ITIC

REPORT

OCTOBER 2024

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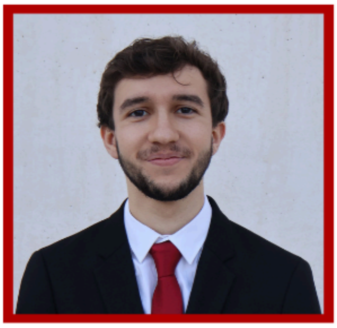

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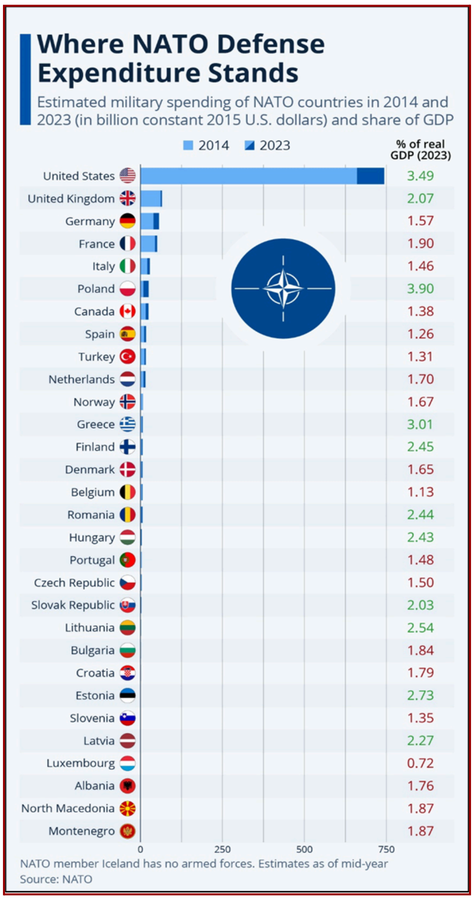
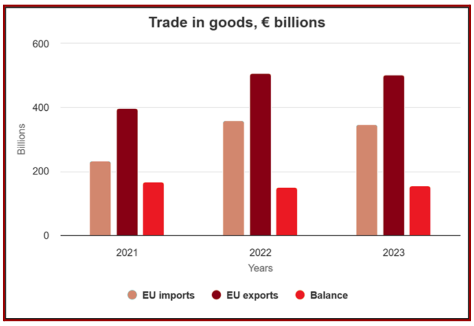
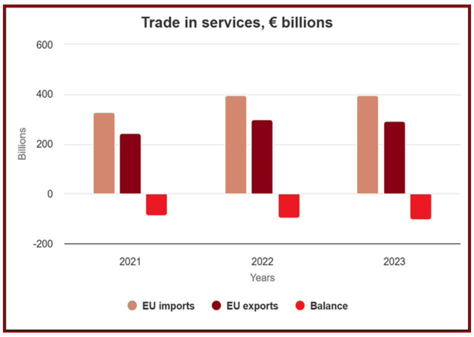




Trade in goods between EU and US – Source: European Commission



Trade in services between EU and US – Source: European Commission

North American Elections and Their Future Impact on Europe

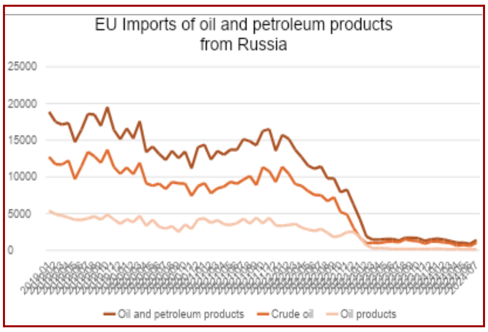
On November 5, Donald Trump was elected as the 45th President of the United States. The Republican Party's victory was welcomed by several business leaders, and the stock market reacted positively to the election outcome. The Dow Industrials, S&P 500, and Nasdaq Composite all reached record levels, driven in part by optimism regarding the pro-growth policies central to Trump's economic platform.

