What to expect in 2025

Politics could have a significant impact on the economy in 2025. Incoming US President Trump is likely to push for even higher tariffs, which could exacerbate the conflict with China. In Germany, the federal elections are likely to lead to a reform of the debt brake, but not to a significant change of economic policy, which is why the economy is unlikely to grow much further. Finally, the central banks are unlikely to succeed in bringing inflation fully under control. We provide an overview of what will be important in 2025.

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President Trump loves tariffs...

On January 20, investors will turn their attention to Washington, D.C., where Donald Trump will be inaugurated as the 47th US president. The new administration's trade policy will be crucial for its trading partners. During his election campaign, Trump repeatedly announced massive tariff increases, some of which were to come into force on the first day of his term of office. His trade policy is difficult to assess because he has made numerous and sometimes contradictory statements in recent months and has not provided any details, for example, on the groups of goods affected. The main trading partners can be divided into three groups:

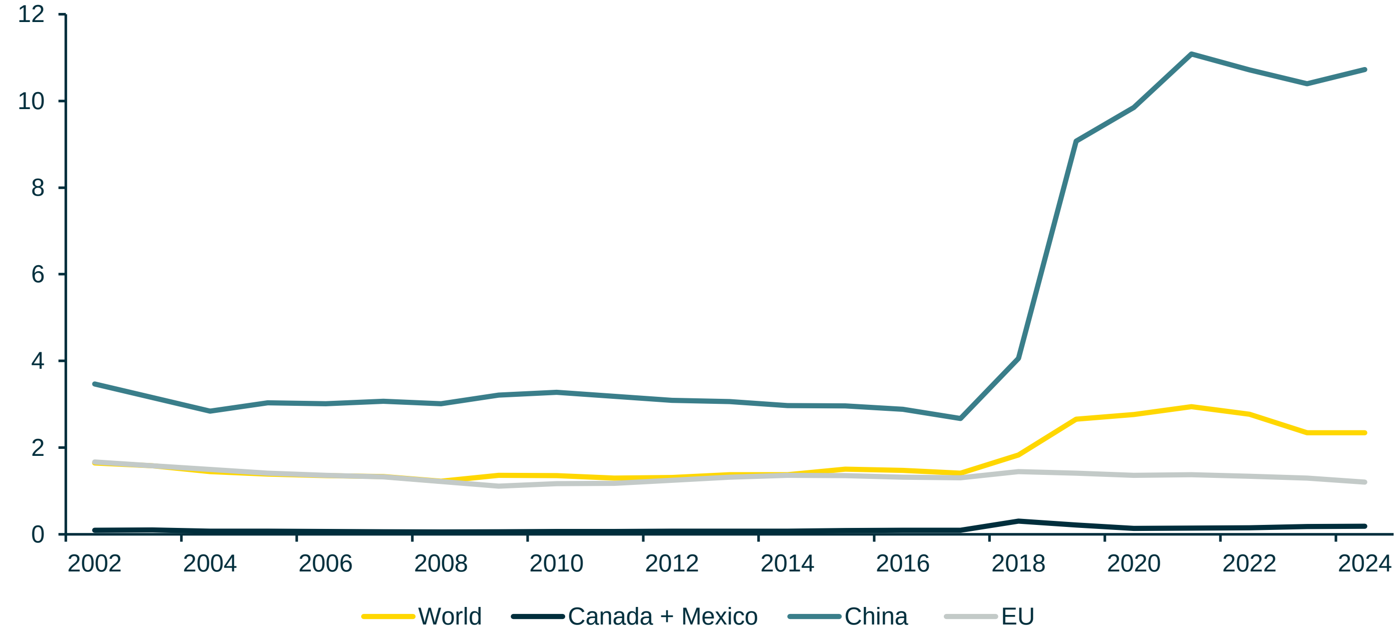
- The US has a free trade agreement with 20 countries. This group of countries accounts for around 38% of US imports. The most important of these are **Mexico** and **Canada**, with which the US is bound by the USMCA, the successor to NAFTA. Trump had just threatened Canada and Mexico with immediate tariffs of 25% (the effective tariff rate on imports from these countries is currently 0.2%, see chart 1). However, this threat is more likely to be seen as a lever for negotiations. The main aim is probably to improve border security in order to reduce illegal immigration into the US.

- Around 13% of US imports currently come from **China**. The tariff has already been raised significantly since 2017 and currently stands at just under 11%. Trump has brought a further increase of 10% into play here, and has also mentioned 60%. Defensive measures against China enjoy broad bipartisan support; the Biden administration had maintained the Trump tariffs and even imposed further tariffs on some product groups. Even higher tariffs are very likely, although it is not entirely clear whether these will be imposed on all imports from China or only on goods important to security policy.

