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# What to watch: The EU Competitiveness Compass, Eurozone back to stagnation and DeepSeek's AI breakthrough

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## In summary

This week we look at three critical issues:

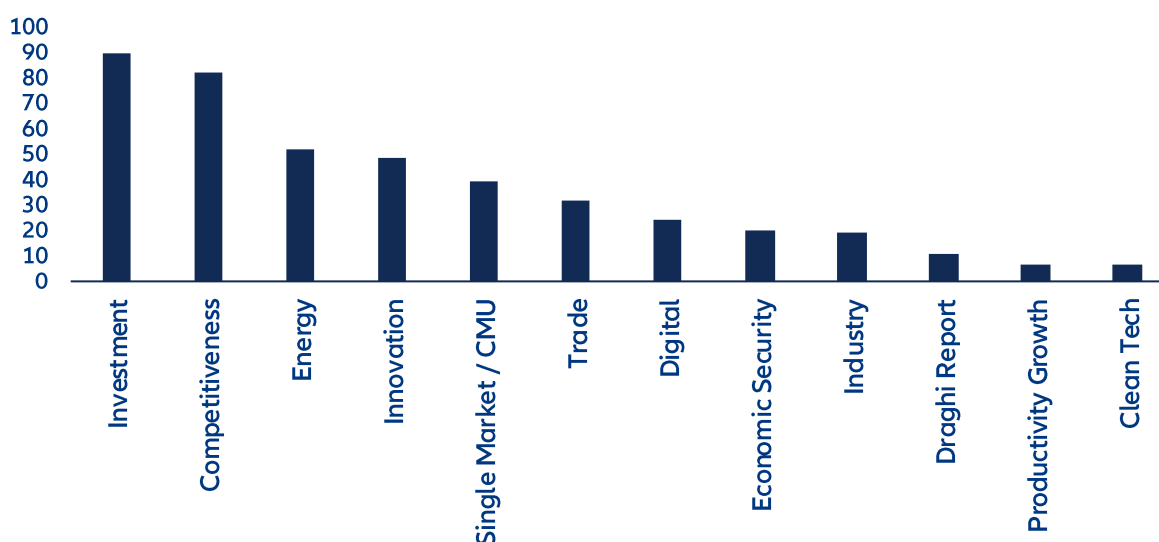
- **An ambition to put the EU back on track, without new ideas.** The Commission's new "Competitiveness Compass" focuses on boosting investments, simplifying regulatory burdens and addressing structural challenges, particularly the ongoing energy crisis. But financial details remain vague. One concrete target is a 25% cut in annual reporting costs (EUR37.5bn), a modest +0.5pp of additional margin for companies. Another is to mobilize up to EUR470bn in additional financing by finally completing the Capital Markets Union, though this falls short of the EUR800bn annual investment gap identified in the Draghi report. The plan also promises a new Clean Industrial Deal, supporting energy-intensive industries and strategic sectors such as AI, space and clean tech. While a new EUR500bn European Competitiveness Fund is expected by year-end, its impact will depend on strong public guarantees or Eurobonds to scale up funding. Turning plans into action will require overcoming deep political resistance and execution challenges, as seen with the NGEU funds, of which 60% remains to be disbursed.
- **Eurozone: back to stagnation.** Zero quarterly growth in Q4 brings annual growth in 2024 to +0.7%, slightly below expectations. Germany (-0.2% q/q) and France (-0.1%) contracted due to weak exports and base effects from the Olympics, respectively. Italy flat-lined while Spain (+0.8%) and Portugal (+1.5%) powered on. The still weak growth picture combined with lackluster survey data in early 2025 adds fears of a delayed recovery, and potentially a prolonged recession in Germany. However, consumer spending picked up, with disinflation supporting purchasing power. This should remain a driver of growth and investment will start to benefit from lower financing costs. Overall, we expect Eurozone GDP to rise by +1.2% in 2025 but downside risks are looming amid potential trade disputes with the US and lingering political uncertainty in France. According to national data available, Eurozone inflation (to be released on Monday) is expected to have inched down from 2.4% y/y to 2.3% in January.
- **DeepSeek's AI breakthrough: Sputnik moment or Potemkin village?** DeepSeek's low-cost and open-source R1 models sent huge shockwaves through global tech and stock markets this week, challenging US dominance in the field including trade choices, as well as AI firms' business models and valuations. Its success paves the way for higher AI adoption as costs go down, which could push up productivity by an average of +16% for telecom, business services, publishing and financial services, 5x times higher than in a low-adoption scenario. Demand for chips and AI-related hardware and services should continue to grow but the sector could face a rebalancing in terms of product mix. As a result, investor scrutiny will increase, and equity investors should brace for more episodes of volatility.

## The EU's new competitiveness agenda: the ambition has been voiced, the plan is still fuzzy

**The European Commission's competitiveness agenda is starting to take shape.** On 29 January, the European Commission published its "Competitiveness Compass", which unveils its plan to revamp the EU's competitiveness over the next five years, translating the Draghi recommendations into concrete actions.

**Brace for impact: around 40 initiatives were announced on wide-ranging topics, such as artificial intelligence, decarbonization, industrial policy, critical materials, financial services, R&D and agriculture.** Perhaps unsurprisingly, the document mentions "investments" more than 90 times (Figure 1). This is in line with the Draghi report, which quantified the additional annual investment needs at over EUR800bn in several key sectors such as energy, digital and industry. This investment is even more urgent as fixed capital formation in the Eurozone remains 6% below pre-pandemic levels, contrasting with the US and UK, which are 15% and 6% above, respectively.

Figure 1: Most frequently used words in the Competitiveness Compass, word count



Sources: European Commission, Allianz Research

**New flagship "horizontal policies" will quickly be put on the table.** In order to mobilize up to EUR470bn in additional financing (out of the EUR545bn excess savings at the EU level), the European Commission plans to finally complete its decade long project of creating a Capital Markets Union (CMU), which has been rebranded as the Savings and Investments Union. How? With the introduction of "single and low-cost saving and investment products at EU level", the "unlocking of securitization" and measured for a more "unified supervision". However, even if successful, this falls short of the EUR800bn annual investment gap identified in the Draghi report.