However, this news is not entirely positive, especially for Europe. The European Union is currently facing several significant challenges, including declining birth rates, an aging population, high levels of immigration, the rise of extreme right-wing movements, a crisis in its social model, and disrupted energy supplies, along with geopolitical tensions related to Russia and the war in Ukraine. Germany, which plays a crucial role in EU policies and is regarded as a leading member, is facing a political crisis due to the collapse of the current coalition government. Since Germany's industry is closely connected to the American economy, Trump's proposed tariffs are expected to result in a loss of growth that could exceed double the European average. According to a Goldman Sachs study, the eurozone can expect a 0,5% hit on Real GDP, while Germany could expect a 0,6% hit, being one of the most affected.

Donald Trump has been very vocal about NATO's expenditure levels among its members, noting that most countries have not achieved the 2% GDP spending guideline for several years. The soon-to-be President has expressed a desire to reduce aid to Ukraine and to reconsider support for European defense. This serves as a wake-up call for the EU, which will likely need to increase its defense spending and take coordinated steps to become more self-reliant, especially as tensions with Russia escalate.

Major European economies are still lagging behind the U.S. in their post-pandemic recovery. Furthermore, the protectionist policies introduced by the U.S. after Trump takes office in January could lead to the prospect of a trade war. The European Union and the U.S. share the largest bilateral trade and investment relationship, particularly in services and investment. However, with tariff threats looming over European imports, retaliation seems likely, leading us to anticipate a new global trade landscape. If these developments come to pass, both economies could suffer, as North American inflation may rise and European exports could decline. This situation could also lead to the creation of new commercial supply chains, with China potentially playing a significant role.

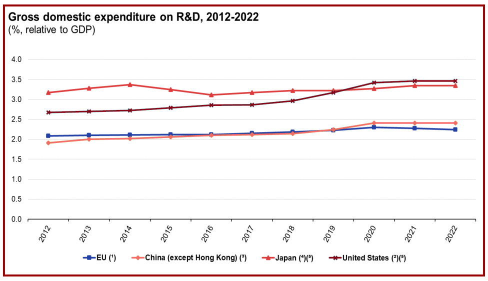
Draghi Report: A Blueprint for Europe's Salvation?



In September, the latest Draghi Report was published, authored by Mario Draghi, the former president of the European Central Bank and ex-Prime Minister of Italy. The report discusses the future of European competitiveness and is perceived by some as a potential salvation plan.

The report addresses important issues and challenges facing the European project, providing a clear diagnosis of the continent's economic situation. Over the past few decades, European countries have lost competitiveness compared to global superpowers like the USA and China, showing no signs of recovery or viable coordination.

Currently, Europe finds itself in a challenging position. Four years after the onset of the COVID-19 pandemic, which altered many of the economic and social foundations we once took for granted, Europe faces new challenges, including the rapid advancement of artificial intelligence, the war in Ukraine, and the imperialistic ambitions of Russia. Additionally, Europe's dependence on Russian fossil fuels has prompted a need to reevaluate its future.



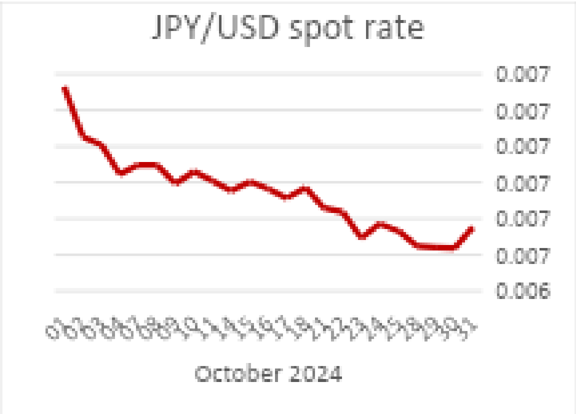
In the report, Draghi emphasizes crucial strategies for achieving viable and sustainable economic growth. He argues that Europe must focus on innovation and increased investment to build infrastructure and create added value. The continent has fallen behind in research and development on the global stage and has adopted a regulatory approach that prioritizes regulation over innovation. Draghi also highlights the importance of reinforcing supply chains, reducing dependencies, and pursuing decarbonization as key aspects for Europe's future.

