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What to watch: Germany's big spending, the Transatlantic gap persists in corporate earnings and China's turning point reinforced by stimulus

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In summary

Germany: From belt-tightening to big spending? The Union and SPD have proposed a bold step to create fiscal space by exempting defense spending >1% of GDP from the debt brake and establishing a EUR500bn special infrastructure fund over ten years, marking a shift toward a looser fiscal stance. If implemented quickly, the proposed fiscal package of +2% of GDP could pull Germany out of stagnation in the next two years, potentially raising GDP by +0.5% in 2025, +2.1% in 2026 and +2.4% in 2027. Risks include higher inflation, while deficits could rise to -3.5% and debt to 68% of GDP by 2027. Markets have reacted with historic moves as the German 10y yield rose by the most in 30 years, surpassing 2.9%. This move can be seen as pro-growth as opposed to a credit-risk move as it was largely driven by higher real yields, soaring equity prices and a stronger euro. Overall, the proposal is an important step in creating fiscal flexibility, but Germany still urgently needs structural reforms in pensions, decarbonization, labor markets, taxes and innovation to secure future growth.

Q4 corporate earnings season: The Transatlantic gap widens. A challenging global environment did not stand in the way of overall growth in Q4 2024 (revenues: +2.6% y/y and EPS: +10.7%), but cyclical sectors continued to struggle (e.g. paper, transport equipment, textiles). US firms are still outshining the rest of the world (EPS: +17.1%), driven by a strong consumer spending, fast technological adoption and the strong competitive advantage of lower energy costs. But the real challenge lies ahead as tariffs kick in. The Q1 2025 earnings forecast for US companies has been cut to +8.0% from +12.8% in December. Meanwhile, though European companies managed to record modest revenue growth after six consecutive quarters of declines, earnings projections for Q1 2025 have been revised down to just +0.9% (vs. +7% one year ago) amid looming tariffs and mounting regulatory pressures.

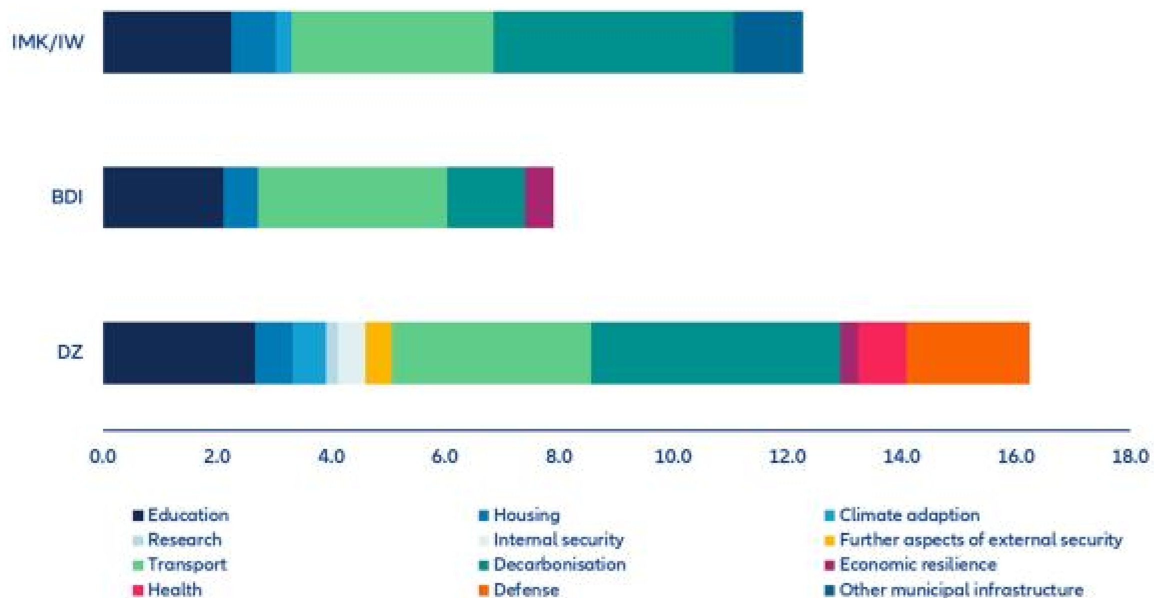
China: On the brink of a lasting turning point. Since mid-January, China has become the best performing major equity market (+13.1% YTD), though onshore and offshore markets tell a different story. For the bull market to last, fundamentals will need to recover further but the earnings picture remains weak, particularly amid rising uncertainties over US tariffs and heightened geopolitical tensions. Ultimately, the outlook will depend on whether the fiscal package of RMB2.9trn announced at the Two Sessions is enough to revive demand. It is slightly smaller than what we had expected, but authorities have clearly sent the signal that more can be expected. Early signs of stabilization in household consumption are emerging, but more stimulus is needed to effectively brighten the outlook this year. Chinese authorities have kept the GDP growth target for 2025 unchanged at "around 5%", and we expect +4.6% in 2025 and +4.2% in 2026 for now, assuming that the policy mix will be eased accordingly to mitigate the negative impact of the trade war.

