Risks to our 2025 outlook

Four weeks ago, we published our outlook for 2025. Today we are analyzing whether things could turn out differently. For example, we are looking at whether the Fed will raise interest rates due to higher inflation as a result of tariffs, whether the eurozone will slide into recession and deflation fears will arise again or whether the high level of government debt in countries such as France will trigger a crisis.

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Fed is walking a fine line

The coming year is unlikely to be easy for the Federal Reserve. Inflation is likely to remain above its target of 2% in the coming year. Capacity utilization in the economy remains high, which suggests that wages will continue to rise quite strongly, which companies will probably largely pass on to their customers. Added to this is the emerging economic policy of the new Trump administration. The planned significantly higher tariffs and more expansionary fiscal policy are likely to significantly increase inflationary pressure.

The Fed will be walking a fine line when reacting to the rise in inflation. If it raises interest rates significantly, this would place a heavy burden on the financial markets. After all, the prospect of lower interest rates has at least contributed to the very positive development of the stock markets in recent months, and no interest rate hike is currently priced in on the futures markets. On the other hand, the Fed standing still despite rising inflation could also cause unrest on the financial markets and cause inflation expectations to rise, especially if there is a suspicion that the Fed would give in to political pressure. This would probably leave deep marks on the bond market in particular.

We assume that the Fed will successfully walk this tightrope. One argument against interest rate hikes (which are certainly appropriate in the longer term) is that this would put the Fed in open conflict with the government. The expected attacks from the White House would probably make some investors doubt that the Fed could maintain its independence in the long term. We therefore assume that it will not respond to higher inflation with interest rate hikes for the time being.

However, it is likely to stop its interest rate cuts at a key interest rate of 4% and point out that interest rates are still at a rather restrictive level. Investors are likely to take this on board and not revise their long-term inflation expectations upwards. After all, the Fed enjoys great confidence on the markets. As a result, investors' inflation expectations remained well anchored even if the central bank initially reacted hesitantly to the inflation shock in 2022.

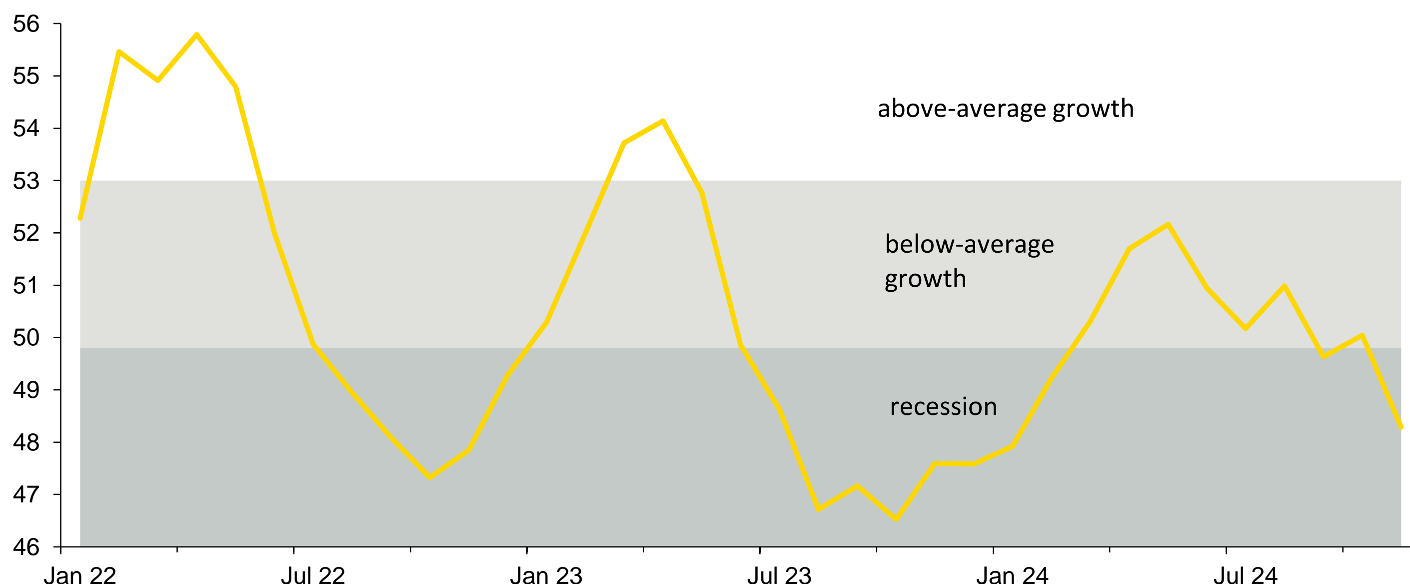
Recession in the eurozone?

While the US economy continues to grow quite strongly and is thus conjuring up inflationary risks, there is still no sign of the generally expected upturn in the eurozone. On the contrary, the Composite PMI fell again in November and is now at a level at which the eurozone economy was mostly in recession in previous cycles (Chart 1). Therefore, it cannot be ruled out that the eurozone economy will slide into recession before it picks up. After all, there are plenty of potential negative factors: weak demand from China, the threat of US tariffs on imports from Europe and the urgent need to consolidate public finances in some eurozone countries such as France and Italy.

