HOW THE 2025 DAVOS CONSENSUS WAS UPENDED IN TWO MONTHS, AND WHAT COMES NEXT

They say the Davos consensus is always wrong, but it usually takes longer than a couple of months to be apparent. Not so in 2025.

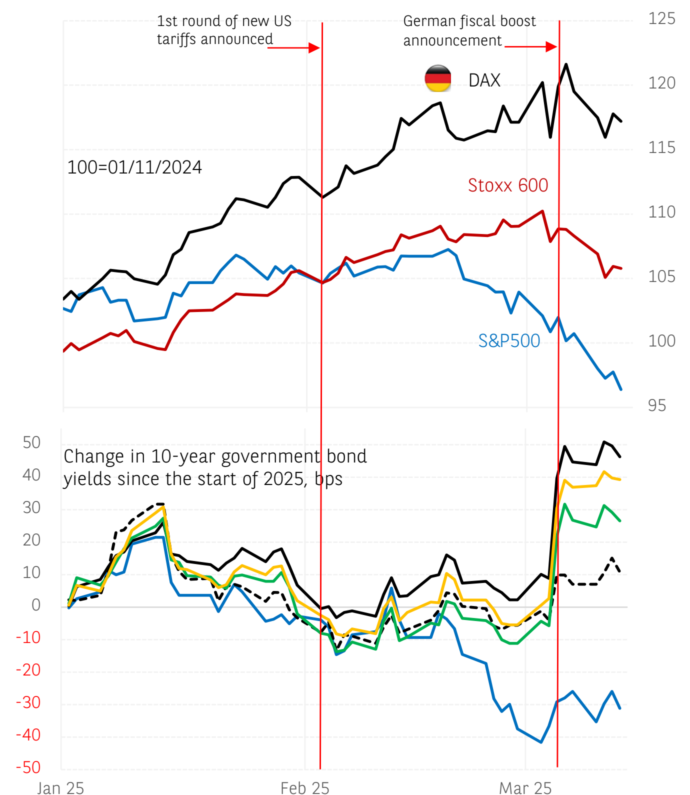
Back on Inauguration Day, world elites gathered in the Swiss Alps were enthusiastic about the prospects of the US economy under Donald Trump's second mandate. So were US households and small business owners, according to confidence surveys. The US stock and bond markets agreed, with the former reaching an all-time high that week and the latter touching 4.79% days earlier, its 2nd highest level since 2008. Meanwhile, after historic underperformance of the STOXX Europe 600 index versus the S&P 500 in 2024 (by 23% percentage points in dollar terms), consensus was for the euro to fall to parity with the dollar. The Eurozone's already sluggish economy was seen as ill-prepared to absorb the shock of President's Trump looming tariffs. Questions were frequently being asked about recession risks in Europe.

Fast forward to today, and recession risk is back in focus, but this time for the US economy. US 10-year interest rates have plummeted, while European ones have soared, the euro is up over 5% against the dollar year to date, and stock markets' respective performances have been reversed (*see chart*). In the US, households and business confidence indicators are rolling over—in some cases sharply, while they are starting to improve in Europe.

What explains this sudden reversal, and is it warranted? Developments on both sides of the Atlantic have moved against expectations. US investors were counting on the sweets from President Trump's economic platform and had high hopes for tax cuts and deregulation. Instead, they got the sours in the form of massive tariffs on the US largest trading partners, along with federal spending and job cuts. That both have been rolled out in a highly discretionary and hence unpredictable manner has caused uncertainty to surge, and magnified their chilling effect on activity. Meanwhile, in Europe, the sudden urgency to boost military capabilities has led to an historic change in mindset, both in Germany, its largest and one of its most frugal economies, and at EU level. This week, Germany's Parliament is expected to approve a plan allowing an additional 1 trillion euros in infrastructure and defense investment over the next 10 years, while the European Commission has proposed reforms that would allow additional defense spending of 800bn euros. German growth could triple as a result in 2025 (from a low base, admittedly), and Eurozone growth be higher by several decimal points of GDP.

Will this pattern persist? Some repricing was probably inevitable. Since last November, markets had been pricing in only the good news from Trumponomics, forgetting the bad. Conversely, expectations about Europe had got so implausibly low that beating them required only to show minimal agency. That said, the US entered 2025 with a GDP growth carry over of +1%, a very strong labour market, and high levels of confidence across households and businesses. Signs of cooling are appearing: retail sales slowing, credit card and business delinquencies rising fast, optimism about labour market conditions waning, and capex intentions slowing.

BOTH STOCK AND BOND MARKETS HAVE BEEN REVERSING GROWTH EXPECTATIONS OUT OF EUROPE AND THE US



SOURCE: LSEG, BNP PARIBAS

CHART

At the same time, still high inflation and fast-rising inflation expectations will constrain the Fed from cutting rates. In Europe, by contrast, the direction of travel looks positive for most indicators, but starting from a much lower level, symptomatic of an economy still operating with ample spare capacity overall.

This means inflationary pressures are limited. As a result, the ECB is likely to deliver 2 further cuts this year. Where we go from here will depend on the path taken by fiscal and structural economic policies on both sides of the Atlantic.

There are no grounds for complacency. The US economy is still strong, but it is not invincible. If policy uncertainty were to persist at recent record levels, or even intensify further, a much more abrupt slowdown cannot be ruled out. A few months of wobble in consumption and investment decisions can be absorbed without growth turning negative in an economy that started the year as strong as the US did. But a longer standstill in activity could well tip the economy into a recessionary environment. Conversely, Europe should resist the temptation to succumb to *Schadenfreude*. There is much to be optimistic about in recent policy developments. However, part of the near-term boost to growth will simply serve to offset the headwind from US tariffs, and much more work needs to be done to boost growth meaningfully over the medium term. Political agreements to unleash expansive investment are a highly welcome necessary first step. But they are only that. Execution must now follow promptly, on this and all the other growth levers identified in the Competitiveness Compass and Rearm Europe plans. Otherwise, the newfound optimism about Europe's potential will be disappointed.

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