**A new European Competitiveness Fund** (likely totaling EUR500bn) will thus also be introduced in the next budget of the EU (MFF) to "finance investments in strategic technologies and manufacturing – from AI to space, clean tech, and biotech". The ambition is clear, but turning plans into action will require overcoming deep political resistance and execution challenges, as the fund's impact and size will depend on whether strong public guarantees or Eurobonds are introduced to scale up funding. This is illustrated by the NGEU funds, of which 60% still need to be disbursed four years since they were agreed upon, representing a total of about EUR400bn or 3% of EU GDP. Given the low absorption of these funds, if there is one lesson to be learnt it is that implementation procedures need to be simplified and coordination between several levels of government and stakeholders needs to be strengthened so that projects are implemented efficiently and rapidly to eventually boost productivity.

**Simplification, one of the most important topics with high impact for the economy and companies, will also be high on the agenda, with the introduction of a new "competitiveness check".** This will look at the economic impact

of new legislation on companies, particularly on small and medium sized ones (SMEs) – the backbone of many European economies – and should include a stronger sectoral focus. It will assess the competitive position of EU companies in the sectors most affected by each proposal, using indicators and qualitative information. This “check” on new regulations will consider four key dimensions, namely cost/price competitiveness, international competitiveness, capacity to innovate and impacts on the competitiveness of SMEs. The sector focus will also be based on the analysis of a set of indicators, providing a proxy of the competitive position of EU companies affected. If competitiveness issues are identified, mitigating measures will be considered. The competitiveness check will be included in the European Commission’s impact assessments and will include a presentation of the costs and benefits of its proposals. Based on short and medium-term risks (demographics, geopolitics, climate change, race for raw materials) and opportunities (AI, automation, robotics), we expect automotive, defense, tech, transportation, pharmaceuticals, agrifood and electronics to be in focus.

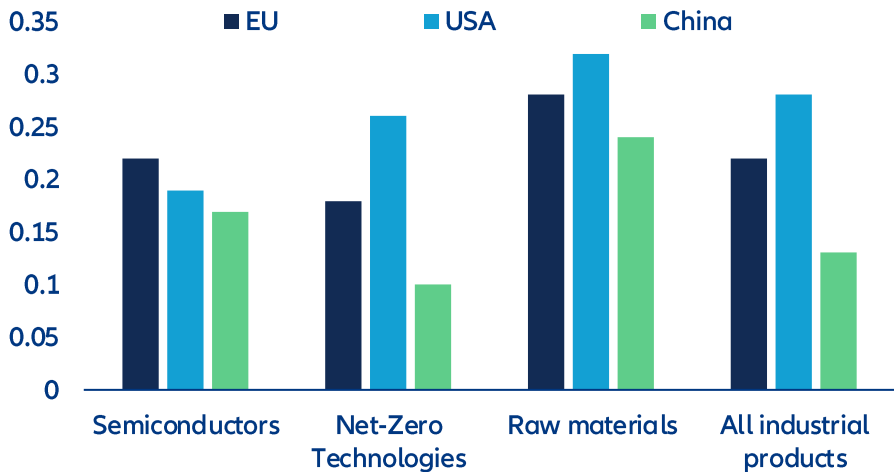
**This radical change in the way the European Commission designs policies is a direct nod to the proposals made by business federations and several European governments.** The overarching goal of the second von der Leyen Commission to slash reporting obligations is thus elevated as the cornerstone of the Commission’s workplan during the next five years. For reference, Eurostat has approximated the overall recurring reporting costs at EUR150bn in the EU, which means that the Commission aims at a EUR37.5bn decrease in annual reporting costs through its simplification agenda. Beyond simplification, the Commission announced a set of new policies that will focus on three pillars: closing the innovation gap, aligning competitiveness with the EU’s decarbonization strategy and reducing dependencies.

**On the innovation front,** the EU will put forward several initiatives, including a “28th legal regime” which will harmonize insolvency, labor and tax laws for innovative companies. Other key proposals will include a new start-up and scale-up strategy, a reinforced TechEU investment program, led by the EIB, a new AI Continent Strategy, an EU Cloud and AI Development Act and a Data Union Strategy – all of this in the first two years of the Commission.

**While there have been calls for the EU to reconsider its climate ambitions, the European Commission will stay on track** and propose to set out a 90% emission-reduction target for 2040 in the European Climate Law, while also aligning competitiveness with its decarbonization’s strategy. The aim is to align green transitions with industrial growth, ensuring energy affordability, and supporting energy-intensive industries which have come under pressure due to higher energy prices since the start of the Ukraine war. A new clean industrial deal (expected for 26 February) will support energy-intensive sectors like steel, cement and chemicals through tailor-made action plans, while promoting clean tech and new circular business models. A new affordable energy action plan will be presented, while a reform to the Carbon Border Adjustment Mechanism to minimize the cases of circumvention is also envisaged.

**Lastly, the EU will aim at regaining its competitiveness by reducing dependencies, integrating security considerations into economic policies.** Alongside the compass, the 2025 Annual Single Market and Competitiveness Report was also released, which will serve as foundation to the forthcoming Clean Industrial Deal and Single Market Strategy. The report includes a brand-new External Vulnerability Indicator (EXVI) that is designed to help policymakers develop effective strategies to reduce vulnerabilities, enhance resilience and drive long-term growth. It reveals that the EU is overall more exposed, facing the greatest vulnerability in raw materials in strategic supply chains such as semiconductors, net zero tech and critical raw materials (Figure 2). The EU is more vulnerable across all three strategic supply chains relative to China but when compared to the US, the EU appears more vulnerable only in chips. To get a grasp on this, the EU will diversify supply chains on raw materials, technologies and medicines and set up a joint purchasing platform to coordinate EU-wide demand. Additionally, as the EU becomes increasingly interested in defense, the European Commission will aim at enhancing defense capabilities, boost EU defense R&D and integrate national industries by establishing a single market for defense products through joint procurement and industrial collaboration.

Figure 2: External Vulnerability Index (EXVI) across strategic supply chains: EU, China and US



Sources: European Commission, based on the latest BACI database (2022). Note: EXVI scores: 0= low vulnerability, 1=high vulnerability, Allianz Research

**Will this be enough to restore the EU’s competitiveness?** The plan is good news overall but to implement this work program the EU will require a decisive political change from the past. As “scale” is the name of the game when it comes to clean and digital revolutions, deep-rooted political resistance from member states to build a truly European industrial policy will have to be overcome. A first analysis of the EU’s upcoming initiatives in terms of impact and likelihood of being fully implemented (Figure 3) shows that the road will be long. Yet, the Trump presidency opens new challenges but also new opportunities for Europe, starting with the clean tech sector now thrown into deep uncertainty in the US. Europe can play an important game here, but it must be faster, smarter and more united.