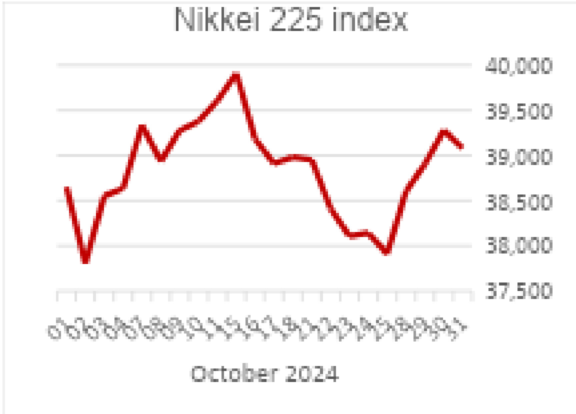
Japan:

On October 27th, the Liberal Democratic Party (LDP) led by Prime Minister Shigeru Ishiba lost the general election, resulting in the loss of their majority in the Lower Chamber of Parliament. Since the coalition with the Komeito party does not provide an absolute majority, a more fragmented government is expected, or the next government may operate as a minority in Parliament.

In the short term, political uncertainty is anticipated to exert downward pressure on financial markets. This is already evident in the JPN/USD spot exchange rate, which has been declining despite an uptick on October 31st. However, the Nikkei 225 index has shown an increase since the elections, despite a 2.7% depreciation in the week leading up to the election.

Some analysts predict that in the coming weeks, we may see further depreciation in these indicators, as well as in the yields of Japanese government bonds. Additionally, if a minority coalition forms in the Japanese Parliament, there could be uncertainty regarding potential government policies, such as lower interest rates or increased public spending. Both factors are likely to contribute to market volatility and uncertainty in the near future.





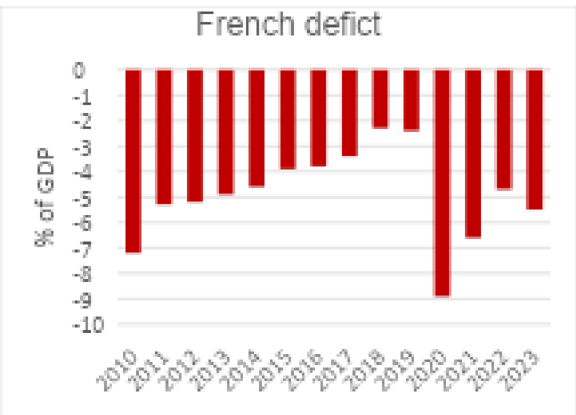
Sources: Jornal de Negócios, October 28 and Investing.com (for graphical data)

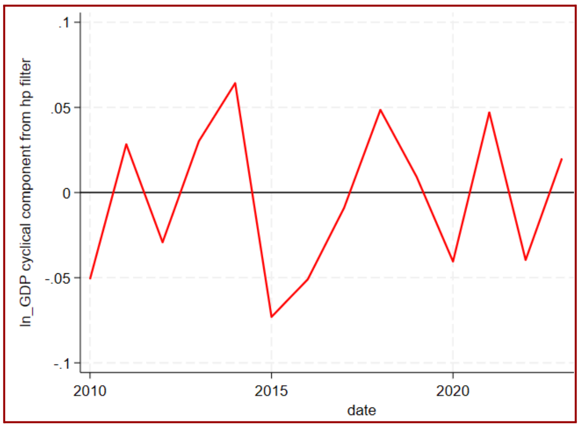
France:

Following the Paris Olympic Games, the French economy's growth accelerated to 0.4% in the third quarter, up from 0.2% in the previous quarter. This increase was largely driven by a surge in tourism, which boosted consumer spending by 0.5% after a stagnant performance in the second quarter. However, GDP growth is now projected at 0.4%, revised down from an earlier forecast of 0.5%.

