



REPORT ON THE ECONOMIC SITUATION

01/2025

Turbulent start to the year

Exclusive report for ACATIS Investment: Prof. Dr. Dr. h.c. Lars P. Feld, University Freiburg and Walter Eucken Institute

The political turbulence that characterised the end of 2024 (not least the vote of confidence of Federal Chancellor Olaf Scholz) continued into early 2025. While Germans are still getting worked up about the interventions of Elon Musk and there are discussions about who will be leaving his social media platform X, the second term of Donald Trump is already making its presence felt: Recently, Trump has laid claim to Greenland and the Panama Canal, and he has pejoratively described Canada as the 51st state of the US.

These are not the fanciful musings of the future president of the United States. More likely, these statements are driven by strategic calculations. At least the talk about Greenland and Panama is about the strategic containment of China. Two ports at the entry and exit points of the Panama Canal are managed by the Chinese conglomerate CK Hutchison Holdings. The US is concerned that this could lead to China effectively controlling the passage through the canal. This passage is crucial for connecting the Atlantic and Pacific fleets of the US Navy. The US objectives with regard to Greenland are less clear, as the US already has extensive rights for American military bases in that region. Speculations that access to rare earths could play a role in this context have not been confirmed.

In any case, Trump's recent forays demonstrate that the rivalry between the US and China will enter a new and more intensive phase after he becomes President on 20 January 2025. It is not clear how China will react. Against this background, there have been interesting developments in the bond markets during the first days of January. While the yield for ten-year Chinese government bonds is at around 1.6% (after a steep decline), the yields for ten-year US government bonds have increased significantly to 4.65%. In addition to other reasons (not least the expectation of higher government debt under Trump), China's withdrawal from American government bonds also plays a role. It means that China continues to decouple itself from the US; in 2024, China already gradually withdrew from American government bonds.

In view of the economic and financial policy plans of the Trump administration, these are remarkable developments. Trump is planning massive tax decreases. For example, corporate taxes are supposed to decrease to the minimum rate of 15 percent, and the income tax relief originally introduced by Trump as a temporary measure in his first term (and extended by the Biden administration) is supposed to be made permanent. By themselves, these initiatives will lead to higher government debt, which is expected to rise significantly based on the vague reciprocal financing: Higher customs

duties, potential savings from deregulation and the closure of government offices, or stronger economic growth from this dedicated supply policy, will not be able to compensate for the lost revenue from the tax de-creases.

It means that the US will become an even bigger net capital importer than it is currently, which will only exacerbate the current account deficit. These imbalances will be particularly apparent vis-a-vis Europe, if China continues to retreat from the American capital market. Tariffs will not do much to change this situation.

This is almost a textbook case of how the world is drifting into two strategic blocks: the West, with the US as the leading power, and the Chinese-Russian axis on the other side. Interestingly, in the Western camp the US under Donald Trump is anything but cooperative. It may be a reaction to the fact that the (still friendly) requests by George W. Bush and Barack Obama for increased European engagement fell on deaf ears. At the same time, it is not helpful to threaten the countries in the West if the objective is to contain China. Therefore, it is high time that Europeans impress upon the US the importance of the continent to American objectives.

What do these deliberations mean for financial planning? Uncertainties are increasing and will likely lead to higher volatility - with all of the ensuing opportunities and risks.

The same applies to economic policy: things are about to get more uncomfortable.

Prof. Dr. Dr. h.c. Lars P. Feld