Figure 3: A first impact assessment of the European Commission’s upcoming initiatives

|                  | Low Impact*   | High Impact   |
|------------------|---|---|
| High Probability | <p>Water Resilience Strategy (Q2 2025)</p> <p>Space Act (Q3 2025)</p> <p>European Strategy for Research and Technology Infrastructures (Q3 2025)</p> <p>Revision of the Standardisation Regulation (TBD 2026)</p> <p>European Port Strategy (TBD 2026)</p> <p>Revision of public procurement at Union level (TBD 2026)</p> <p>Circular Economy Act (TBD 2026)</p> | <p>Affordable Energy Action Plan (Q1 2025)</p> <p>Clean Industrial Deal (Q1 2025)</p> <p>Carbon Border Adjustment Mechanism Extension (Review in 2025)</p> <p>Omnibus simplification and definition of small mid-caps (Q1 2025)</p> <p>Chemicals industry package (Q4 2025)</p>   |
| Low Probability* | <p>Sustainable Transport Investment Pact (Q3 2025)</p> <p>Digital Networks Act (Q4 2025)</p> <p>European Biotech Act (Q4 2025)</p> <p>Critical Medicines Act (TBD 2025)</p> <p>Advanced Materials Act (TBD 2026)</p> <p>European Research Area Act (TBD 2026)</p>   | <p>European Savings and Investment Union (Q2 2025)</p> <p>Common European Defence Strategy (Q1 2025)</p> <p>Start-up and Scale-up Strategy (Q2 2025)</p> <p>EU Quantum Strategy (Q2 2025)</p> <p>Joint purchasing platform for Critical Raw Minerals (Q3 2025)</p> <p>AI Continent Initiative (Q4 2025)</p> <p>New Competitiveness Fund in the next EU budget (TBD 2025)</p> <p>European Climate Adaptation Plan (TBD 2026)</p> <p>28th regime for companies (TBD 2026)</p> <p>Union of Skills, Skills Portability Initiative &amp; Quality of Jobs (TBD 2026)</p> <p>New State Aid Framework (Q2 2025)</p> |

\* Low probability/impact can mean that the policy or regulation will either not be implemented or watered down

Competitiveness and decarbonisation  
 Color Closing the innovation gap  
 code Horizontal enablers  
 Security and reducing dependencies

Sources: European Commission, Allianz Research

**Eurozone: back to stagnation**

Preliminary GDP data suggest that the Eurozone economy stagnated at the end of 2024, with growth slowing from +0.4% q/q (+0.9% y/y) in Q3 to +0.0% q/q (+0.9% y/y) in Q4, missing both consensus expectations (+0.1%) and our own (+0.2%). As a result, annual growth in 2024 stood at +0.7%, up from 0.5% in 2023. However, full details are still to be released, with the flash estimate based on a limited set of national level contributions (Figure 4). Notably, highly volatile economic growth in Ireland contributed to the slowdown of the aggregate Eurozone number. Despite representing only 4% of the Eurozone economy, its GDP growth slowdown from +3.5% q/q in Q3 to -1.3% q/q in Q4 accounted for almost half of the deceleration of the entire Eurozone. At the country level, the Iberian Peninsula was again the bright spot, with Spain and Portugal showing robust growth, while Germany and France contracted slightly. Another encouraging aspect of this week’s preliminary GDP release is that private consumption appears to have made a strong contribution for the second consecutive quarter, while weakness stems from a drag in net exports. This aligns with our long-standing view that domestic demand is rebounding, supported by rising real

wages and easing monetary policy. Overall, we expect GDP to rise by 1.2% in 2025 but the balance of risks remains tilted to the downside amid potential trade disputes with the US and lingering political uncertainty in France.

**After a year marked by both economic and structural challenges, Germany's economic activity contracted by -0.2% q/q in Q4 2024, largely due to a decline in exports.** On a positive note, household consumption continued to grow, supported by rising consumer sentiment due to strong real wage growth, and government final consumption increased (Figure 4). However, the manufacturing sector, a critical pillar of the German economy, remains in recession as reflected in PMIs and the Ifo business climate survey. In contrast, the services sector has shown notable resilience. Despite these positive developments, economic and political uncertainties are dampening investment. The outlook for 2025 remains fragile, with the risk of stagnation. Government spending is expected to remain constrained until a new coalition is formed and Germany's export-reliant growth model faces headwinds, compounded by the potential for trade disputes. Investment remains cautious as uncertainty about the future of political and economic policies looms.

**France's GDP contracted by -0.1% q/q in Q4, but this reflected mostly a payback from the Olympics-related boost in Q3. Underlying domestic demand was soft but resilient to domestic and international headwinds.** Consumption (ticket sales registration) and exports (sales of broadcasting rights) of services pulled back sharply after the Olympics-related boost in the previous quarter. Meanwhile, construction investment remained very weak, slipping sharply over Q4 (-1.2% after -0.2%). However, the other components of GDP were resilient to the rise in political uncertainty. Business investment in services (+1.1%) and manufacturing products (+0.2%) edged up over the quarter, while households' consumption increased sharply for automobiles and grew decently for food products. Manufacturing production (+0.2%) managed to edge up a bit despite a weak European industrial sector and sharp increase in trade policy uncertainty, though it remains weak. Goods exports rebounded and wrapped up a relatively good year. The French economy's momentum at the beginning of 2025 seems to remain soft and growth is expected to record modest gains in Q1 (+0.1/0.2%) amid lingering domestic and international uncertainty, a weakening labor market and slowing government consumption growth.

**Italy's economy stagnated for the second consecutive quarter in Q4, falling short of both our expectations and the consensus forecast.** According to the preliminary estimate, the domestic component contributed negatively to growth, while net trade supported activity. Conversely to Germany and France, it seems that private consumption remained weak; retail sales declined by -0.8% and -0.6% m/m in October and November, respectively, and consumer sentiment deteriorated during the last quarter of 2024. This means overall GDP growth of +0.5% in 2024 and a 0% carry-over effect for 2025. Moreover, the labor market, once the bright spot of the Italian economy, also sent some warning signs: the unemployment rate increased to 6.2% in December, 0.3pp up from the month earlier, after four years of marked improvements. All in all, we still expect a soft rebound in 2025 on the back of recovering consumer sentiment and spending, but the outlook remains challenged.