By the end of the year, France is expected to have a deficit of 6.1% with a public debt of 112.9% of GDP. French Prime Minister Michel Barnier presented a proposal to Brussels to improve the structural balance by 0.9 percentage points, accounting for 60 billion euros in savings. The proposed measures include postponing pension updates, reducing job numbers in the Civil Service, and increasing taxes on large companies, wealthier individuals, and environmental taxes.

Overall, France is experiencing fiscal policy tightening, as evidenced by a positive structural budget variance despite a negative potential GDP. Nevertheless, the ITIC Research Team has estimated a small positive output gap for 2023.





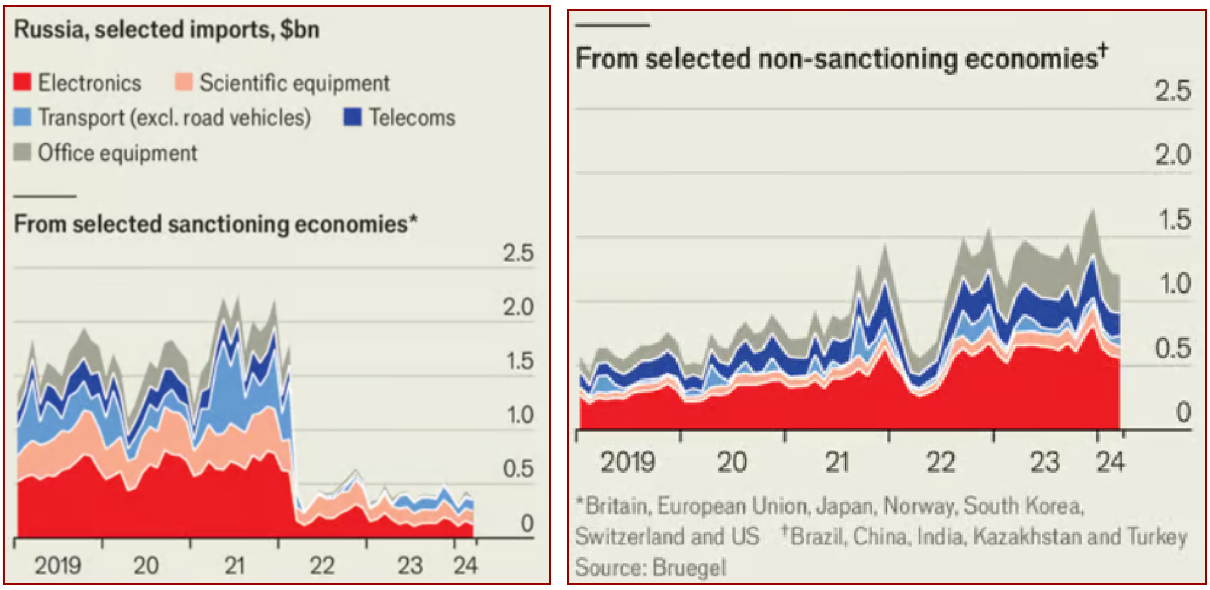
Sources: Reuters (https://www.reuters.com/markets/europe/french-economy-expanded-04-q3-insee-says-2024-10-30/), Jornal de Negócios, October 21, EUROSTAT (for graphical data, on the left), and Fred St. Louis (for data; the estimations are ITIC's property and displayed on the right)

Russia:

Vladimir Putin plans to invest $70 billion over the next decade in constructing transport routes to connect Russia with trade partners in Asia and the Middle East. This comes at a time when the Russian invasion of Ukraine has cost over $200 billion, equivalent to 10% of Russia's GDP.

