Yardeni Research

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Morning Briefing

Europe's Debt Trap

Check out the accompanying chart collection.

Executive Summary: A new wave of sovereign risk is washing over European economies, with the UK and France most vulnerable as they navigate fiscal fragility, political instability, and cratering bond market confidence. Will the UK and France need bailouts from the IMF's limited funds? Are they "too big to save"? William examines how each country got to this point of debt reckoning and how Trump's tariffs have upped the stakes. The Bond Vigilantes, he warns, smell blood. … Also: Not only in Europe have Trump's actions—his tariffs and attempts to abolish the Fed's independence—rained problems on world economies.

YRI Weekly Webcast. This week, Dr Ed's live Q&A webinar will be held on Tuesday at 11 a.m. EST, with special guest Jim Lucier of *Capital Alpha Partners* discussing the latest developments in Trump's tariff turmoil. You will receive an email with the link to the webinar one hour before showtime. Replays of the weekly webcasts are available *here*.

European Economies I: UK & France on the Brink. When Liz Truss, of all people, is warning of a financial crisis, you know the UK has serious problems. In her super-brief 2022 stint as prime minister, Truss triggered one of modern history's most spectacular bond market crashes (see "*Liz Truss Moment*"). France also finds itself on the financial brink, with French Finance Minister Eric Lombard worrying aloud that Europe's third-biggest economy asking the International Monetary Fund (IMF) for help "*is a risk that is in front of us*."

Parallels to the *Greek bailout crisis* 15 years ago seem exaggerated. But the trade war unfolding in the background is raising the stakes. This leaves officials in both London and Paris with a *Hobson's choice*: They can slash public spending aggressively and hike taxes in ways that risk enraging voters or face the wrath of the Bond Vigilantes.

Whether either economy will require an IMF bailout and which one needs stimulus assistance more are questions complicated by the IMF's limited financial resources. Are *London and Paris* "too big to save"?

What's clear is that the European debt narrative has pivoted from the periphery to the core. The UK and France are at the vanguard of a new wave of sovereign risk. Fiscal fragility, political instability, and cratering market confidence are colliding in real time.

Let's look at the different debt reckonings facing the UK and France:

(1) *The Truss legacy*. The UK debt market hasn't quite been the same since the Truss government came and went in September-October 2022. Truss and Chancellor of the Exchequer Kwasi Kwarteng tried to sneak an unfunded and ill-timed tax cut past the bond market. It did not go well.

As the gilt market convulsed and the British pound fell to its lowest-ever level against the dollar, a UK tabloid, the *Daily Star*, live-streamed a head of lettuce next to a framed Truss photo to see if it could outlast her premiership. After 49 days, the *lettuce won* (*Fig. 1* and *Fig. 2*).

(2) *Below the surface*. The crisis of confidence lingered. As the trade deal between UK Prime Minister Keir Starmer and US President Donald Trump took effect on June 30, financial tensions were bubbling up again. The US-UK pact was a big moment for both leaders. For Trump, it marked the first deal with a Group of Seven nation. For Starmer, it was a win in that the UK gave up little, benefiting from a first-mover advantage.

Celebrations were short-lived. Roughly a week later, on July 8, the *Office for Budget Responsibility* (OBR) warned that public finances are "in an unsustainable position in the long run." As the watchdog group's chair Richard Hughes said, "the UK *cannot afford* the array of promises that it has made to the public."

Hughes cautioned that UK government debt would rise to *270% of GDP* by 2070—up from nearly 100% now—if today's policy mix is maintained. The OBR notes that the UK has "the sixth-highest debt, fifth-highest deficit and third-highest borrowing costs among 36 advanced economies."

(3) *Trump's Tariff Turmoil.* These domestic challenges are exacerbated by the collateral damage from Trump's tariffs and US pressure on Starmer's Labor Party to increase defense spending to 5% of the UK's GDP over the next decade. The trouble is, the OBR calculates that *US tariffs* with the rest of the world averaging about 20% could reduce UK GDP growth by 1% annually, making the 2035 target even more daunting.