Germany: From belt-tightening to big spending?

Germany's likely coalition partners the Union and SPD have proposed a bold move to create fiscal space for defense and infrastructure. With the new US administration's actions raising concerns about continued support for Ukraine in the war against Russia, Europe, and particularly Germany, is now more vulnerable. In this context, Germany's likely coalition partners the Union and SPD have proposed a bold move to create the fiscal space to ramp up defense spending. It entails exempting amounts above 1% of GDP from the debt brake, meaning there will be no borrowing cap to finance increases in defense expenditure, and the exemption will be open-ended. Raising defense spending from the current level of 2.1% to 3% of GDP would add EUR40bn in debt-financed spending, potentially boosting growth by 0.5-1.4% annually. Additionally, the parties plan to establish a deficit-financed special infrastructure fund worth EUR500bn over ten years (about 12% of GDP), with EUR100bn earmarked for the federal states. This fund would also be exempt from the debt brake and could contribute 1.1-1.7% of additional growth per year. To secure support in the federal council, the 16 federal states would be allowed to run deficits of up to 0.35% of GDP (EUR15.4bn annually) instead of being required to balance their budgets.

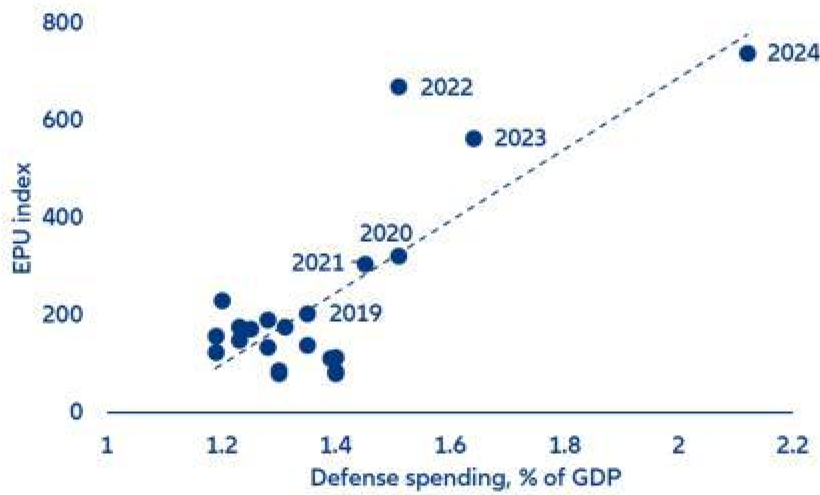
Germany is under increasing pressure due to years of delayed reforms and current shifts in geopolitical dynamics. Struggling with both cyclical and structural challenges, Germany faces significant financing needs, particularly for decarbonization (4.4% of GDP over the next five years, Figure 1), transport infrastructure (3.5%), education (2.7%) and defense (2.2%). These challenges are compounded by the threat of a trade war with the US, which would harm the already struggling German manufacturing sector, particularly automotive. In this environment, the need for increased defense spending amid heightened economic and policy uncertainty (Figure 2) has put additional pressure on the already struggling economy. At the same time, the debt brake limits Germany's borrowing capacity, restricting its ability to address the economic recession, invest in defense and overhaul its aging infrastructure. In this regard, exempting defense spending from the debt brake is an important step in creating fiscal flexibility, and signals a significant shift toward loosening fiscal policy. Moreover, an expert commission will be set up to propose long-term reforms to the German debt brake, aimed at encouraging more investment. Announced even before the new government is formed, this major policy change highlights that all parties involved recognize the gravity of the situation in Europe and are ready to act decisively.

Figure 1: Estimates of public financing needs, % of GDP



Sources: LSEG Datastream, Dezernat Zukunft, BDI, IMK/IW, Allianz Research

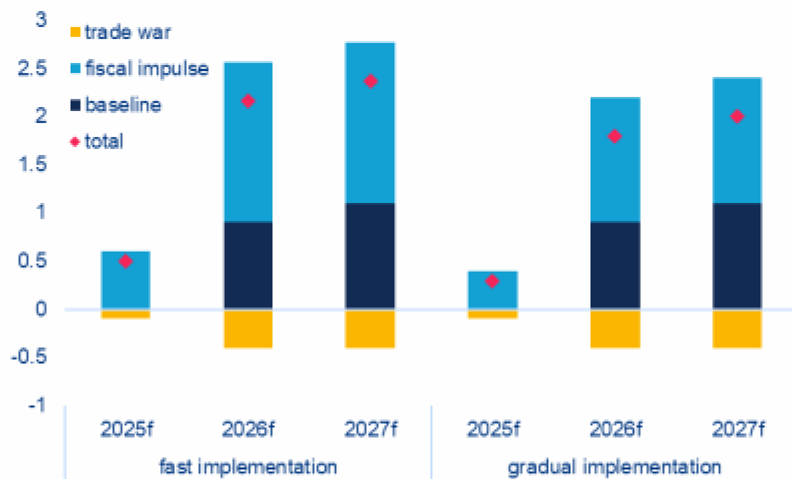
Figure 2: Defense spending and economic policy uncertainty, in % of GDP and index