As a result of economic sanctions imposed by Western economies, China and India have stepped in to replace the lost trade with the West. Last year, trade between Russia and China reached a record $240 billion, up by two-thirds since 2021. India is another key player in Putin's strategy, as its demand for coal and oil is expected to remain strong until 2030. Additionally, Putin has agreed to finance Iran's Rasht-Astara railway, completing the INSTC. This project aims to transform Iran into a hub for Russian goods destined for the Middle East, Asia, and other regions.

However, Putin's plans face several obstacles. The ice cover still limits the use of the Northern Sea Route, and Russia's eastern railways handled 13% less goods than their capacity last year. The Sherpa Group expects private investment in Russia's state transport program to fall from 927 billion roubles in 2022 to 180 billion roubles in 2026. Sanctions are also delaying progress on sanctions-defying routes, and the INSTC could increase competition between Russia and Iran, which export similar products to separate markets. Lastly, Russian economic growth will only be sustained if the prices are favourable for China and India.



Source: The Economist

(https://www.economist.com/finance-and-economics/2024/08/28/how-vladimir-putin-hopes-to-transform-russian-trade) (for both content and images)

Spain:

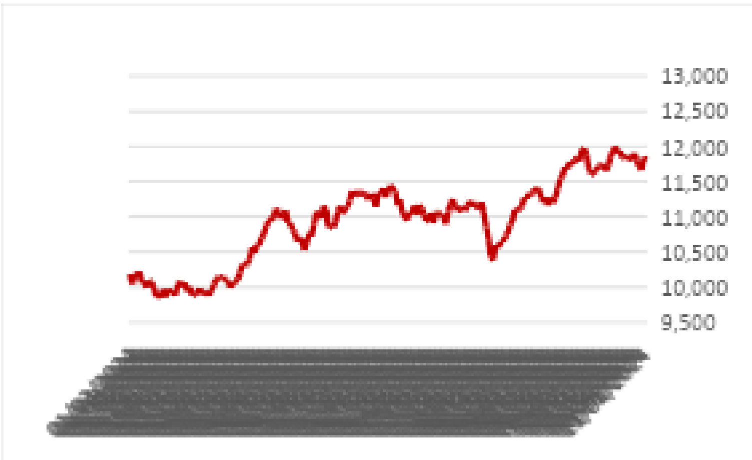
The Spanish economy is thriving this year, driven by tourism, domestic spending, and investment. In the final quarter of 2023, the economy grew by 0.6%, spurred by resilient domestic demand, persistent inflationary pressures, and high interest rates.

In February, retail sales increased by 1.9% year-over-year, and inflation has been on a downward trend since the beginning of the year, returning to approximately pre-pandemic levels. Additionally, the spread between Spain's 10-year bonds and German bonds was 85 basis points at the end of the first quarter of 2024.

Moody's rating agency has revised the outlook on the Government of Spain to positive, maintaining a rating of Baa1. The agency highlighted Spain's low private sector leverage, strong banking sector, current account surplus, and improved labour market. However, challenges such as a higher debt burden and an aging population may impact fiscal stability.

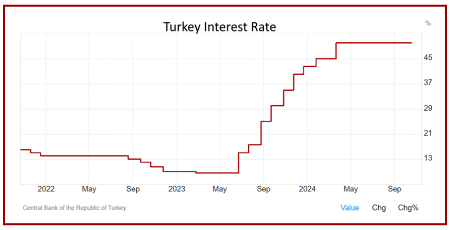
According to Eurostat, the primary drivers of the Spanish economy are consumption and investment. The expansion of the private economy has been supported by real income gains and the use of accumulated household savings. Investment growth is bolstered by the implementation of the Spanish Recovery and Resilience Plan.