(4) *No way out*. Count Glenn Handley of SecFin Solutions among those in a *1976 state of mind*. That year, a time of 25% inflation and 17% interest rates, was the last time that the UK went, hat in hand, to the IMF for emergency financing. "I've traded through everything," Handley *wrote on LinkedIn*, referencing the *1992 pound crisis*, when the currency crashed out of the European Exchange Rate Mechanism; the 1998 *collapse* of Long-Term Capital Management LP; the 2008 *Lehman Brothers shock*; the 2022 Liability-Driven Investment crisis triggered by the Truss government. But, Handley notes, "this is the first time I don't see a way out" for UK policymakers. "Every escape route is blocked." If Chancellor of the Exchequer Rachel Reeves cuts spending, Handley argues, "the unions riot. Raise taxes more? Already destroying the economy. Print money? Stirling crashes. Borrow money? Markets saying no."

The problem, Handley concludes, is that "when Bond Vigilantes smell blood, they don't stop until someone capitulates. And Reeves? She's out of ammunition."

European Economies II: Bond Vigilantes Smell Blood. Others are convinced that London can tame the financial markets. The immediate aftermath of the Truss episode, many say, highlighted the UK economy's resiliency, earning it some benefit of the doubt. It helps, too, that the UK, unlike France, controls its own currency, giving the Bank of England scope to stabilize bond market volatility.

Consider the following:

(1) *Weathering the storm*. "If the UK could weather that storm without turning to the IMF, there is little reason to think it will do so now in more benign conditions," Capital Economics argues in a recent report.

The real question, notes Dhaval Joshi at BCA Research, is will the UK government avoid risking the wrath of the bond market? "After all," he argues, "the BOE has a primary mandate to maintain price stability. And the UK government will not want a rerun of the Liz Truss fiasco. So, even though the UK economy is sick, the conclusion is to structurally overweight pound/dollar and structurally overweight UK gilts versus US T-bonds."

(2) *UK versus France*. Indeed, many economists say the UK is better off in 2025 than France. Whereas the UK's debt-to-GDP ratio may be *headed toward 108%* by 2028, France's, which ended 2024 *at 113%*, looks bound for 120% by 2030. Worries that France might trigger the next global crisis are indeed gaining currency in some market circles.

Already, France is operating at twice the requirements set out by the EU's Stability and

Growth Pact. Last November, this landed France in EDP (excessive deficit procedure) territory, the EU's equivalent of high-school detention.

(3) *French austerity debate*. Hence, the austerity plan is being pushed by French Prime Minister François Bayrou. He's proposing *44 billion euros* ($51.6 billion) in budgetary cuts for 2026, targeting pensions, welfare spending, and the number of public holidays. The package is a non-starter for opposition parties planning a September 8 no-confidence vote against Bayrou's minority administration.

These plans are causing political gridlock and public unrest of the kind that unnerves global investors. Should Bayrou's strategy backfire, France could be in for a snap election, which might only increase uncertainty and further delay fiscal reforms.

(4) *The new Italy?* Bayrou cuts have created an unlikely coalition between left-wing and right-wing lawmakers. Goldman Sachs *warns* that without a compromise across the political spectrum, the budget deficit could widen, boosting bond yields and drawing the ire of credit rating companies. There's an argument, too, notes Torsten Slok of Apollo Global Management, that the yields on Italy's *long-term government debt* could be below those of France by year-end (*Fig. 3*).

French President Emmanuel Macron has assumed his now-familiar crouch of defiance as Bayrou faces the perilous task of steering his budget through a recalcitrant National Assembly. Macron is ruling out resigning if he loses the *sixth prime minister* of his eight years in power. Polymarket assigns a *95% chance* Bayrou will be gone by September 30.

(5) *Pre-existing conditions.* Along with global tariff pain, France confronts a number of pre-existing structural conditions now vying for Macron's attention and that of his Renaissance Party. They include a fast-aging population, chronically *weak productivity*, rising defense outlays, and soaring costs related to *climate change*.

One reason for the Greek comparisons: French *30-year bond yields* have been trading at *their highest* since 2011, back when Athens spawned a crisis that spread to bond markets across the continent. The same goes for German yields: Though Germany isn't facing off against the Bond Vigilantes directly, unexpected fiscal spending surges have catapulted yields skyward (*Fig. 4*).