Sources: NATO, LSEG Datastream, Allianz Research

Depending on how quickly it is implemented, the proposed package could pull Germany out of stagnation in the next two years. To calculate the impact, we have applied the lower bound of multipliers for infrastructure and defense as ramping up infrastructure will take time and defense spending tends to have a modest impact, with a portion of the funds directed toward imported equipment rather than domestic production. Assuming a fast implementation of an additional 2% of GDP debt-financed fiscal spending[1], GDP could rise by +0.5% in 2025 (from a baseline of stagnation), +2.1% in 2026 (from +0.9%) and +2.4% in 2027 (from +1.1%). In contrast, with a gradual implementation approach, growth would be +0.3% in 2025, +1.8% in 2026 and +2.1% in 2027 (Figure 3). The foreseeable plans likely increase another risk: inflation. If debt-inflated demand meets capacity constraints that limit output growth, there is a higher risk of stronger wage growth and inflation. Deficits would significantly increase under the fast implementation scenario, rising from -2.1% in 2024 to about -3.5% by 2027, while the debt-to-GDP ratio would steadily rise to 68%. With a gradual implementation, deficits would stabilize around -3% by 2027, with the debt-to-GDP ratio reaching 66%. However, there is little risk of Germany violating European Commission rules as President von der Leyen has proposed activating an escape clause in the EU's fiscal framework to accommodate higher defense spending. The Commission is also likely to view additional infrastructure investments favorably.

Figure 3: Growth upside from more fiscal spending, y/y in %



Sources: LSEG Datastream, NATO, Oxford Economics, IfW Kiel, Council of Economic Experts, Allianz Research

[1] *Defense spending reaching 3% of GDP and infrastructure spending beginning to materialize from 2026. We also factor in in 25% reciprocal aluminium and auto tariffs from the US (impact Germany: -0.1% in 2025, -0.4% in both 2026 and 2027).*

In fact, the recently announced "ReArm Europe Plan" proposes several actions to boost defense spending across EU member states. First, the Stability and Growth Pact's national escape clause will be activated, allowing increased defense spending without triggering penalties, potentially freeing up EUR650bn. A new EUR150bn loan instrument will support joint procurement of defense capabilities, strengthening Europe's defense and aiding Ukraine. The EU budget will also be directed to defense investments, with incentives for member states to increase spending. Lastly, private capital will be mobilized through the Savings and Investment Union and the European Investment Bank.

However, time is scarce and Germany still urgently needs broader structural reforms. While the proposed figures seem substantial, the timeline is tight and there are several caveats. To secure the two-thirds majority required for constitutional amendments, the CDU/CSU and SPD aim to have the proposal approved by the outgoing parliament within the next two weeks. For this to happen, they must bring the Greens on board. Besides the tight timeline, no specific amount has been set for the additional defense spending, which was around 2.1% of GDP last year. In addition, some of the infrastructure spending financed by the new fund may overlap with existing plans, meaning the actual spending could be less than the full 1.2% per year allowed by the special fund. Much of the money may actually be redirected toward already planned projects rather than new ones and local governments could face challenges in quickly ramping up infrastructure spending. In order to avoid a backlog, the special infrastructure fund must be accompanied by an acceleration of the approval process. To make Germany's economy more resilient, the coalition must also push forward with broader structural reforms, addressing the strong headwinds of demographics, decarbonization and deglobalization. This will require action on social spending, pensions, labor market incentives, tax reforms, innovation and above all the development of a future-oriented German economic model.

Germany's 10y government bond yields surged by 30bps on the first day, the largest one-day move since the 1990s. We expect high volatility in the coming weeks as any sign of the proposal not going through parliament will lead to huge swings. With the sell-off continuing, Germany's benchmark yield breached 2.9% at some point (+41bps since the announcement), the highest level since 2023 when inflation in the Eurozone reached double-digits (Figure 4). Despite rising Bund yields, investors viewed the move as growth-positive rather than a credit-negative, contrasting with the UK's market turmoil in 2022. The euro hit a three-month high against the dollar and surpassed 1.08 while German stocks surged (Dax +3.4%), with infrastructure and defense companies leading the gains. Moreover, 63% of the rates move (26bps) was driven by higher real yields and only a lesser extent by breakeven inflation expectations (37% / 15bps). Swap spreads tightened strongly, reflecting a higher term premium over the expected central bank policy path amid the additional bond supply (Figure 5). The German yield curve also steepened strongly. At the same time, the sell-off in German bunds also spread to other markets, albeit to a lesser extent, causing Eurozone spreads to tighten (measured against the German 10y yield). Notably, however, US yields hardly moved in comparison, thus leading to a historic drop in the US-DE 10y spread (Figure 4). Our fair value model sees the Bund yield rising by around 40bps from previous levels. From that perspective, a lot is already priced in now. On top of this, volatility is expected to remain high in the coming weeks as any sign of this proposal not going through in parliament will lead to huge swings. With that, we stay cautiously optimistic on duration.

Figure 4: 10y yields, %

Sources: Bloomberg, Allianz Research.

