FEBRUARY 2025

Frequently asked questions: February 2025

Summary

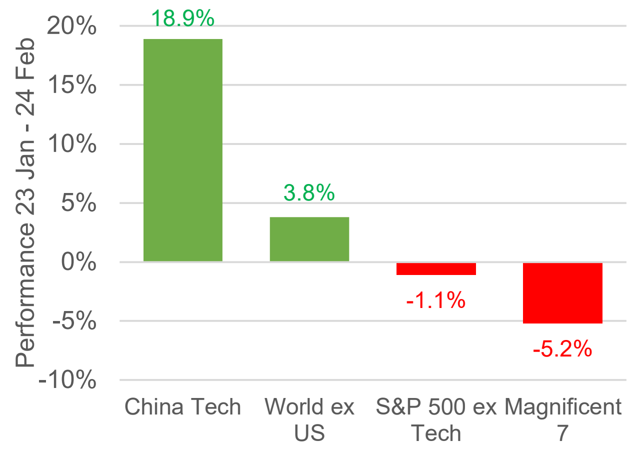
1. **Can the eurozone improve economic growth through key reforms?** We expect initiatives in the coming months to improve the economy, particularly through deregulation. We continue to believe that investors are too pessimistic about the eurozone. High savings rates in the EU, moderating inflation and growing confidence in EU reforms and investment programmes, could drive real GDP growth close to 1%.

2. **Are US and eurozone government debt burdens sustainable**? There is no universal threshold for how much debt a country can sustain before facing sustainability concerns or the risk of default. In theory, there are three ways to reduce public debt: i) faster economic growth; ii) fiscal consolidation and iii) financial repression. At this stage, deficits and debt burdens do not pose a major source of stress.

3. **What does the DeepSeek announcement mean for the AI investment theme?** So far, there has been no suggestion of slower AI investment growth by the big 4 US hyperscalers. We expect the commoditisation of AI with the rapid introduction of competing generative AI models to lower entry costs for end users. This should accelerate widescale adoption of this technology in the wider economy. Economies could benefit from faster productivity growth with attendant disinflationary pressures on labour costs.

4. **Should investors hold or take profits on gold?** The gold price has risen to a new all-time-high, close to our USD 3000 target. Aside from ongoing buying by central banks (diversifying their reserves away from USD assets), the gold price is mainly supported by investors' flight to safe havens due to high geopolitical uncertainties, mainly due to President Trump's policies. Longer term, we still expect the uptrend to continue, supported by further gold reserves accumulation by central banks, combined with the likely continuation of geopolitical and economic uncertainties. **Hence, we slightly increase our 12-month target for gold from USD 3000/oz to USD 3200/oz and maintain our Positive view.**

CHINESE TECH COMPANIES RALLY 19% SINCE THE 23 JANUARY DEEPSEEK NEWS



Source: BNP Paribas, Bloomberg. As of 24 February 2025

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Can the eurozone improve economic growth through key reforms

EU economic growth has been lagging US growth for decades. This is partly due to higher population growth in the US, but the main driver has been the productivity gap. Indeed, weaker productivity growth leads to slower wage growth, which is a drag on domestic demand. The speed at which the economy can grow without generating inflationary pressures ("potential economic growth") is also determined by other factors. To address the current "existential challenge" for Europe, the focus should be on three main areas: i) innovation; ii) decarbonisation and competitiveness and iii) strategic autonomy.

Regarding innovation: the lack of a capital markets union remains a significant barrier to financing young, innovative companies. Enhancing access to capital, especially venture capital, could be a key driver of both innovation and economic growth. However, while EU regulations protect consumers, excessive restrictions continue to be seen as a "major obstacle" to long-term investment decisions. These regulations also limit the flow of capital from banks, insurance companies or pension funds. Therefore, deregulation is the second key to innovation. Additionally, European institutions, such as the European Investment Bank (EIB) can also play a more active role.

Second, energy security, decarbonisation and competitiveness: the EU's energy security will depend on its ability to transition to self-sufficient energy sources, in particular renewables. Furthermore, supporting domestic production of green technologies could help offset the weakness in the EU's industrial sector, as green investments tend to generate a higher job creation multiplier.

During the transition period to fill energy independence, negotiating fossil energy such as LNG at the EU level would help to reduce the prices. Lowering energy prices should be the top priority to improve competitiveness both in the short and long term.

Finally, achieving strategic autonomy: to reduce vulnerabilities, the EU's foreign economic policy should prioritise securing critical resources while promoting recycling and innovation in alternative materials. This would also extend to key network infrastructure for strategic industries.