- The **EU** currently accounts for around 19% of US imports and the effective tariff rate is 1.2%. However, only 33% of imports from the EU are currently subject to customs duties. At the end of March, an agreement between the EU and the Biden administration expires under which the tariffs imposed by Trump in 2018 on steel and aluminum from the EU (as well as the EU's retaliatory tariffs on motorcycles and whiskey) were temporarily suspended. Higher tariffs on a broad basis against the allied Europeans are much less likely than against China. But the EU itself tends towards protectionism and could rely too heavily on counter-tariffs instead of pragmatically reaching a deal with Trump.

Chart 1 - Status Quo before Trump II: Effective US tariff rates

Tariffs in % of total imports, annual data



Source: US International Trade Administration, Commerzbank Research

In the extreme case, if Donald Trump follows through on his threat of a 60% tariff on imports from China and a 10% tariff on all other imports, tariffs would rise to their highest level since the 1930s (title chart).

... which makes life even more difficult for the Fed

Trump's tariff threats will also keep investors on tenterhooks in 2025 because tariffs increase inflation. Experience with the tariffs imposed after 2016 shows that the associated price increases were largely borne by the US consumer. Sweeping tariff increases would thus likely trigger at least a one-off rise in consumer prices. Depending on the scope of the tariff measures, the inflation rate could rise by up to one percentage point for a year.

The Federal Reserve could dismiss this as a one-off effect and see through the “inflation hump”. However, the decline in inflation has stalled in recent months. Core inflation, as measured by the personal consumption expenditures deflator, the Fed's preferred price index, has been stuck at 2.5% for half a year. From now on, the Fed is likely to lower its key interest rate by only 50 basis points at a time, to 4.0% (upper limit of the key interest rate corridor).

China: between trade conflict and domestic weakness

China has been suffering from weak domestic demand for some time, which is also related to the aftermath of the correction on the overheated real estate market. The government is focusing on investments in future industries in order to replace the construction industry as the engine of growth. However, the production of the significantly expanded capacities is finding its way onto the global market due to the reluctance of unsettled Chinese consumers to buy. Adjusted for price, Chinese exports are growing much faster than those of other countries. This is likely to lead to intensified conflicts with trading partners – and not just those in the West. It is therefore questionable how long the export engine will run smoothly. China is likely to continue to grow relatively slowly little for a long time to come. The days when China was able to propel the global economy are irrevocably over. If anything, the US has taken over this role.

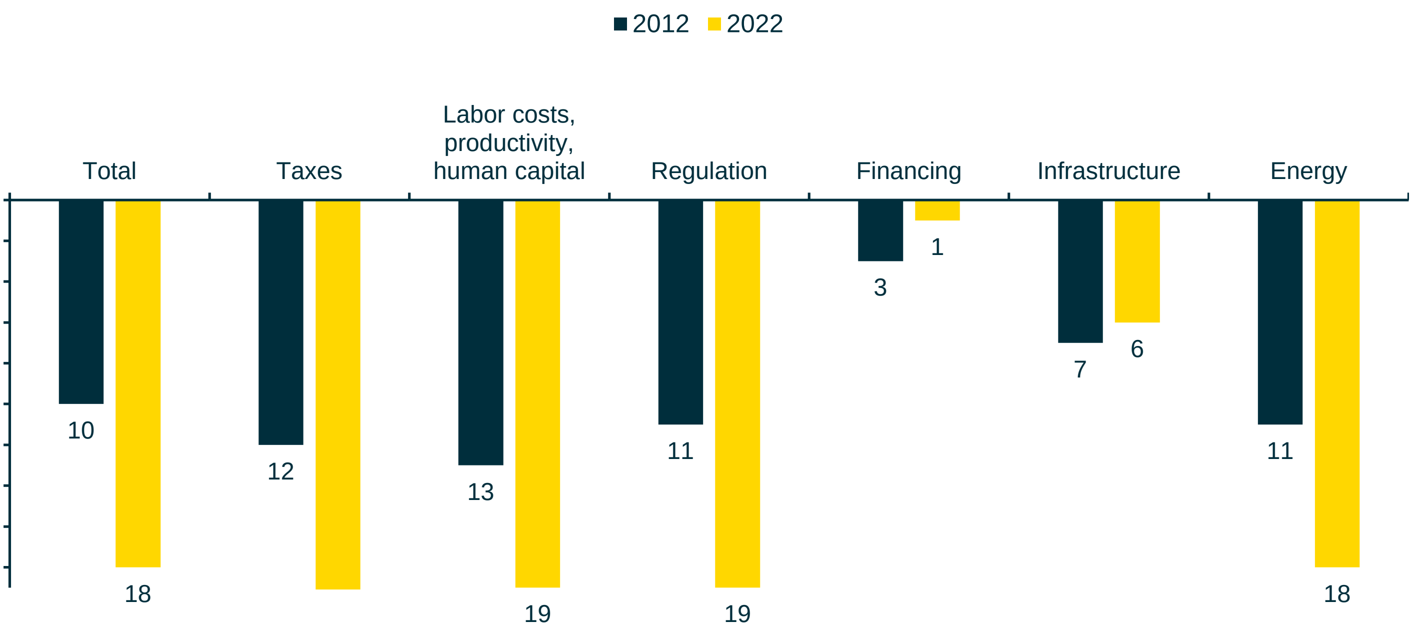
Germany: economic policy reset seems unlikely