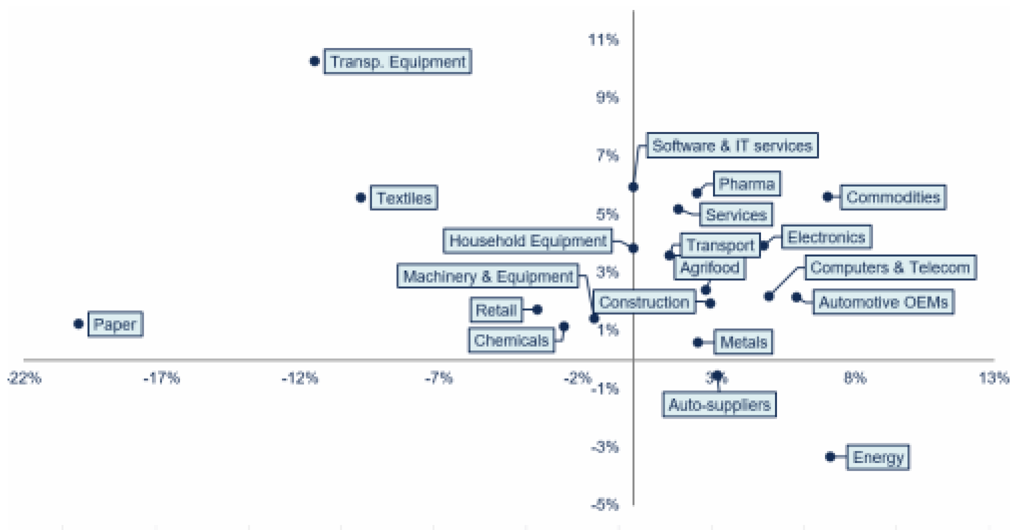
Figure 5: Eurozone spreads versus 10y Germany, bps

Sources: Bloomberg, Allianz Research.

Q4 earnings season: The Transatlantic gap widens

The challenging global economic backdrop did not stand in the way of overall earnings growth, but cyclical sectors continued to struggle. The Q4 earnings season is well underway, with approximately 75% of listed companies having already reported their financial results. Revenues are showing modest growth, having risen by +2.6% y/y in Q4, as both volume and price increases remain constrained. However, earnings have jumped by +10.7% on average as companies continue implementing cost-cutting measures and strategies to preserve cash and optimize operations. The adoption of artificial intelligence, machine learning and cloud computing services is also playing a role. As shown in Figure 6, software & IT services together with computers & telecom are benefiting from increased demand, particularly the semiconductors industry, which provides the high-performance chips used in data centers, AI processors and cloud infrastructure. While other industries, such as pharma, electronics and transport, also reported robust earnings, highly cyclical sectors continue to struggle with weak demand and still-high production costs. Moreover, geopolitical tensions continue exacerbating the already complex business environment, deteriorating the recovery outlook for sectors such as paper (EPS: -20% y/y), transport equipment (-11.5%), textiles (-9.8%), retail (-3.5%), chemicals (-2.5%) and machinery (-1.4%), which have been underperforming for around ten consecutive quarters now.

Figure 6: Revenue (Y axis) and earnings (X axis) growth rates in Q4 (y/y), median per selected sector



Sources: LSEG Workspace, Allianz Research

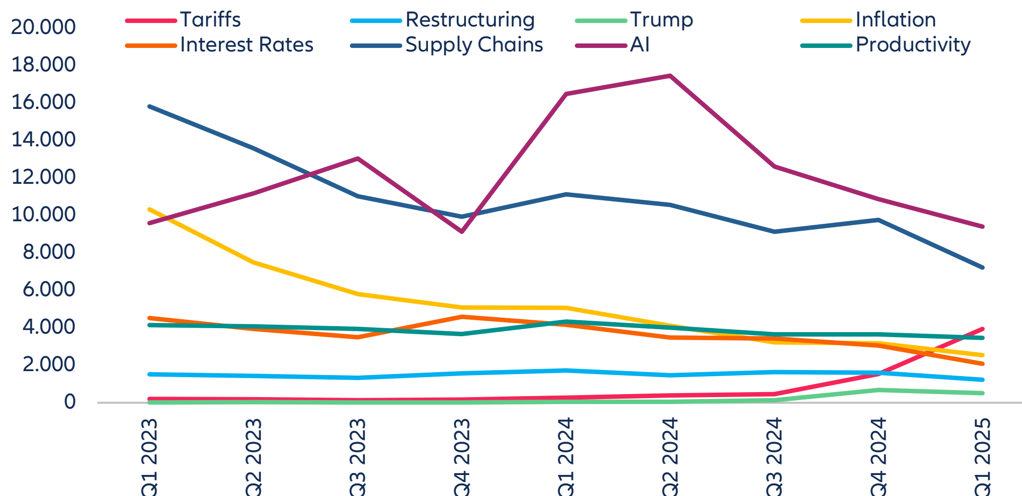
US companies continued to outshine the rest of the world... The US has the highest proportion of businesses beating revenue and earnings expectations (64% and 62%, respectively), while the rest of the world just met estimates on average. Indeed, strong consumer spending is undoubtedly keeping industrial activity on the rise, leading US firms to report the highest level of revenue growth in Q4 (+5.0% y/y vs +2.6% for the world). In parallel, lower energy prices (US natural gas prices are a quarter of those in Europe) remain a strong competitive advantage, giving an extra lift to US profits (+17.1% y/y). The S&P 500 index also echoed this strong performance, reporting the highest EPS growth rate in three years (+17% y/y, Figure 7), particularly boosted by the banking industry, which not only vastly surpassed estimates but also offered encouraging guidance for the upcoming quarters.