**In Spain, private consumption and investment have started to catch up with the strong export activity, with the country posting another solid +0.8% q/q growth rate in Q4 2024.** This marks the sixth consecutive quarter of strong growth and brings the economy 7.5% above pre-Covid levels (compared to 4.7% for the Eurozone average). Encouragingly, the expansion was less driven by export activity, the dominant engine of the post-pandemic rebound, but rather investment activity picked up markedly (+2.8% q/q) and private consumption resumed (+1.0%). Exports increased only slightly (+0.1%) and imports rose by +1.3%. This means 2024 growth surpassed our +3.0% call, reaching +3.2%. Even if we expect the pace of activity to slow down in 2025, the Spanish economy will still outperform its Eurozone peers, with recovering spending and NGEU investment to provide further support.

Figure 4: GDP contributions (EZ, DE, IT contributions for Q4 are Allianz Research estimates) %

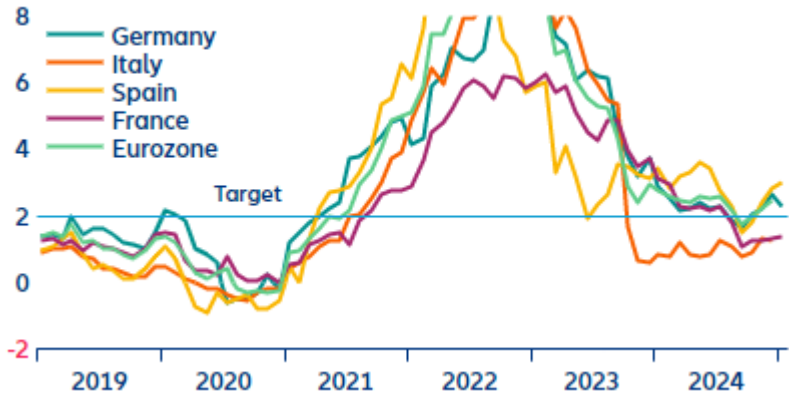


Sources: LSEG Datastream, Allianz Research

Meanwhile, inflation in the Eurozone is set to move back towards the ECB's target rate of 2% in 2025 after having inched up for three consecutive months from 1.7% y/y in September last year to 2.4% y/y in December. Over the past months, inflation largely increased on base effects, which should dissipate going further, as well as a rebound in energy prices partly fueled by a weaker euro (Figure 5). Preliminary estimates for January inflation from Germany, France and Spain show a mixed bag. In **Germany** inflation decreased by 0.3pps to 2.3%, primarily driven by a decline in goods and food prices, which both fell below 1%. However, services remain persistent at 4.0%, mainly due to rising public transportation costs ("Deutschlandticket"). There are still some upside risks as the higher CO2 price - up EUR10 from EUR45 to EUR55 per ton - could lead to increased costs for a wide range of products, not just energy.

In **France**, inflation increased slightly to +1.4% y/y, but services inflation continued to pull back, breaking below 2% for the first time since December 2021. In **Spain**, higher fuel and electricity prices pushed inflation up to 3.0% y/y in January (from 2.8% in December), while core pressures eased to 2.4% y/y (-0.5% m/m, from 2.6% y/y). For the Eurozone's aggregate inflation, set for release on Monday, this preliminary data from national accounts suggests a slight decline from 2.4% to 2.3% in January.

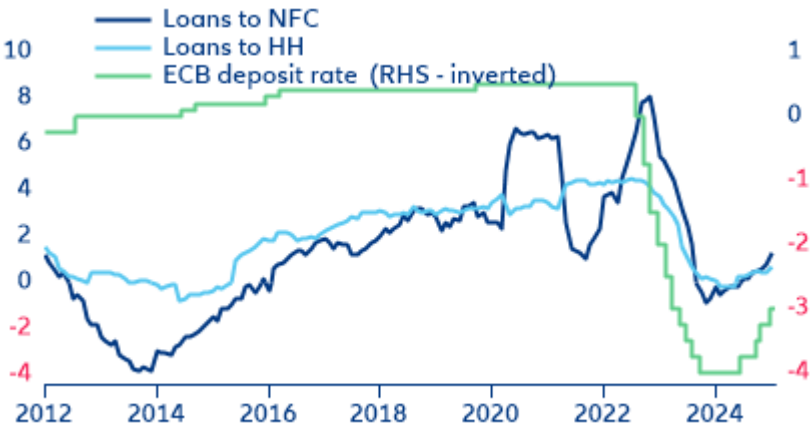
Figure 5: Inflation across Eurozone economies, % y/y



Sources: LSEG Datastream, Allianz Research

**This week’s credit and banking data further confuse the picture for Eurozone consumers and firms.** If the ECB’s Bank Lending Survey signaled a tightening of credit conditions – at least for corporates – the pick-up in credit growth to the private sector was the highest in two years at the end of 2024, showing the impact of monetary policy easing. Harsher lending terms for firms were driven by higher perceived risks related to the economic outlook and by banks’ lower risk tolerance; the tightening trend is also expected to continue in the current quarter. This was particularly evident in Germany and France, which experienced increased political uncertainty. But banks’ credit to firms picked up substantially to 1.5% y/y in December (from 1.0% a month earlier) (Figure 6). Moreover, the ECB’s Survey on Access to Finance for Enterprises reported declining bank interest rates on corporate loans in Q4 2024, although indicating a slight further tightening of other lending conditions. Overall, demand for corporate loans remained weak, given the still muted business investment. Households faced broadly unchanged credit standards for housing loans, in contrast with the strong net easing that banks had expected in the previous quarter, despite a significant rebound in demand on the back of declining interest rates and recovering housing market prospects.