Germany will attract investor interest primarily due to the Bundestag elections on February 23. The country urgently needs a fresh start in terms of economic policy after underperforming the rest of the eurozone since 2017 and showing no economic growth at all since 2019. The epicenter of the crisis is the manufacturing sector. Companies are suffering from excessive bureaucracy, uncompetitive energy costs and tax rates as well as a crumbling infrastructure. German companies have become much more pessimistic in their assessment of the quality of Germany as a business location (Chart 2). Many SMEs have lost confidence in economic policy and are increasingly investing abroad.

In order for companies to gain confidence and for the economy to pick up again, they are hoping for a government whose coalition partners have a common understanding of how to improve the economic framework conditions. Looking at the polls, however, a coalition between the CDU/CSU and the SPD or perhaps the Greens is emerging. Such a government is likely to relax the debt brake, for example by excluding state investments. In this respect, a new federal government could make significantly more funds available for investment in infrastructure. However, in most other areas of economic policy, the coalition partners would have significantly different views, which speaks against the necessary new start in economic policy. We remain cautious with regard to the German economy and expect de facto stagnation in 2025 (forecast: 0.2%).

Chart 2 - German competitiveness is eroding

Country index of the German family bussinesses association, Germany's ranking, total and in different categories compread with 20 advanced economies



Source: Stiftung Familienunternehmen, Commerzbank Research

... and France is also muddling through

In addition to Germany, France is also in crisis in the eurozone. This is not so much about economic growth (forecast 2024: 1.1%) as about the high and rising national debt. The debt level is already more than 110% of the gross domestic product, and a budget deficit of 6% of the gross domestic product is emerging for the past year. Even if the new government, despite lacking a majority in the National Assembly, were to succeed in reducing the budget deficit to 5.0 to 5.5% as targeted, it would still be too high to stop an increase in the debt-to-GDP ratio. The unstable political situation without a clear majority of the moderates in the National Assembly is not likely to change, even if President Macron were to call for new elections in the summer of 2025, which he wanted to avoid before the end of his term in 2027.

Nevertheless, investors should continue to price in the rising fundamental risks in an orderly fashion. The ECB's deeply layered defense system argues against a sovereign debt crisis. It was only in the summer of 2022 that the ECB expanded its toolbox to include the Transmission Protection Instrument (TPI), which allows it to buy government bonds on a large scale if it considers risk premiums to be fundamentally too high.

ECB: Rate cuts in the face of excessive inflation

For investors, the ECB's policy in 2025 will be a long-running issue. The ECB has already cut its deposit rate four times to 3.0%. It will probably reduce it to 2.0% by the middle of the year. On the one hand, the weakness of the economy argues in favor of this. The important Purchasing Managers' Index has fallen sharply since the summer of last year and is on the brink of recession, a fact that worries many supporters of a fundamentally loose monetary policy in the ECB Governing Council (“doves”). In their view, further interest rate cuts are justified by inflation. At 2.4%, inflation is still well above the ECB's target of 2%. But the majority of ECB Governing Council members expect wage growth to slow this year and inflation to fall.