Figure 7: Revenue and earnings growth rate (y/y) per quarter, S&P 500 index

Sources: LSEG Workspace, Allianz Research

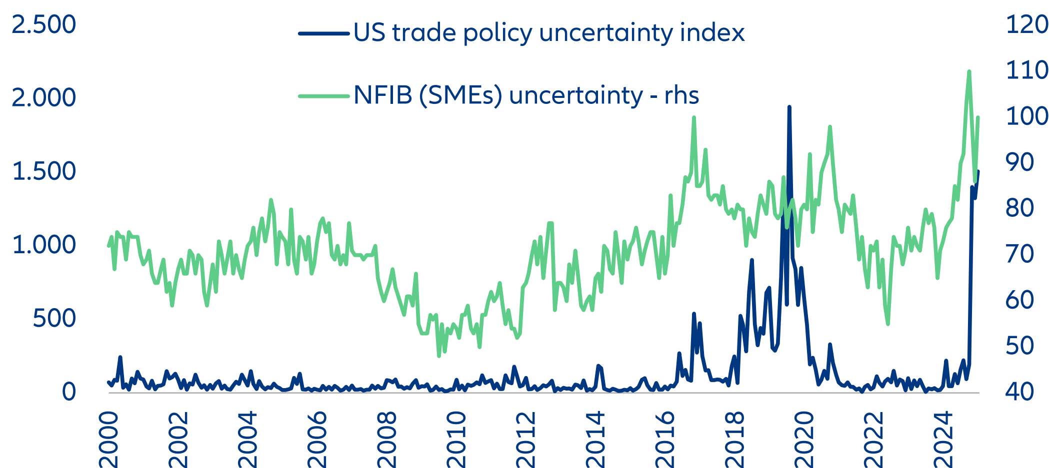
But the real challenge lies ahead... Starting this quarter, American companies should begin to feel the impact of newly implemented trade tariffs on imported goods from China, Mexico and Canada, which will certainly put pressure on margins. Indeed, international supply chains will become more costly, especially in sectors like technology machinery, automobiles and pharmaceuticals, which rely heavily on imported goods and are vital to the US economy. As illustrated in Figure 8, tariffs are quickly emerging as the primary concern for investors and CFOs, overshadowing inflation and supply-chain issues. With potential retaliatory tariffs also on the horizon, uncertainty is mounting (Figure 9). On average, about 35% of US companies' sales come from international markets, with the tech sector being the most exposed (65%). As a result, US earnings expectations for the upcoming quarters have been significantly revised downwards. For instance, the Q1 2025 earnings forecast has been adjusted from an anticipated double-digit growth of +12.8% in December to just +8.0% this week, with cyclical sectors experiencing the most substantial downward revisions.

Figure 8: Word count of selected topics featured in corporate earnings results and investor meetings in the US



Sources: Bloomberg, Allianz Research

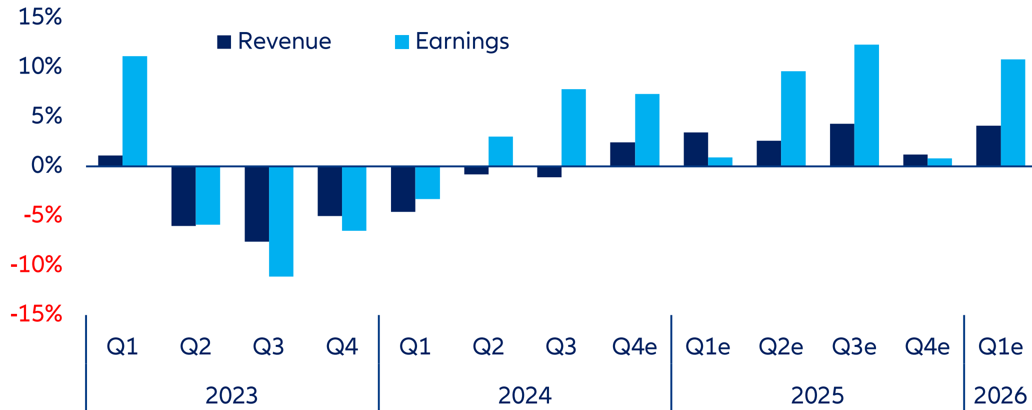
Figure 9: US trade policy uncertainty index and NFIB's (small business) uncertainty index