Figure 6: Eurozone loan growth, % y/y



Sources: LSEG Datastream, Allianz Research



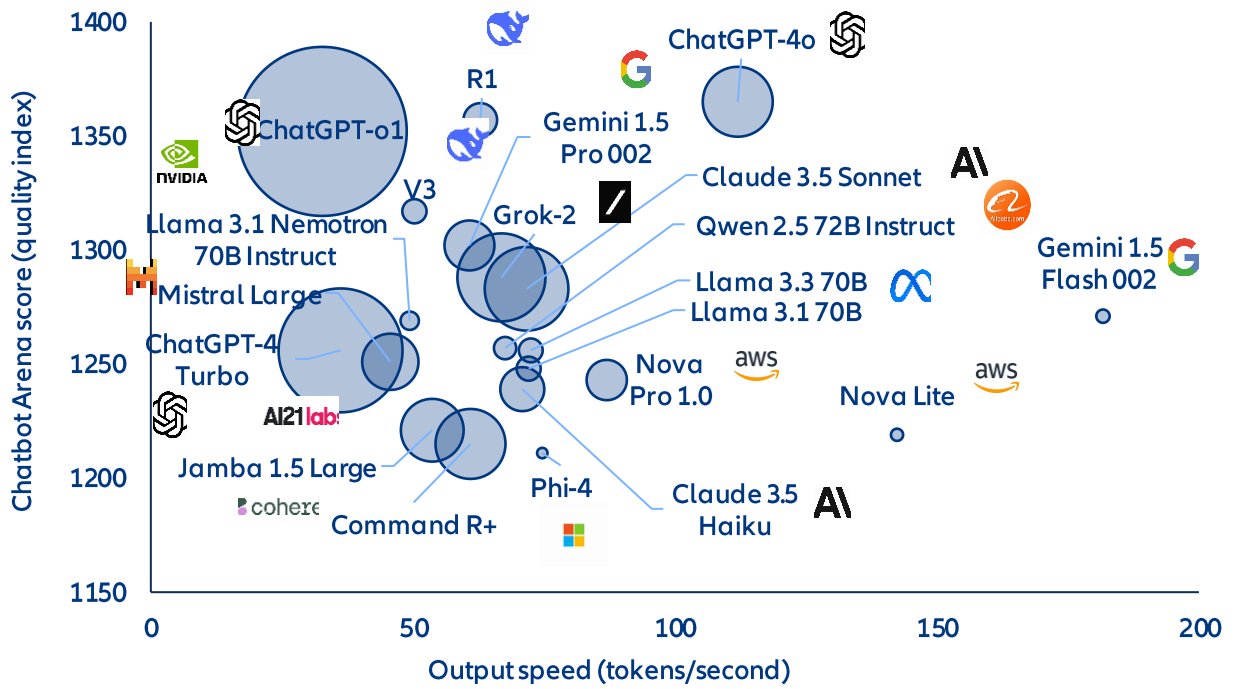
**Against this backdrop, the ECB delivered its fifth rate cut and further easing is expected.** As expected, the ECB lowered the deposit rate by 25bps to 2.75% this week. The disappointing growth picture combined with lackluster survey data reaffirms our expectation of continued cuts at each upcoming meeting, reaching a terminal rate of 2.0% by June 2025. This level would remain above the current estimate of the neutral rate using the Holsten-Laubach-Williams approach (1.8%). It would also be in the middle of the range of ECB staff expectations (1.5%-3.0%) but would be considerably lower than structural nominal GDP growth rate (+3.2%), which serves as another anchor for a long-term neutral rate. Several ECB officials have raised concerns about moving below the neutral rate in order to keep a buffer should economic conditions deteriorate, particularly amid rising geopolitical risks.

## **DeepSeek breakthrough: Is AI living a Sputnik moment or facing a Potemkin village?**

**Did ChatGPT just lose its job to AI?** The success of Chinese start-up DeepSeek's R1 model sparked a wave of panic across global markets on 27 January. Fearing snowball effects from a bleaker outlook for the semiconductor industry, investors heavily sanctioned not only the rising star of the US equity market (chipmaker Nvidia, which lost a record USD600bn in market capitalization (-17%)) but also other key players connected directly and indirectly to the AI industry. DeepSeek, which has been around for less than two years, managed to design and create an open-source Large Language Model (LLM) that competes with those built by US big tech companies such as OpenAI (ChatGPT-4o, o1), Anthropic (Claude Sonnet 3.5) and Google (Gemini 2.0 Flash) in coding and solving mathematical problems and reasoning tasks. The performance is all the more striking as DeepSeek claims to have relied on a much smaller budget as it is not officially supported by a major technology company with deep pockets, nor backed by a state agency. Moreover, since 2022, it has also suffered from reduced access to cutting-edge US chips after the Biden administration implemented export controls on US technology hardware towards China. The company is reported to have trained its R1 model with a "light version" of the Nvidia star chip H100 – the H800 version – whose capabilities have been reduced before being exported to China (lower chip-to-chip rate), though some are questioning whether DeepSeek managed to bypass restrictions and indirectly gain access to cutting-edge chips. Nevertheless, based on publicly released figures, DeepSeek would have spent around USD5.6mn in total to train its most recent R1 model. In comparison, the CEO of the US firm OpenAI reported a training cost of over USD100mn for version 4 of its ChatGPT model.

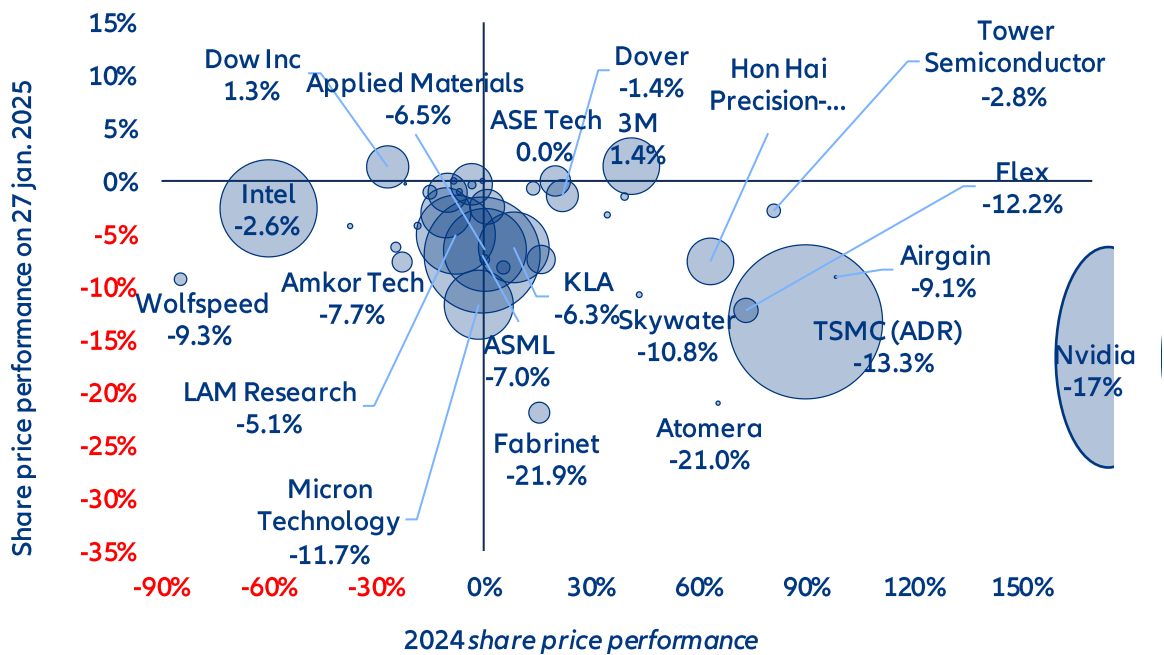
**While developers, scientists and economists are cheered by the prospects of accelerating digitalization at a lower cost, from an investor standpoint, the DeepSeek achievement opens the door to a less chip intensive AI-driven economy.** While it is too early to see how far this technological breakthrough will go, it does mark a pivotal moment that could trigger long-lasting impacts on trade, markets and the capital environment. The timing of the market rout is also thorn in the side for the new US administration, coming just after the announcement of the massive USD500bn Stargate project to boost AI. A correction in what looks like an overheating equity market is not a bad thing from an investor's perspective as it brings some balance to the market, offering some buying opportunities to investors that missed the rally and, counter-intuitively, strengthening the confidence among retail investors that the market remains sensible. We do not think that the bull trend is over due to DeepSeek's advancements, but it is nevertheless likely that investors will scrutinize the "AI yield" further in the future, or returns from AI-dedicated capex that so far are not materially visible.