These measures should be implemented gradually, leading to a significant boost in potential GDP growth. On the demand side, the necessary investment will have a major multiplier effect (higher investments create jobs and income, driving further demand and economic growth).

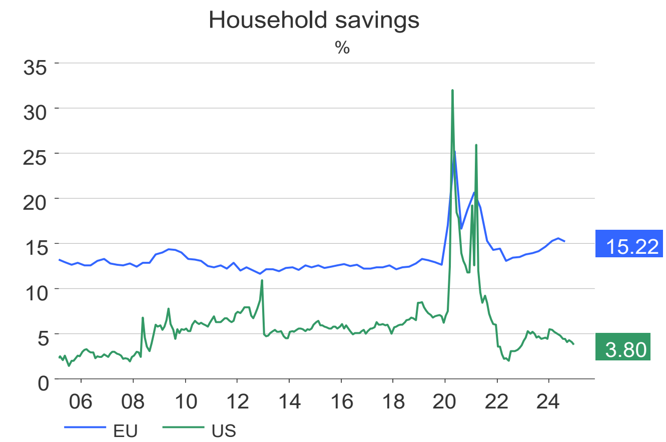
However, we must stay realistic. First, we need to assess the priorities of the new German government and the likelihood of reforming the debt brake. If successful, Germany could play a leading role at the EU level, sparking large-scale investment programmes. Defence investments will also be key.

In summary, we expect initiatives in the coming months to improve the German economy, particularly through deregulation. While major investments will follow, the speed of initiatives will depend on the new German ruling coalition and the potential debt brake reform. We continue to believe that investors are too pessimistic about the eurozone's future. High savings rates in the EU, combined with moderating inflation and growing confidence in EU reforms and investment programmes, could drive real GDP growth close to 1%.

CHART 1: REAL INCOME GAP

Source: LSEG Datastream, Jan 25

CHART 2: COMPARING SAVINGS RATES



Source: LSEG Datastream, Q3 24

Are US and eurozone government debt burdens sustainable?

Government debt accumulates from deficits. It is typically expressed as a percentage of GDP, enabling comparisons across countries of varying sizes (see chart 3).

There is no universal threshold for how much debt a country can sustain before facing sustainability concerns or the risk of default.

There are useful rules and ratios for evaluating sustainable debts levels and default probabilities. Assuming no new deficit, a key guideline is that economic growth should be higher than the average cost of existing debt (average coupon on a bond). Government income, mainly from taxes, is typically proportional to growth. Assuming no additional deficits, the primary cost is the interest burden. Since governments issue new debt at varying rates, it's essential to calculate the average cost of debt. For example, we expect the US to achieve a nominal grow at of around 5% this year, while the average debt cost is 2.75%. In the eurozone, nominal GDP growth should be around 3% with an average cost of debt of around 2% (see chart 4). There is thus no stress at this stage.

In theory, there are three ways to reduce public debt: i) faster economic growth; ii) fiscal consolidation and iii) financial repression.

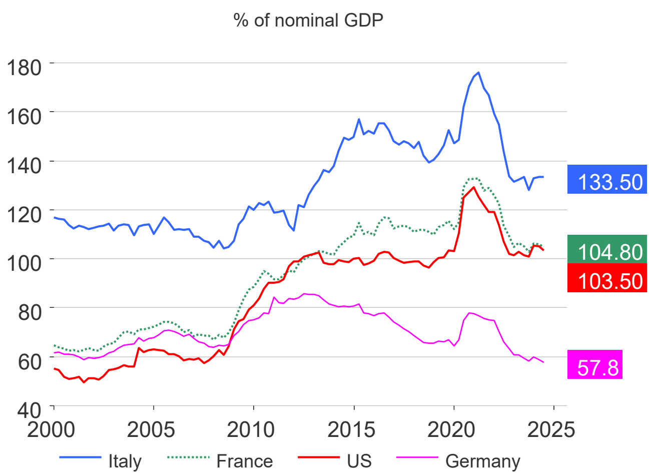
First, the economic growth potential is higher in the US than in the EU. In both regions, nominal growth rates should exceed the average cost of debt. As mentioned above, the EU will focus on boosting growth through productivity-enhancing investments and deregulation. This is already the case in the US.

Second, fiscal consolidation is underway in the US, with the deficit planned to be reduce from -6% of GDP to -3%, with further cuts possible if needed. In the EU, deficits may stay high during the investment period covered by the Draghi report, but governments can raise taxes in case of stress. The potential for tax income depends mainly on GDP per capita which is high in the US and eurozone. The EU has a very high savings rate. Another option is to reduce government spending, though this typically takes longer. Increasing government efficiency is a further possibility to reduce spending.