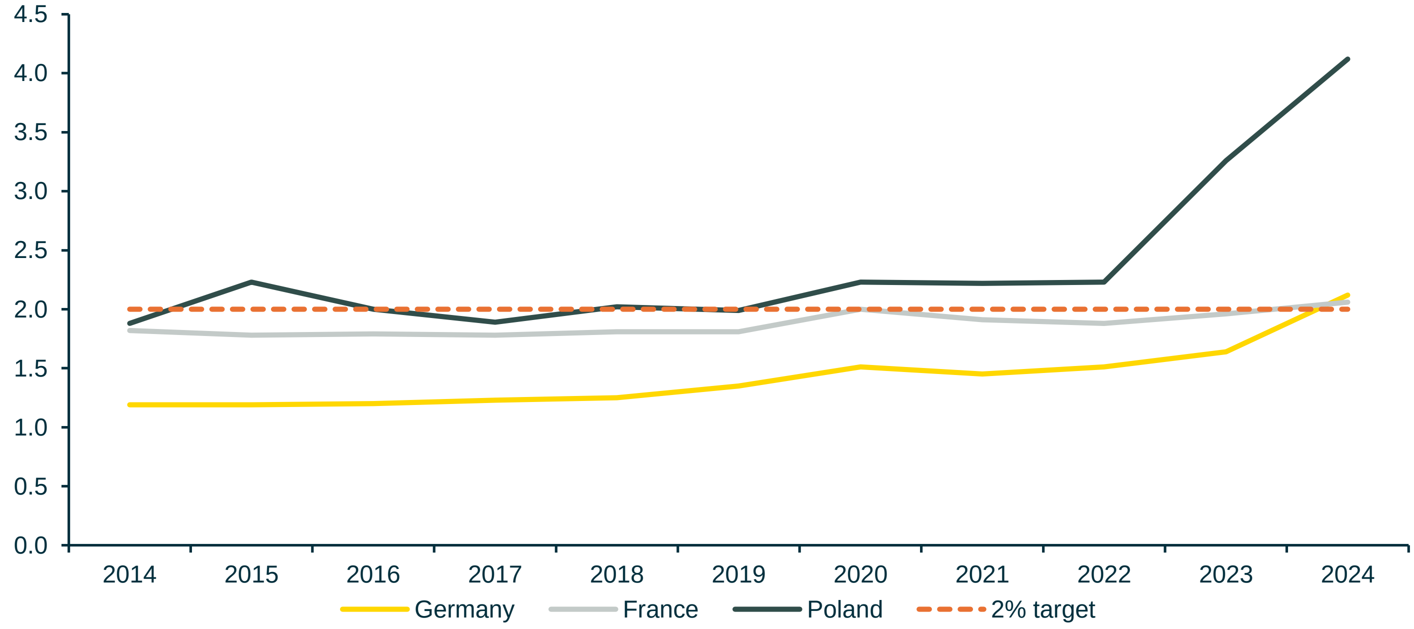
However, the ECB should not be expected to lower its deposit rate below 2%. First, the ECB sees 2% as the lower limit of the so-called neutral interest rate, which ensures that the ECB's inflation target is achieved in the long term. Secondly, persistently high services inflation argues against inflation falling below 2% in 2025 (Commerzbank forecast: 2.1%). Thirdly, there are upside risks to inflation due to Trump's tariff policy and a possible collapse of the rules-based world trade order.

Ukraine: A frozen conflict would not change much economically

During his election campaign, Donald Trump promised a swift end to the war in Ukraine. Many investors are hoping that this will bring relief. But a genuine peace is extremely unlikely because Putin has no real interest in one. Instead, we are likely to see a frozen conflict along the current front line, along the lines of the Korean Armistice Agreement of 1953. In such a scenario, little would change economically. The EU is likely to continue to boycott Russian gas, and because of Russia's continued imperialistic behavior, the democracies in Europe would significantly increase their defense spending (Chart 3). This applies all the more as the Americans do not want to keep pulling the chestnuts out of the fire for the Europeans. New demands will be made on Germany in particular, as the NATO 2% target was only just achieved after a ten-year delay and only with recourse to a “special fund”. According to many military experts, 2% is too little in the current situation anyway.

Chart 3 - Europeans will have to boost their defence expenditures

Defense expenditures in % of GDP. The 2014 NATO summit agreed on a 2% target



Source: NATO, Commerzbank Research

To sum up: what all this means for investors

The Federal Reserve is likely to lower its key rates only twice more this year due to the increased risk of inflation. However, this is not expected to be a major problem for the stock markets overall, because Trump will improve the long-term growth prospects for the US economy through lower corporate taxes and deregulation. 2025 should not be a bad year for equities, provided that Trump does not implement his tariff threats from the election campaign one-to-one.

With regard to the bond markets, we expect slightly rising bond yields in the second half of the year if US inflation rises due to tariffs and Trump increasingly interferes with monetary policy. This should have an impact on longer-dated German government bonds.

The dollar should continue to benefit a little from the planned US tax cuts and deregulation, which increase the profitability of real capital investments in the US. However, if it later becomes apparent that the US Federal Reserve is not unimpressed by Trump's pressure, the dollar should weaken again and the EUR-USD should recover accordingly.

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