Figure 7: New DeepSeek LLM models (R1 & V3) are among the best performing despite a low training cost



Sources: Chatbot Arena, Artificial Analysis, Allianz Research. Note: Bubble size = total training cost (input + output cost in USD/1Mln token).

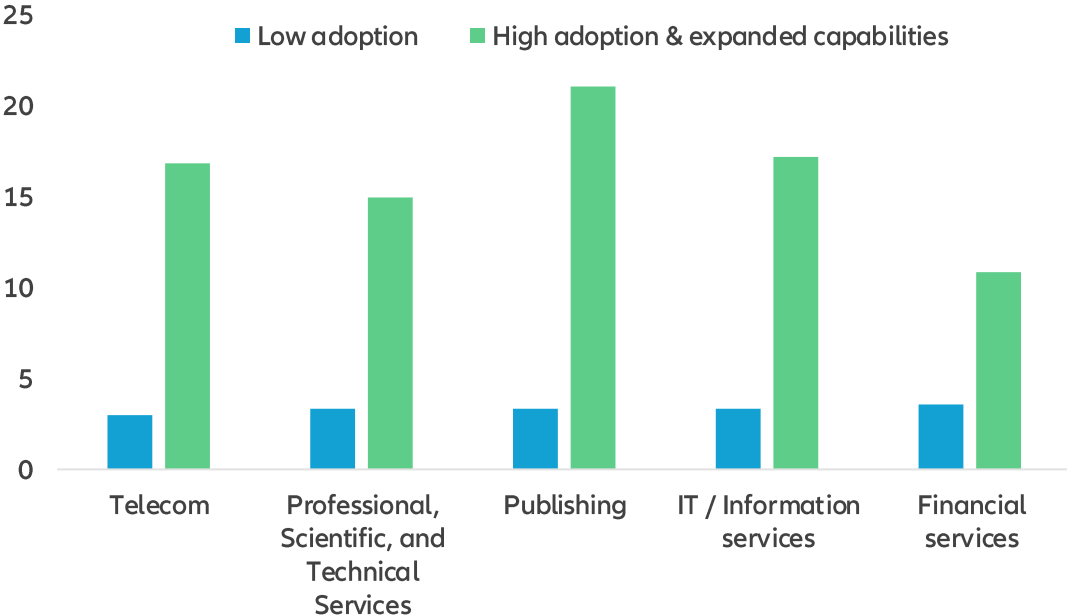
Figure 8: A rough week for the whole Nvidia ecosystem in financial markets (suppliers)



Sources: Datatstream, Allianz Research. Note: Bubble size = market capitalization in US\$

**Will open-sourcing lead to more democratization and innovation?** DeepSeek’s open-source model opens up a wide range of possibilities, not just for the tech industry but also for non-tech companies to either scale up innovation or adopt an advanced technology at a fraction of the cost. It should increase competition in the LLM industry as laggards will have the opportunity to dig into DeepSeek’s model to close the technology gap with current market leader OpenAI. But it will also allow the industry to consider a new, more efficient and less expensive approach. Though there are suspicions that the Chinese startup used a distillation technique that consists in using the output from competitors to train its own model, its highly adaptive approach diverges from the dominant method of AI-model training, focusing more on reinforcement learning instead of the expensive and computing-intensive supervised fine-tuning process (SFT) used by competitors. By bringing ingenuity instead of muscle (i.e. more computing power and chips), DeepSeek could help to further democratize AI, potentially nudging those that were reluctant because of over-reliance concerns and/or cost constraints. More competition would inevitably make AI cheaper and help democratize AI tools around the world, and support a broader deployment of the technology in SMEs. Faster adoption and expanding technological capabilities could drive up total productivity by an average of 16% for telecom, business services (IT, professional, scientific, and technical), publishing and financial services, 5x times higher than in a low-adoption scenario.

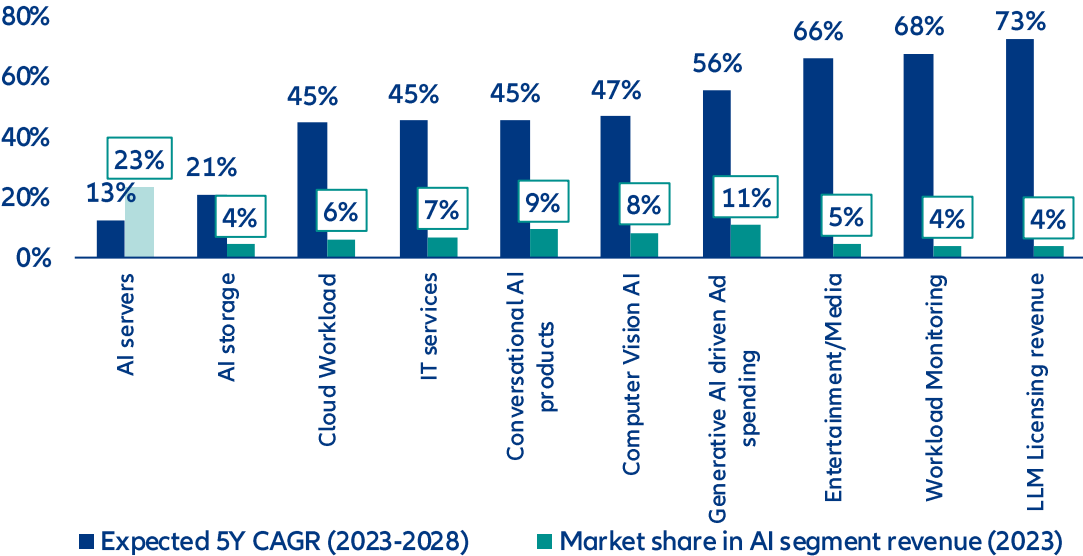
Figure 9: A faster adoption of AI could imply a 5x increase of productivity for some sectors