The third option is financial repression which involves keeping interest rates lower than what market forces would typically dictate. Historically, this strategy has been used to place government debt at yields below inflation. One example of this is central bank bond purchases after the Great Financial Crisis and the quantitative easing that starting during the EU debt crisis. These purchases remain a powerful tool to for limiting the rise in the cost of debt, especially when a country faces temporary stress within the European Union. To reduce the risk of a government debt crisis, the EU has implemented measures such as stricter bank regulation, a bail-in mechanism, and reduced exposure of domestic banks to local government bonds.

We should monitor deficit and debt levels, but at this stage, they do not pose a major source of stress.

CHART 3: DEBT TO GDP - EU VS US



Source: LSEG Datastream, Q2 24

CHART 4: DEBT SUSTAINABILITY

Country	Average Maturity	Coupon Average		Golden Rule*	
		21/02/2025	Average 5Y	21/02/2025	Average 5Y
US	5.79	2.75	2.02	2.95	5.04
France	8.18	1.73	1.65	0.07	2.00
Germany	6.96	1.59	1.26	1.01	2.96
Italy	7.03	2.83	2.57	-0.03	1.81

* Difference between the Nominal GDP and the cost of debt (coupon)

Source: Bloomberg

What does the DeepSeek announcement mean for the AI theme?

US Tech sell-off reaction

We saw a sell-off in the mega-cap tech and semiconductor sectors following the surprising 23 January announcement of the impressive results from the low-cost Chinese DeepSeek R1 large-language model. But this event has merely accelerated a sector rotation away from US large-cap Technology, which had already started in late 2024.

Since 23 January, the Magnificent 7 US tech stocks have lost 5.2%, while the World ex-US index advanced 3.8% and the Nasdaq Gold Dragon index of Chinese tech stocks has risen a heady 18.9%.

The bigger story here is the commoditisation of AI – that more and cheaper AI models and algorithms will provide a more cost-effective route for companies to embed AI-enabled processes into their businesses.

No suggestion of slowing of AI capex

Thus far, the four US "hyperscalers" (Microsoft, Amazon, Google, Meta) have committed to growing their AI-related capital expenditures by nearly 50% to USD 317bn this year, with no change to these intentions despite the AI-related announcements from DeepSeek and other Chinese tech companies such as Alibaba.

It is difficult to see companies such as Google (Alphabet) cutting their capex intentions, as this massive investment in AI can be seen in large part as a defensive investment to try to maintain their heavy dominance in online advertising, driven by their near-monopoly in internet search engines with Google Search.

There is early anecdotal evidence that sophisticated users are preferring to use AI large-language model apps, such ChatGPT and Perplexity.ai, for more intelligent internet searches than can be performed currently with Google Search.

The Jevons Paradox and AI

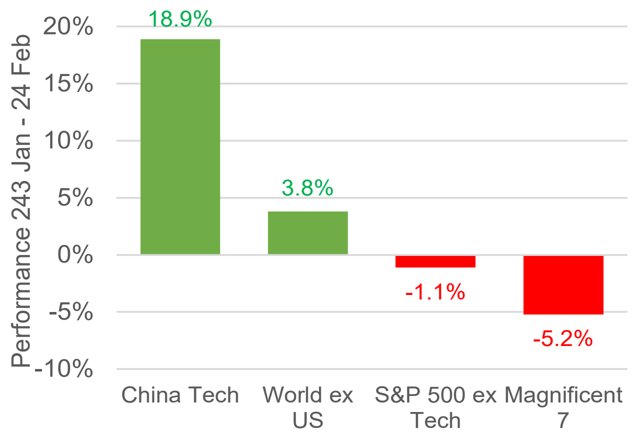
According to the Jevons Paradox, as technological improvements increase the efficiency of resource use, the overall consumption of the resource tends to increase (not decrease), as demand increases sharply.

Cheaper leading-edge AI models should accelerate their adoption in the wider economy, driving productivity gains across sectors and driving even faster electricity demand growth. The big winners from this next stage in the AI development cycle will not necessarily be the Magnificent 7, but companies that can drive significant AI-related productivity benefits in the financial, healthcare and software sectors. AI commoditisation should also spur the development of a new wave of businesses and industries, as seen with the widespread adoption of mobile internet and smartphones.