Sources: LSEG Workspace, Allianz Research

On the other hand, European firms will have it harder for longer. After six consecutive quarters of declining revenue, corporates in Europe finally registered modest revenue growth of +2.4% y/y in Q4 (Figure 10). Excluding the energy sector – the worst performer of the region – revenues increased by +4.4%. Nevertheless, Europe remains the laggard, with Germany still recording negative revenue growth (-0.7%). Transatlantic discrepancies also persist in earnings, with projections for the region being consistently revised downward. One year ago, market consensus anticipated Q1 2025 EPS growth of approximately +7% in Q1 2025; now, expectations have been adjusted to a modest +0.9%. Firms in Europe are still grappling with economic stagnation, high energy costs, supply-chain disruptions and reduced demand in key manufacturing sectors. These challenges are likely to be further exacerbated by mounting regulatory pressures and the impending rise in tariffs. However, companies are implementing proactive measures to safeguard cash flows – such as prudent investments, working capital optimization and a reduction in stock buybacks – and also driving initiatives focused on productivity gains. Moreover, Europe's big plans to spend more on defense will eventually benefit sectors such as aerospace, weapons manufacturing, shipbuilding, tankers, software, electronic systems and satellite technologies.

Figure 10: Revenue and earnings growth rate (y/y) per quarter, EuroStoxx-600 index

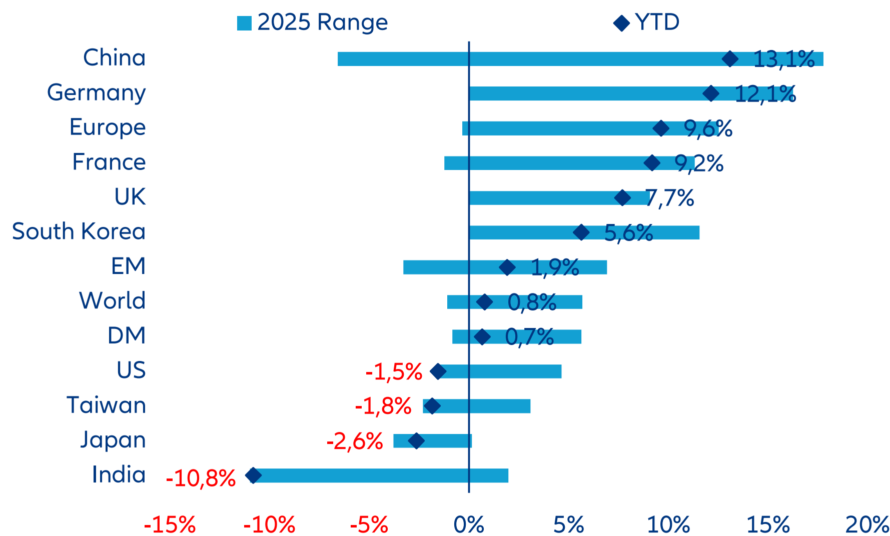


Sources: LSEG Workspace, Allianz Research

China: On the brink of a lasting turning point

The Chinese equity market has outperformed global peers so far this year, despite challenging macro conditions. At the start of the year, with stimulus measures falling short of market expectations amid persistently weak domestic consumption and tariff risks, China's equity market continued its correction from last September's short-lived rally. However, milder-than-expected US tariffs have provided some relief, while the unexpected breakthrough of DeepSeek's cost-efficient AI model has ignited new optimism. Since mid-January, Chinese stocks have rebounded strongly, rising +13.1% ytd (Figure 11) and outperforming both the US and Europe. They have also driven a rare outperformance of emerging market stocks over those of developed markets, given China's significant weight in the benchmark index.

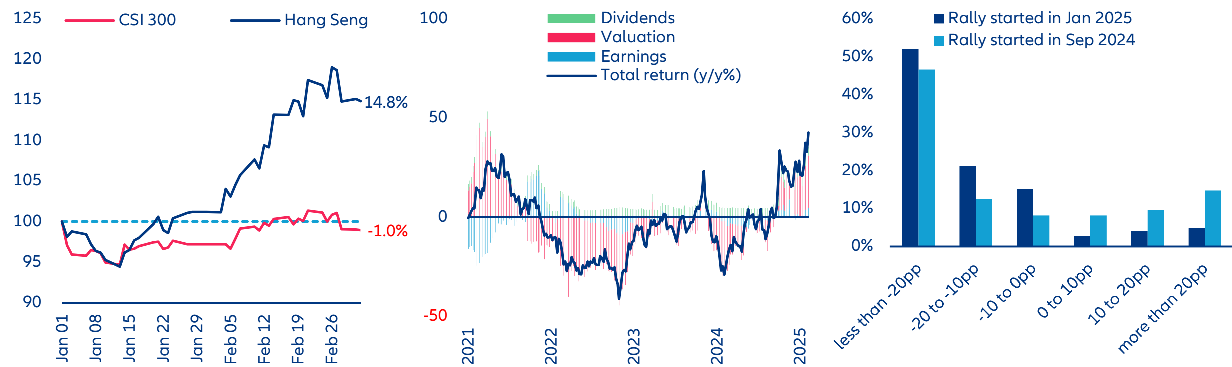
Figure 11: China is the best-performing major global equity market ytd



Sources: LSEG Datastream, Allianz Research. Note: Data as of 4 March 2025.