Sources: Filippucci et al. (2024), Allianz Research

**DeepSeek’s success also calls into question the licensing business model, which was previously poised for the most potential growth.** Direct competitors might suffer the most in the short run as they are not (yet) profitable and would need to seriously reconsider their licensing business models and pricing policy, along with their innovation processes. While the licensing business accounts for a small share of the total revenue of the AI industry (4% in 2023), it was viewed as the segment with the most potential growth. Now, technology-led pricing power has suddenly decreased significantly, though it could be compensated by a volume effect if AI democratization intensifies. Also, DeepSeek’s success might lead such companies to reduce some development costs and work on a more efficient allocation of their funds.

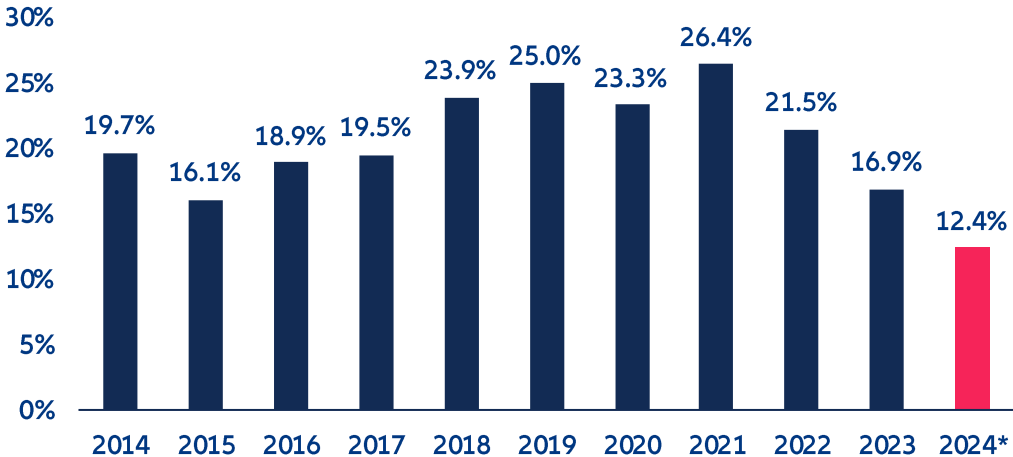
Figure 10: LLM Licensing segment potential growth could be hammered by DeepSeek’s breakthrough



Sources: Bloomberg Intelligence, Allianz Research. Note: Last BI forecast updated on September 2024.

**A ramped-up US-China AI rivalry will not help in normalizing bilateral relations.** The DeepSeek announcement coupled with Alibaba’s announcement of its brand new LLM (Qwen 2.5-Max) are the latest punches in the US-China AI fight. Chips and AI are perceived as the new drivers of the third industrial revolution in which we transit toward a more digital, automated and connected world. Controlling and securing a technological edge is key to maintain an influential position. Against this backdrop, we expect further trade restrictions on US technology exports to China, but also potentially to other countries that could be used as “smuggling hubs”. We could even envisage restrictions towards “friendly” trade partners to avoid risks of technology drain. If China can succeed in bypassing trade restrictions or even develop an in-house semiconductor and AI research industry able to compete with US Big Tech, it would call into question the efficiency of trade restrictions. Nevertheless, US companies have already started to adapt to a likely more difficult trade relationship with China. Notably, Nvidia dramatically cut its reliance on China for its revenue: the country’s weight has been more than halved since 2021 (Figure 11). For China, the achievement of DeepSeek could be a step towards spreading AI-empowered process across Asia and extending its influence in the continent. Surging interest from India toward the AI industry, highlighted by the Ambani project to build up the world’s biggest AI-driven data center, will also indicate how the US and China are positioning toward contenders.

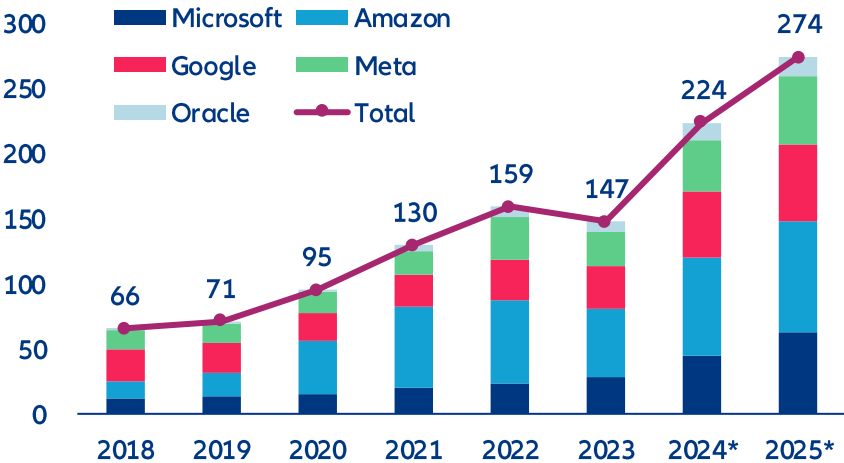
Figure 11: The weight of China in Nvidia revenue has dramatically decreased since 2022 US chip restrictions



\* Quarterly average over the Q1-Q2-Q3 period. Sources: Corporate filings, Bloomberg, Allianz Research

**All in all, DeepSeek is not a revolution but it is a positive step for AI development.** Talking about a “Sputnik” moment or industrial revolution is a little bit overdone, in our view, and it would be more relevant to describe the DeepSeek episode as a positive and critical step in the ongoing transition toward an AI-powered economy. We do not expect a bleak outlook for semiconductors. In fact, a better optimization of GPU use could favor a wider deployment across the global economy as the excessive costs of cutting-edge chips could limit companies from exploring new AI-dedicated projects that could help their businesses to save costs and/or exploring new activities. This breakthrough is also unlikely to deter US big tech from investing massively in AI; on the contrary, they will certainly try to use their capital advantage to increase their capabilities and try to (re)create a technology gap with competitors. The optimization approach brought by the Chinese start-up could in fact help them to identify flaws in their process and gain in efficiency and productivity, allowing them to allocate more money to new projects. Historically, more efficient technologies did not lead to rationalization in terms of hardware in the tech industry. When file compression technologies improved, hard drives sales did not decrease, Likewise, getting “more” out of chips will drive the industry forward. The market rout on tech and AI-related stocks should be short-lived as the global picture remains bright.