However, the biggest negative factor of the past two years is likely to become less and less important: the ECB's massive rate hikes between summer 2022 and autumn 2023. By now, the economy should have largely become accustomed to the fact that borrowed funds have a significantly higher price again. Projects that are no longer profitable with higher interest rates are likely to have been largely discontinued, meaning that this adjustment process will no longer slow down growth. Instead, the rate cuts made by the ECB and many other central banks since the summer are likely to have an increasingly positive impact over the course of the coming year and stimulate an economic recovery, albeit a weak one (forecast for the eurozone in 2025: 0.9%).

Chart 1 - Euro area PMI in recession territorry

Euro Area, Purchasing Managers Index, seasonally adjusted



Source: S&P Global, Commerzbank Research

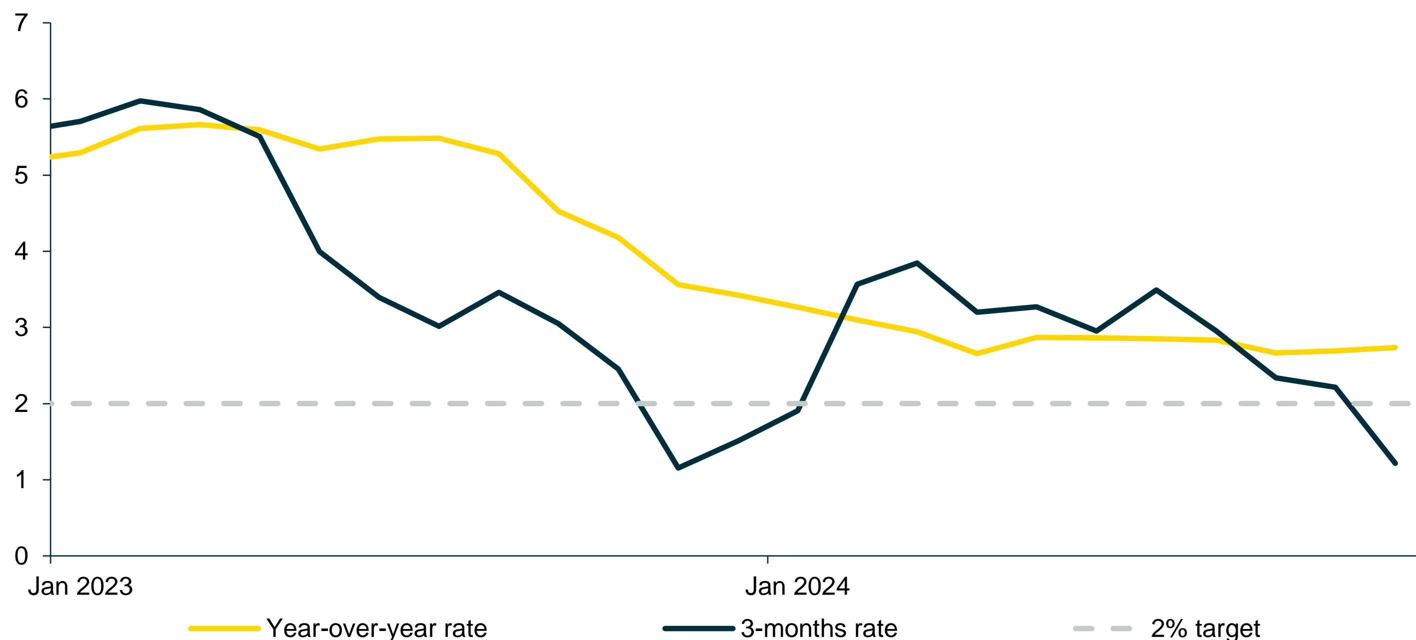
Eurozone: Are deflation fears returning?

At first glance, the inflation problem in the eurozone has not yet been solved. After all, core inflation (excluding energy, food and beverages) recently stood at 2.7%, still well above the ECB's 2% target. If individual ECB Governing Council members are nevertheless already warning of an undershooting of inflation, then they have the shorter-term inflation dynamics in mind. In fact, core consumer prices have only risen by 1.2% in the last three months on an annualized basis (Chart 2). If this trend continues, core inflation would fall well below the 2% mark in the course of the coming year. Warnings of a possible slide into deflation would then emerge – coupled with calls to cut the key interest rate well below the neutral level of 2% and to consider resuming net bond purchases. This would noticeably depress bond yields.

We expect core inflation to fall towards 2% in the coming quarters (forecast 2025: 2.3% after 2.9% in 2024), even if we continue to see inflation risks in the longer term due to structural factors such as de-globalization. The forecast decline in inflation in the coming year is primarily due to weak economic growth, which limits the pricing power of companies. In addition, the fall in oil prices is having an impact on core inflation – via transportation services, for example. However, the continued strong growth in wages speaks against core inflation of well below 2%. Collectively agreed wages in the eurozone rose by an average of 4.6% in the first three quarters of this year, which is not compatible with an inflation target of 2% in the longer term.