However, there is a significant divergence between onshore and offshore markets, with offshore market gains primarily driven by valuation expansion and by a handful of stocks. The strong performance of the MSCI China Index, which includes both onshore and offshore listed companies, has been largely led by more heavily weighted tech companies. But the stark difference between onshore and offshore equity markets suggests that the broader market has not fully benefited. While the tech-heavy offshore Hang Seng Index has surged +14.8% ytd, the onshore CSI 300 has actually declined by -1.0% (Figure 12, left). Although earnings have recently turned into a positive contributor to total returns, valuation remains the primary driver, accounting for around 80% of total returns (Figure 12, middle). In addition, compared to last September's rally when expectations of policy stimulus were seen as a broad economic boost, this rally has been even more concentrated in a handful of stocks. Only 11.6% of index constituents have outperformed the benchmark, compared to 32.6% in the last rally, while 52.1% have underperformed the benchmark by more than 20pps (Figure 12, right).

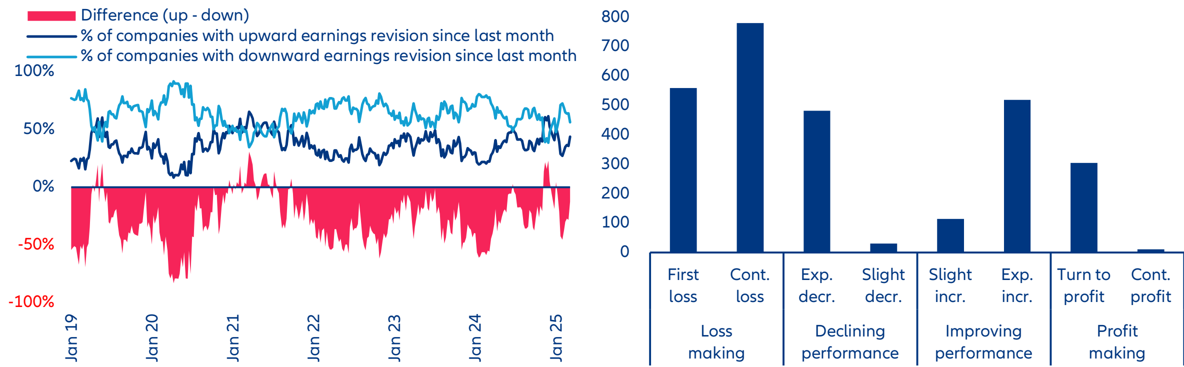
Figure 12: Significant divergence between onshore and offshore markets (left), with offshore gains driven mainly by valuations (middle) and a handful of stocks (right)



Sources: LSEG Datastream, Allianz Research. Note: Data as of 4 March 2025; "Rally started in Jan 2025" refers to the period 23 January 2025 to 26 February 2025 and "rally started in Sep 2024" refers to the period between 10 July 2024 and 23 Sept 2024

For the bull market to last, fundamentals will need to recover further, but the earnings picture remains weak for the most part. After several quarters of disappointing results, the number of companies with downward earnings revisions has still consistently exceeded those with upward revisions in the offshore market, though this gap has been narrowing in recent weeks (Figure 13, left). The outlook is not much better in the onshore market. Among the 2,815 companies that have issued earnings warnings for the ongoing earnings season, slightly more reported improving performance (22.5%) than declining performance (18.2%), while 47.6% reported losses and only 11.2% reported profits (Figure 13, right). Although valuations in the offshore market remain among the lowest globally even after the recent rally and are still below the historical average, providing some downside cushion, further gains will depend on a continued recovery in fundamentals and improvements in structural issues. Investors are likely to seek more evidence of earnings growth, particularly amid rising uncertainties over US tariffs and heightened geopolitical tensions.

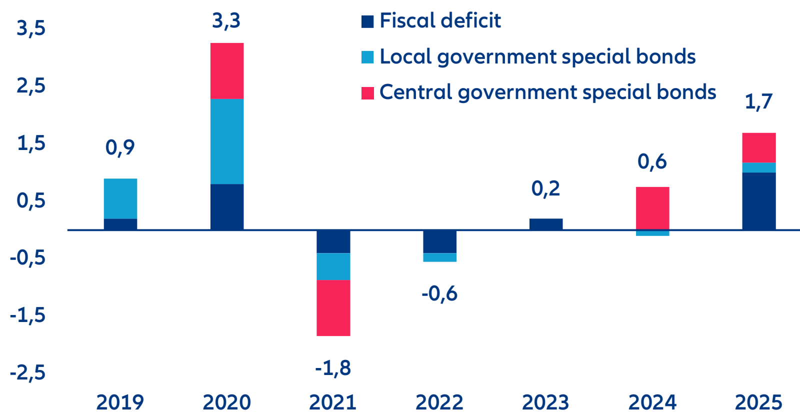
Figure 13: Downwards earnings revisions still far outnumber upwards revisions for offshore companies (left), while earnings warnings continue to signal more downside risks in the onshore market (right)



