Market View
Monumental fiscal regime shift in Germany

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At a glance

- Germany's new coalition looks set to dismantle decades of fiscal policy in order to boost their defence spending.
- This follows a week of uncertainty in Europe, which has led to a strengthening of alliances in the face of distancing from other Western powers.
- Early market conditions indicate that the recent strengthening of European resolve has given the eurozone a boost, and would benefit further from a de-escalation and reconstruction efforts in Ukraine.

As investors, we are always trying to separate meaningful information from the noise, not an easy task within the ever-changing geopolitical landscape. But this week, amid the barrage of news coming out of Washington, we felt the most significant events came from Germany, which announced plans for one of the largest fiscal regime shifts in post-war history.

In recent years, Europe has been grappling with sluggish growth and burgeoning debt in an increasingly complex and dynamic global landscape. President Donald Trump's US-centric approach, combined with an internal acknowledgment of the need for change—evidenced by frequent comments and papers from individuals like former European Central Bank ("ECB") President Mario Draghi—has prompted Europe to rethink its strategy and embark on a bold, fiscally expansive trajectory to upgrade its military and infrastructure as it decouples from the US.

Earlier this week, Germany's new coalition tentatively agreed to all but dismantle the country's debt brake by announcing plans that include a €500 billion special purpose vehicle for infrastructure investment, an exemption from the debt brake for defence spending above 1% of GDP and a rise in the net borrowing cap for federal states. The magnitude of the proposal was well above what markets were expecting. This was monumental and marks a stunning reversal for the political establishment in a country known for its cautious culture.

"The world is not waiting for us"

Less than two weeks after Friedrich Merz led his Christian Democrats and their sister party Christian Social Union to victory in Germany's election, it is looking likely that Merz will form a coalition with the Social Democrats. Merz—who swiftly assumed the role chancellor-in-waiting—has moved fast, urging his country to quickly address challenges both domestically and internationally, as "the world is not waiting for us."[1]

And move fast they have. Just 10 days after Germany elected a new parliament, leaders of the Christian Democrats and the Social Democrats agreed to three material changes to the debt brake before the end of the outgoing parliament, where the centrist parties still hold a constitutional majority.

Although the debt brake—a rule put in place by Angela Merkel in 2009 that limits Germany's annual borrowing to 0.35% of GDP—is anchored in its constitution and would remain in place, it

would be abolished for military expenditure on defence spending when it exceeds 1% of GDP.[2] Some German economists believe defence spending could rise to as much as 3% of GDP as early as next year, with these proposals allowing Germany to invest heavily in their military. Although passing these plans may not prove straightforward—the Green party's support is needed for a constitutional majority, and they have not yet confirmed if they will support these changes—economists believe they will support it.[3]

On 5 March, the EU also announced plans for a new defence package ahead of the EU leaders summit on 6 March, the proposals which would allow member states to increase defence spending without triggering the EU's deficit rules. They also proposed a new instrument that would provide €150 billion of loans for defence spending.[4]

The scale and speed of these deals underscores how European countries are prioritising cooperation and defence spend at a time when the continent faces uncertainty over changing Western alliances.

What does this mean for the EU and for growth?

Germany's swift action in forming a new government and outlining fiscal plans could be positive for long-term growth prospects in the bloc. While it is still early days, this fiscally expansive approach, combined with more cohesive leadership and improving fundamentals against a backdrop of cheaper valuations, could be just the tonic for European companies. Equities in Germany, France and Italy have posted strong returns so far this year, and just over $4 billion went into passive funds last week, the largest weekly inflow into Europe in 15 years. [5]

While the announced stimulus may take time to implement, regional markets will no doubt benefit from some clarity.[6] In addition, a de-escalation of the war in Ukraine could lower energy prices and stimulate European growth and reconstruction efforts in Ukraine. The euro has strengthened on the news, while looser fiscal policy has sent German bund yields higher. Some forecast 10-year German bunds could reach 3% as investors turn towards equities. While the ECB cut its deposit rate on Thursday to 2.5% from 2.75%, the path forward amid the scale of fiscal stimulus has become more complex.

Conclusion

Outside of a pandemic, rarely has the macro climate changed in such a short period of time. Trump entered the White House promising US exceptionalism. But US companies are paring back expenditure, as indicated by weak PMI services and ISM manufacturing data, and consumer confidence is low, bringing 'American exceptionalism' into question. The catastrophic meeting between Trump and Ukrainian President Volodymyr Zelensky late last month meant investors have had to recalibrate expectations of the US-led world order. After suspending US military aid to Ukraine, Trump signalled a willingness to reset the relationship with Ukraine after Zelensky sent him a message saying Ukraine was "ready to come to the negotiating table as soon as possible to bring lasting peace closer."[7]

This past week specifically was volatile for global markets, as Trump's tariffs came into effect on 4 March, which include 25% tariffs on Canada and Mexico and additional 10% levies on China. These have resulted in retaliatory tariffs and sharp movements in US equities. (As of 6 March, Trump paused some of these tariffs on Canada and Mexico.) Since the start of this year, not only have US equities significantly underperformed European equities—in anticipation of this new German led fiscal regime—but they are now trading at levels just below those seen on Trump's first day in the White House.

The strengthening of European alliances, off the back of a turbulent decade within the Eurozone, is proving to be significantly positive for European markets. This reunification and subsequent market growth presents opportunities for investors. As always, we continue to seek good, quality companies at fair valuations, with some bond and alternative exposure, which will ultimately benefit investors long-term.

[1] New York Times: https://www.nytimes.com/2025/03/04/opinion/friedrich-merz-germany-chancellor.html

[2] Euractiv: https://www.euractiv.com/section/politics/news/germanys-centrist-parties-plan-to-unlock-billions-for-defence-and-infrastructure/

[3] Deutsche Bank

[4] EU: https://ec.europa.eu/commission/presscorner/detail/sv/statement_25_673

[5] Selwood Asset Management

[6] Funds Society: https://www.fundssociety.com/en/news/markets/the-debt-brake-defense-spending-and-fiscal-policy-at-the-center-of-the-debate-after-the-german-elections/

[7] https://www.nytimes.com/2025/03/04/world/europe/ukraine-us-trump-military-support.html

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