Chart 2 - Eurozone: Underlying inflation recently below 2%

Consumer price index for the eurozone, excluding energy, food, beverages and tobacco, changes over 12 and 3 months, in % p.a.



Source: ECB, Commerzbank-Research

Danger from high government debt?

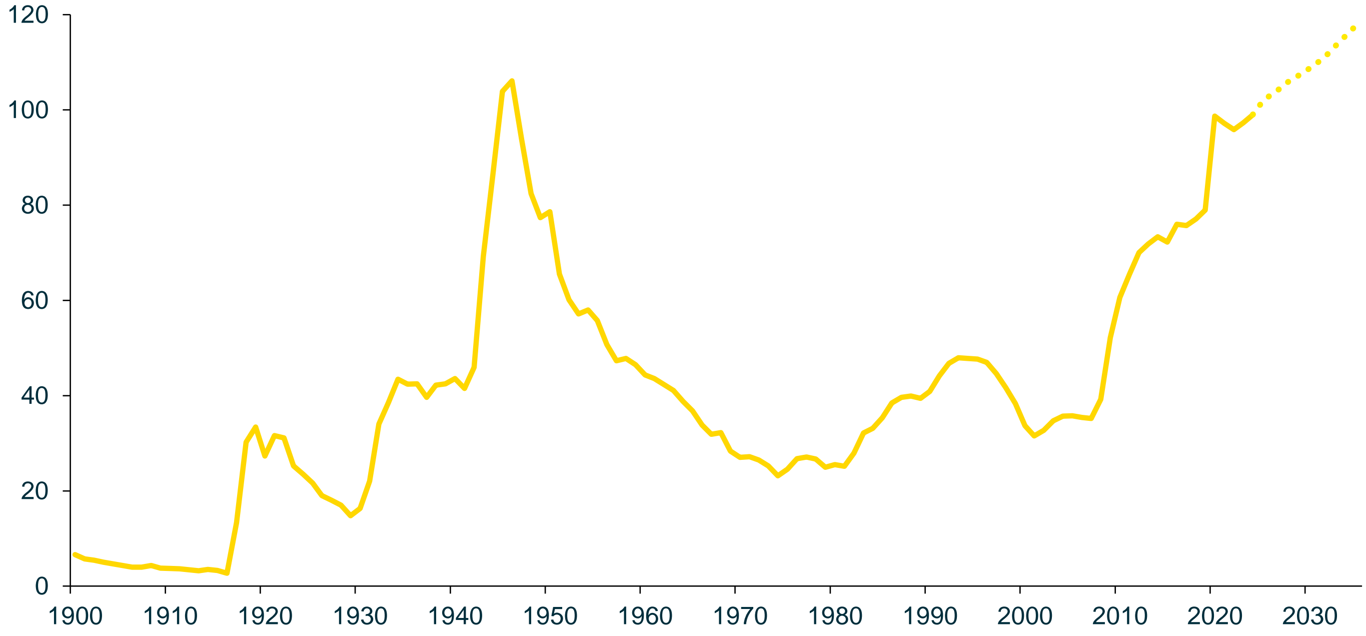
While some investors are worried about inflation being too low, there are also repeated concerns about excessive government debt. For example, the US federal government is heading for a budget deficit of more than 6% of GDP this year, although the unemployment rate is very low. The federal debt is almost 100% of GDP – similar to the level at the end of the Second World War (Chart 3). Public debt is also rising in the eurozone. In France, it is already at more than 110% of GDP, with the majority of the extreme left-wing and right-wing parties in the National Assembly making it unlikely that the far too high budget deficit of 6% of gross domestic product (2024) will fall significantly in the coming year. Against this backdrop, concerns about government debt in Western countries are understandable, especially as it is not possible to calculate exactly where the sustainability of government debt ends. A decline in investors' appetite for risk may be enough to trigger a strong reaction on the government bond markets.

The US continues to benefit from the status of the dollar as the world's reserve currency. There are no alternatives to the dollar in sight. The Chinese currency, for example, is not freely exchangeable and the euro suffers from the construction problem of a lack of political union. In this respect, the risk of turbulence on the government bond markets in the USA in 2025, as in the UK in 2022 ("Liz Truss moment"), is low. The fear of this is also likely to prevent Donald Trump from legally ending the independence of the Federal Reserve.

With regard to the eurozone, we have been emphasizing for many years that the causes of the sovereign debt crisis, namely the lack of budgetary discipline, have not been resolved. The events in France confirm this thesis. However, we have also been saying for a long time that we do not expect a new sovereign debt crisis. Since Draghi's famous speech in the summer of 2012, the ECB has built up a deeply staggered defense system. This includes two potential bond purchase programs (Outright Monetary Transactions from 2012, Transmission Protection Instrument from 2022) as well as the large stock of government bonds already purchased, which the ECB intends to continue for the most part in the long term in the form of a structural bond portfolio.

Chart 3 - US government debt about as high as at the end of WW II

US federal debt held by the public, in % of GDP, fiscal years. CBO forecast as of 2025



Source: CBO, Commerzbank Research

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