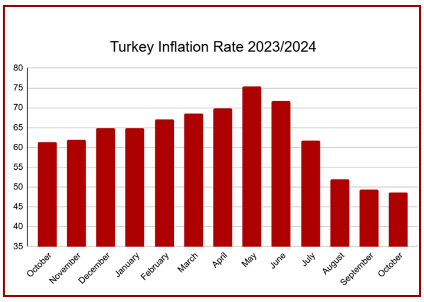
Looking ahead, the inflation outlook is expected to moderate, with headline inflation projected at 3.2% for this year. In 2025, Spanish inflation is projected to decline to 2.1%, above the 1.5% reached in September.

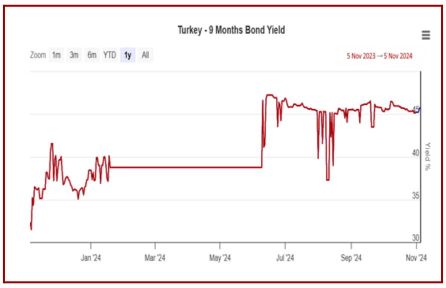


Source: Euronews (https://www.euronews.com/business/2024/03/29/spains-economy-thrives-why-its-growing-more-than-its-eu-rivals), MarketWatch (for graphical data about IBEX 35 index, first graph), and TradingEconomics (for graphical data about inflation, second graph)

Highest Government Bond







Today, as of November 5th, the Government Bond with the highest yield worldwide is Turkey 9 months. This Bond has an actual yield of 45.74% if investors hold it until its maturity. This represents a high reward for their investment, but at the same time represents the risk of investing in the country's debt. Turkey is the only country where Bonds are above 40% and it is highly influenced by inflation and Central Bank policies. According to Fitch Ratings the country's Short Term Issuer Default Rating and Local Currency Long Term Issuer Default Rating are classified at B (highly speculative) and BBrespectively. Last week, on the November 1st, S&P Ratings raised the Turkey's rating from B+ to BB- as the outlook looks stable. This was possible after The Central Bank of the Republic of Turkey (CBRT) tight monetary policy helped stabilize the Lira and bring down inflation. S&P also noticed that inflation will go below 10% only beyond 2027 and currently real GDP growth is estimated between 2% and 3%. Looking now to Turkish politics, since the last constitution (written in 2017), the executive branch can sack and appoint the leadership of the CBRT by law, which creates instability to the economy regarding the Government's power to change the economic scenario with no discretion. No elections are expected before 2028, what gives some time to the Government work in a medium-term economic goal. Inflation has been a problem to Turkey for some years. This year the highest inflation rate registered was 75.45% in May.

Nevertheless, the Central Bank has worked to change this scenario and the inflation rate in October was of 48.58%, a considerable decline. When buying Bonds, it is important to look at the country's currency. In the last year, the Turkish Lira – Dollar exchange rate has declined 17.15%. However, according to S&P Global, Real Effective Exchange Rate growth is expected to be of 6% next year. The Turkish Lira has been extremely volatile over the last decade, and this may keep more moderate investors away from the country. Furthermore, unemployment rate is likely to continue stable, around 10%, for next years. Regarding the Real Interest Rate, it has raised considerably in a year and half. As of May 2023, the real interest rate was declining and reached a minimum of 8.5%. To control the high inflation the CBRT raised to the actual rate of 50% which has not been changed since March 2024. Turkey's central bank is currently maintaining high interest rates due to government control over the CBRT and this could impact policy consistency and investor confidence. In conclusion, while Turkey's 45.74% bond yield reflects attractive returns for high-risk investors, fiscal pressures and currency volatility mean these bonds remain speculative. For those confident in Turkey's monetary policy efforts to curb inflation, this investment may hold appeal, though a safe return is far from guaranteed. The rate given by the Rating Companies reflects the country's policies and it is correct to be classified as B, which can be described highly speculative and cannot give investors a safe return.