Figure 12: Big US Tech companies capital expenditures (in USD million) skyrocket under AI investment

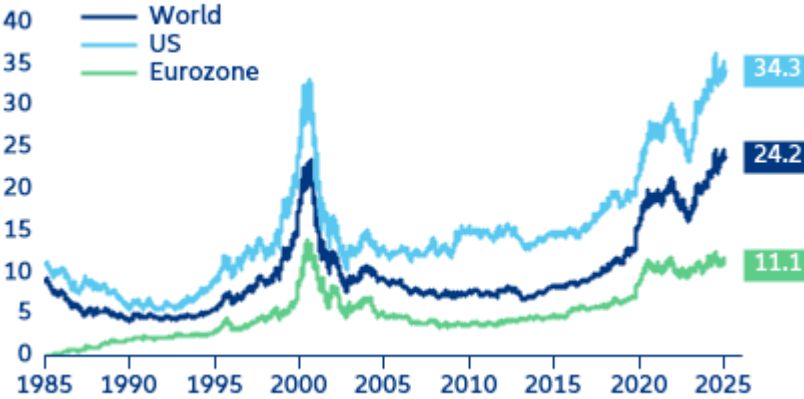


\* Bloomberg consensus. Sources: Bloomberg, Corporate filings, Allianz Research

**However, it is also a reminder that the dominance of tech is both a blessing and a risk for wider markets.** Equity markets have become increasingly concentrated in the technology sector, including AI, with a handful of mega-cap companies driving a significant share of overall market weight and gains. While this dominance has fueled strong rallies, it has also made market performance heavily dependent on just a few key players. Because of this, as

investors continue pouring capital into these companies, the broader market’s stability becomes increasingly tied to the success – or setbacks – of the tech sector. This heightened dependence means that any disruption – whether it be a slowdown in innovation, heightened regulatory scrutiny, intensifying competition or disappointing earnings – could send shockwaves through the market. What once seemed like a surefire growth engine may instead expose investors to unforeseen risks, underscoring the delicate balance between opportunity and vulnerability in today's tech-driven financial landscape (Figure 13).

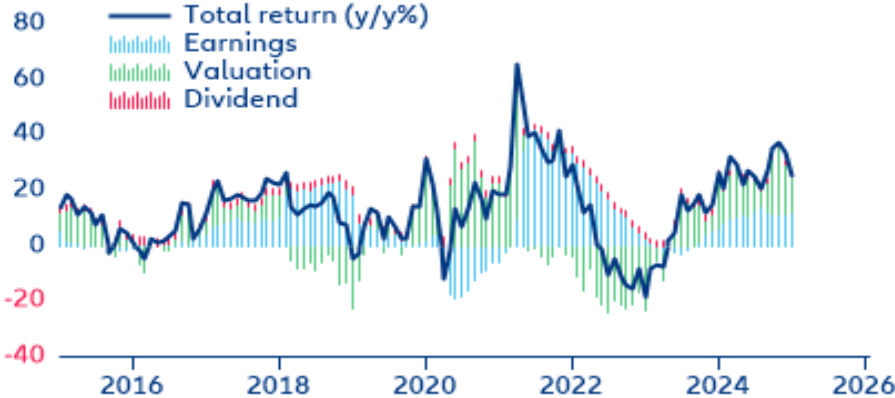
Figure 13: Weight of technology sector in equity markets (% of total market cap)



Sources: LSEG Datastream, Allianz Research

**The current market landscape is already fragile, and further strained by pricing dynamics that offer little room for error.** Over the past several years, stock market gains have been primarily fueled by rising valuations rather than fundamental earnings growth. In other words, investors have been willing to pay increasingly higher prices for shares based on expectations of future growth rather than actual financial performance. However, this disconnect presents a significant challenge. While stock prices have surged, corporate earnings have not kept pace, creating a fragile situation where valuations are elevated but not necessarily backed by corresponding profitability. This dichotomy is particularly relevant for the technology sector, where companies are expected not only to sustain but consistently exceed their current levels of profitability. However, if earnings fail to meet expectations within this sector, these inflated valuations could come under pressure, increasing the risk of sharp corrections in the market, with repercussions across global equity markets (Figure 14).

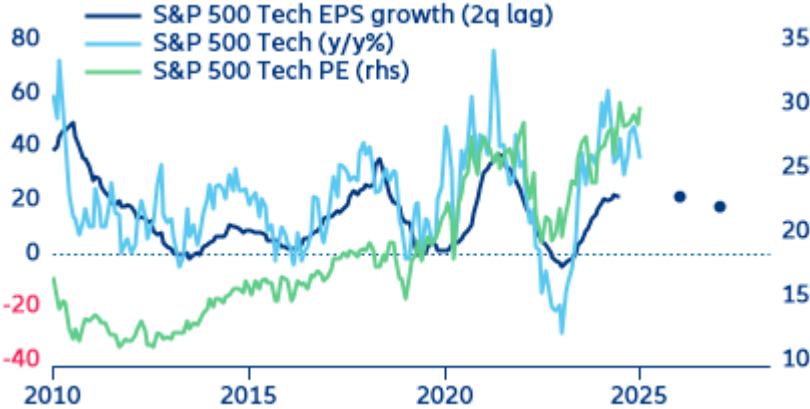
Figure 14: S&P 500 total return breakdown



Sources: LSEG Datastream, Allianz Research

**There are clouds looming over tech earnings.** Factors such as industry consolidation, growing competition, market saturation and regulatory pressures are likely to weigh on future profitability. This disconnection between high expectations and actual financial conditions may limit further upside potential, making it unlikely that we see another +20% equity surge like in 2023-24. Instead, the market is more likely to enter a healthy phase of consolidation, where fundamentals regain some importance relative to valuations. That said, while we still anticipate moderate positive returns this year (around +10%), the road to stabilization will not be without challenges. Episodes like the DeepSeek sell-off could become more frequent as any negative news or weaker-than-expected results may quickly trigger sharp market corrections (Figure 15).

Figure 15: S&P 500 technology sector EPS growth expectations and PE ratio



Sources: LSEG Datastream, Allianz Research - Note: Points represent EPS consensus expectations

These assessments are, as always, subject to the disclaimer provided below.

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