mathematics, with a focus on Mathematical Finance, from Boston University.

Important Information Regarding This Material

Issue selection processes and tools illustrated throughout this presentation are samples and may be modified periodically. These are not the only tools used by the investment teams, are extremely sophisticated, may not always produce the intended results and are not intended for use by non-professionals.

Yield to maturity (YTM) does not represent return. YTM provides a summary measurement of an investment's cash flows, including principal received at maturity based on a given price. Actual yields may fluctuate due to a number of factors such as the holding period, changes in reinvestment rates as cash flows are received and redeployed, receipt of timely income and principal payments. DoubleLine views YTM as a characteristic of a portfolio of holdings often used, along with other risk measures such as duration and spread, to determine the relative attractiveness of an investment.

DoubleLine has no obligation to provide revised assessments in the event of changed circumstances. While we have gathered this information from sources believed to be reliable, DoubleLine cannot guarantee the accuracy of the information provided. Securities discussed are not recommendations and are presented as examples of issue selection or portfolio management processes. They have been picked for comparison or illustration purposes only. No security presented within is either offered for sale or purchase. DoubleLine reserves the right to change its investment perspective and outlook without notice as market conditions dictate or as additional information becomes available. This material may include statements that constitute "forward-looking statements" under the U.S. securities laws. Forward-looking statements include, among other things, projections, estimates, and information about possible or future results related to a client's account, or market or regulatory developments.

Important Information Regarding Risk Factors

Investment strategies may not achieve the desired results due to implementation lag, other timing factors, portfolio management decision-making, economic or market conditions or other unanticipated factors. The views and forecasts expressed in this material are as of the date indicated, are subject to change without notice, may not come to pass and do not represent a recommendation or offer of any particular security, strategy, or investment. All investments involve risks. Please request a copy of DoubleLine's Form ADV Part 2A to review the material risks involved in DoubleLine's strategies. Past performance is no guarantee of future results.

Important Information Regarding DoubleLine

To receive a copy of DoubleLine's current Form ADV (which contains important additional disclosure information, including risk disclosures), please contact DoubleLine's Client Services or visit our website at DoubleLine.com.

CFA® is a registered trademark owned by CFA Institute.

DoubleLine Group is not an investment adviser registered with the Securities and Exchange Commission (SEC).

DoubleLine® is a registered trademark of DoubleLine Capital LP.

© 2024 DoubleLine Capital LP

Los Angeles
Tampa
Dubai
Tokyo
London

(813) 791-7333
DoubleLine.com
@DLineCap
DoubleLine-Capital