Sources: LSEG Datastream, WIND, Allianz Research

Ultimately, the outlook for companies will depend on whether the Chinese government's latest fiscal package of RMB2.9trn is enough to revive domestic demand – though it is slightly smaller than we had expected. During the Two Sessions, on 5 March, Beijing kept the GDP growth target for 2025 unchanged at "around 5%". The inflation target was lowered to "around 2%" from "around 3%" (with likely limited policy implications as it is viewed more as a ceiling than a target). Objectives related to the labor market were kept unchanged, with new urban job creation to exceed 12mn and the surveyed unemployment rate at "around 5.5%". These targets come largely in line with market and our expectations, denoting Chinese authorities' willingness to provide further support to domestic demand in 2025 as the economy is likely to face more headwinds externally. On the fiscal side, the budget deficit target was raised to a record high of "around 4%" of GDP in 2025 (from "around 3%" in 2024), the annual quota for local government special bonds was raised to RMB4.4trn (from RMB3.9tn in 2024) and that for central government special bonds to RMB1.8trn (from RMB1trn in 2024). All this amounts to a fiscal package worth RMB2.9trn and a fiscal impulse of 1.7pps of GDP, roughly half of that in 2020 (see Figure 14). The fiscal package is marginally lower than what we had expected and, more importantly, despite an upgrade in policy priorities, the amounts allocated to consumers are smaller than anticipated.

Figure 14: Fiscal impulse (pp)

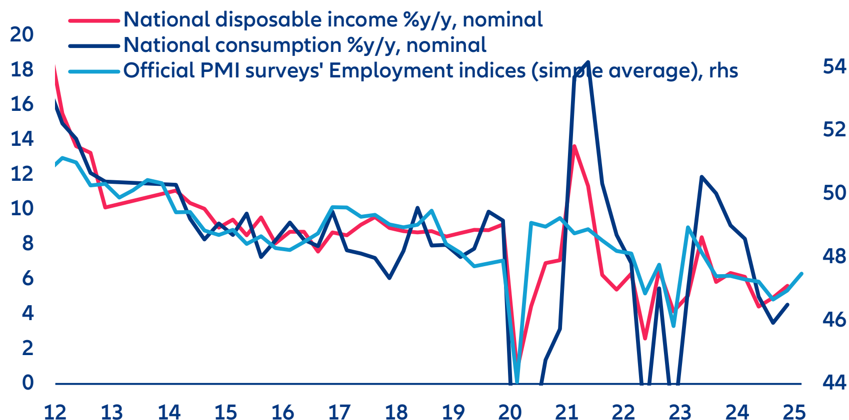


Sources: national sources, Allianz Research

Nevertheless, boosting domestic demand has become the top policy priority this year. Early signs of stabilization in household consumption are emerging, but more stimulus is needed to effectively brighten the outlook this year. Funding for the consumer goods trade-in program was doubled to RMB300bn this year (but we had expected at least RMB500bn), wages for civil servants were raised, the basic pension was increased and other pledges in favor of households were also announced. The strategy will likely be to try and restore consumer confidence (which has remained in the doldrums since 2022) through government subsidies, improving the scope and protection of the welfare system, supporting household income and putting a floor under housing prices. Some of these channels seem to be yielding results: retail sales of certain types of goods (mainly consumer electronics and household

appliances) are likely to continue outperforming, thanks to the consumer goods trade-in program, and housing prices seemed to have reached an inflection point at the end of last year. As a result, after a clear slowdown in Q2 and Q3 last year, Q4 saw improvements in household disposable income (+5.6% y/y vs. +4.7% on average in Q2-Q3) and household consumption (+4.5% y/y vs. +4.3% on average in Q2-Q3). Soft data from the beginning of the year suggest this recovery is likely to continue (see Figure 15). Real private consumption rose by +5.1% last year, roughly in line with overall GDP (which increased by +5%). We expect private consumption to outperform this year, rising by +5.2% compared with GDP growth at +4.6%, provided policy support is stepped up.

Figure 15: National disposal income growth (nominal %y/y) and Official PMI surveys' employment indices



Sources: national sources, Allianz Research

The stakes are even higher amid a renewed trade war with the US. The fiscal package announced in the Two Sessions may not have accounted for the latest round of tariff hikes, but the door was left open to increase policy support. On 3 March, the US hiked tariffs on imports coming from China by another +10pps (following a first round on 4 February) and China responded with a combination of retaliatory measures. We see three channels through which China is responding to the ongoing trade war. First, unlike during the trade war under the first Trump administration, this time China's retaliation against the US has been smaller and authorities have not relied on the depreciation of the CNY to mitigate the impact of higher tariff rates. The aim is probably to leave room for negotiating a deal with the US. Second, this year's Two Sessions showed a slightly stronger wording around opening the economy to the rest of the world, with a goal to stabilize foreign trade and investment. Finally, domestically, the strategy is to further boost technology, innovation and demand. All else equal, we estimate that the cumulative +20pps US tariff hike since February would hit China's GDP growth by -0.6pp over 2025-2026. We are keeping our GDP growth forecasts at +4.6% in 2025 and +4.2% in 2026 for now, assuming that the policy mix will be eased accordingly to mitigate the negative impact of the trade war.

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

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