Wider economic benefits from AI adoption

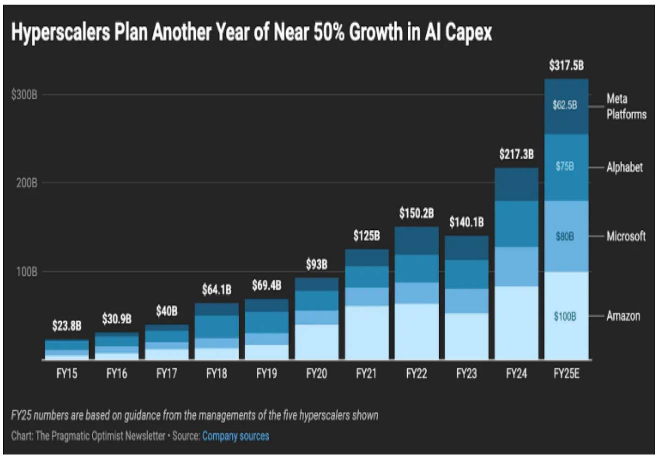
Over the longer term, we see substantial productivity potential across the global economy, as was previously seen over prior technological innovation cycles involving the adoption of the desktop PC and the internet. A study by Erik Brynjolfsson (National Bureau of Economic Research), Danielle Li and Lindsey R. Raymond (both from Massachusetts Institute of Technology) estimates that generative AI could boost worker productivity by 14% on average and by 34% for new and low-skilled workers.

CHART 5: SUDDEN ROTATION AWAY FROM MAGNIFICENT 7 TO CHINA TECH



Source: BNP Paribas

CHART 6: THE 4 US "HYPERSCALERS" TO GROW AI CAPEX NEARLY 50% IN 2025



Should we hold or take profits on gold now?

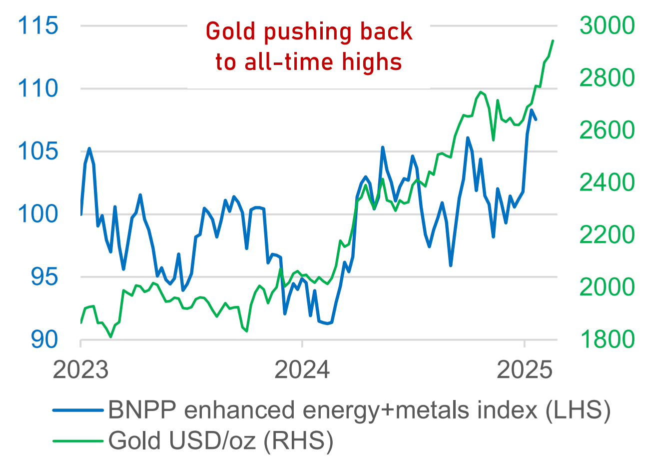
Gold: fuelled by central bank buying and heightened geopolitical uncertainty

The gold price rose to a new all-time-high, close to our USD 3000 target. Apart from ongoing buying by central banks (diversifying their reserves away from USD assets), the gold price is mainly supported by investors' flight to safe havens, due to high geopolitical uncertainties mainly with regards to Trump's policies (threats of higher tariffs, Europe's military isolation and exclusion from negotiations with Russia, will he be able to cool down inflation and reduce fiscal deficit?).

After the recent rally (+16% since the November low), gold may be somewhat overbought. For the short term we think a consolidation or slight correction is possible, particularly if the Russia/Ukraine peace negotiations go in the right direction and/or if there is a trade deal between the US and its main trade partners (China, Europe, Canada, Mexico). But in the longer term, we still expect the upward trend to continue, supported by a further accumulation of gold reserves by central banks, combined with the likely continuation of geopolitical and economic uncertainties (Trump's inflationary policy, high US fiscal deficits and government debt, a possible trade war, military developments).

Hence, we slightly increase our 12-month target for gold from USD 3000/oz to USD 3200/oz and maintain our Positive view. So, any short-term correction could offer new buying opportunities.

GOLD HITS NEW ALL-TIME HIGHS CLOSE TO USD 3000/OUNCE



Source: BNP Paribas

Silver continues to offer an attractive opportunity thanks to both investment and industrial demand

Silver follows the gold rally, benefitting from a substitution effect in the jewellery sector. industrial demand should also continue to increase, notably related to electronics, data centres, and solar panels.

As the market for silver is much smaller than for gold, it is more exposed to potential supply/demand imbalances, which could trigger a further catch-up in prices compared with gold. The gold/silver ratio is currently close to 90 but could eventually move back to 80.

We increase our 12-month target from USD 35 to USD 38/oz.

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