The Silver Bullet | Europe's Turnaround

"You say no to public debt. You say no to the single market. You say no to create a capital market union. You can't say no to everything...Otherwise you have also to admit, to be consistent, that you are not able to deliver on the fundamental values for which this European Union has been created. So when you ask me what is best to do now, I say - I have no idea - but do something!"

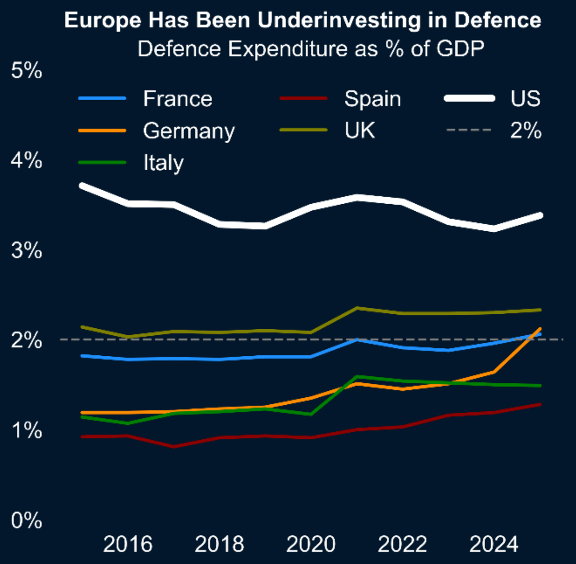
- Mario Draghi, Address to EU Parliament, February 2025

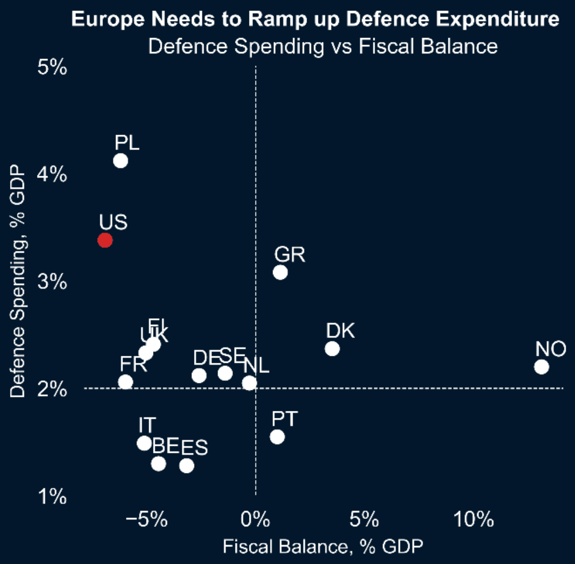
In his first speech after winning elections, Germany's Friedrich Merz called for European independence from the US. The Trump administration's debut in foreign politics couldn't have been more brash. European leaders were prepared for potential sanctions as well as demands for an increase in defence spending. However, the lack of support in recent negotiations and the willingness to exclude Europe from first negotiations on Russia-Ukraine were an unexpected turn around.

Why did the Trump administration decide to position itself squarely in conflict with Europe, and why does Europe matter so much to them? As Martin Sandbu of the FT writes, because "the EU and Europe more broadly, if it can stay united, has the ability to put up resistance that matters to Maga America and its Big Tech oligarchy". *If it can stay united*. Investor consensus remains sceptical around Europe's fragmentation on key issues highlighted by the Draghi report, including defence, energy and technology. As a result, European assets continue to trade at a discount. But what if the Trump administration's antagonism turns out to be the kick European leaders needed to accelerate integration?

We see several key takeaways.

First, Europe will accelerate defence spending, even above and beyond the newly suggested three percent target. We see land and naval defence spending benefiting more than air, where investment has been ongoing over the past decades.





Source: Andromeda Capital Management, NATO, Bloomberg

Second, European governments will likely continue to push for consolidation across strategic sectors, including banking, energy and telecoms.

Third, European countries are likely to move faster towards stronger fiscal integration, starting with EU bonds, as the framework broadly exists from the COVID policy response.

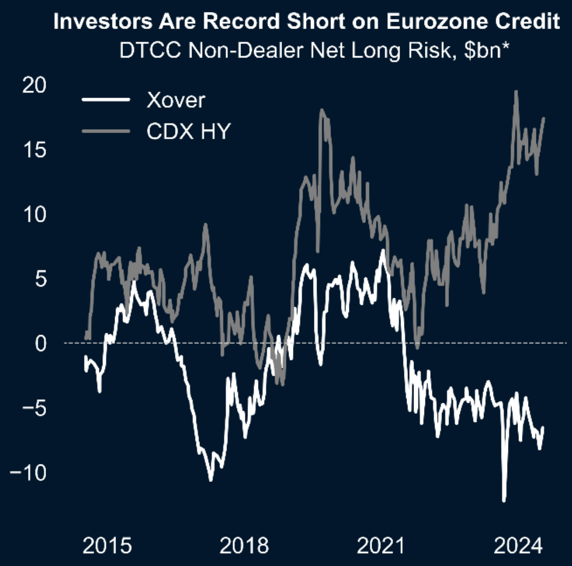
Finally, Europe will play a larger role in guaranteeing Ukraine's security. We view Trump's rhetoric as an attempt to extract a better deal for the US rather than an actual shift away from supporting Ukraine or Eastern Europe. The US recently reaffirmed its commitment to defend Poland, praising its commitment to military spending. A ceasefire will likely accelerate European integration efforts.

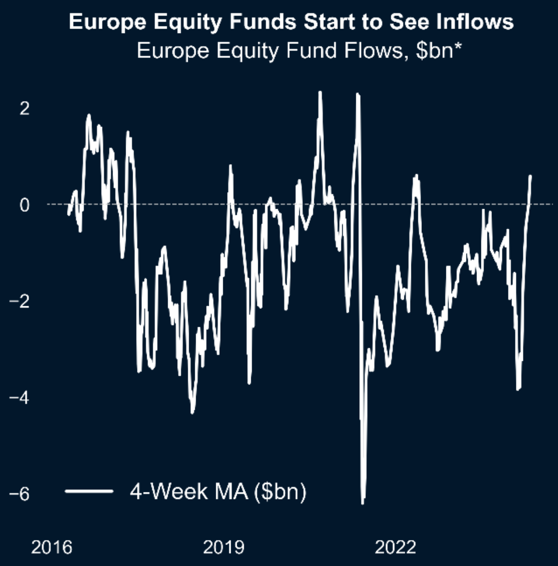
Rebuilding Ukraine will also require nearly $500bn in public and private investment over the next decade, according to World Bank estimates. This represents over twenty percent of Ukrainian GDP annually, providing a major boost to Ukraine's economy. Given the strategic nature of its agricultural and metal resources, Ukraine is likely to attract even more investment.

Conclusions: Europe Offers Value in a Market Priced for Perfection

As credit markets remain close to record tights and equity valuations in the US rise to record multiples over earnings and over GDP, Europe's unloved assets offer value. Investors remain short European risk and long European rates. While European risk assets have repriced higher, positioning remains bearish in credit and in equities too, until recently.

We are now short on overall credit beta vs net long end of last year, given current expensive valuations and potential growth and inflation volatility in the coming quarters. We are long selective credit special situations in Europe, as well as credits likely to consolidate further. We see more upside in Ukraine corporate and sovereign debt.





Source: GS Research, DTCC, BofA Global Investment Strategy, EPFR

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