European Economies III: Debt Troubles Go Global. It's not just European economies that are reeling from Trump effects. In Japan, fears about sticky inflation, potential tax cuts, and Trump’s assault on Federal Reserve independence are sending rates higher (*Fig. 5*). Last month, 20-year yields surged to their highest since 1999, the year that the Bank of Japan first cut short-term rates to zero. The increase to 2.655% came *on August 21* after Tokyo held yet another weak debt auction.

Rising debt-servicing costs are a headache for G7 governments confronting higher spending needs and pressure to issue more debt to offset the headwind emanating from the tariffs. Add the economic slowdown in China, where deflation is deepening.

Here’s more:

(1) *Pressure from China*. Already, Chinese overcapacity is raising the stakes for key European industries like autos. The *competitive threat* from China’s upstart electric vehicle makers threatens to overrun auto giants in Germany, France, and the UK.

Another threat from abroad that complicates Europe’s summer: Trump’s efforts to commandeer the Fed. On top of his oft-expressed desire to oust Chair Jerome Powell, Trump is trying to fire Governor Lisa Cook to put more monetary loyalists on the Federal Reserve Board.

European Central Bank (ECB) officials are attempting to walk a fine line between expressing alarm and not provoking Trump World. Last month, even before Trump moved to remove Cook for alleged mortgage fraud, ECB President Christine Lagarde *said* that when independence is threatened, rate policy “becomes dysfunctional, it starts doing things that it shouldn’t do. The next step is disruption. It is instability, if not worse. So I think that this should not be debated.”

(2) *Gambling with the Fed*. Bank of Greece Governor Yannis Stournaras *told Politico* that “attacking the independence of the Fed, the Trump administration inflicts a serious damage to the American economy. The implications will come sooner rather than later.”

Mārtiņš Kazāks, Bank of Latvia governor, warned on X that central bank independence is “*paramount*” for global stability and that “undermining it means risk of higher future inflation, higher interest rates, and more painful cost to the society from containing inflation.”

Some in Europe cite the example of the *years-long effort* by Turkish President Recep Erdoğan to neuter the central bank and the resulting hyperinflation.

(3) *System not working*. Yet Truss is firmly in the camp that believes Trump is right to rein in the Fed. "As a democrat—somebody that believes in democracy—I just think it's wrong that people should be making those decisions and not be accountable to the electorate," Truss *told Bloomberg* last week. She added that "the Bank of England needs to be accountable to politicians—the current system doesn't work. There is a reckoning coming for the central banks, not just in Britain, but also in the United States, also the ECB."

As Europe's debt crisis moves to the core economies, the euro's odds of rivaling the dollar as the global reserve currency are diminishing. In recent months, ECB's Lagarde has argued that uncertainties about US policies and the safety of the dollar "create the opening for a global euro moment."

In a *May 26 speech* in Berlin, Largarde said, "this is a prime opportunity for Europe to take greater control of its own destiny. But this is not a privilege that will simply be given to us. We have to earn it."

Yet that requires bold and creative policymaking to convince the markets that the "whatever it takes" decree that Largarde's predecessor Mario Draghi made in 2012 is still operational and that governments from London to Paris and beyond are getting serious about getting their fiscal houses in order.

"There's no *magic recipe*," Leo Barincou at Oxford Economics told *The Telegraph*. "France has to show financial markets that there's a commitment, there's a stability necessary to reduce the deficit. There's no other way."

That goes for the UK, too, of course. Though Neil Shearing at Capital Economics thinks "speculation that it may be forced to turn to the IMF for a bailout is far-fetched," global markets have a case of PTSD from the Truss affair. The onus is on London to restore trust.

Calendars

US: Tues: ISM M-PMI & Price Index 49.0 & 65.2; S&P Global PMI 53.3; Construction Spending 0.2%. **Wed:** JOLTS Job Openings 7.4m; Factory Orders -1.4%; MBA Mortgage Applications; Musalem. (Source: FX Street)

Global: Tues: Eurozone Headline & Core CPI Preliminary 2.0% & 2.2%y/y; Elderson. **Wed:** Eurozone PPI 0.2%m/m, 0.1%y/y; Eurozone C-PMI & NM-PMI 51.1 & 50.7; Germany C-

PMI & NM-PMI 50.9 & 50.1; France C-PMI & NM-PMI 49.8 & 49.7; UK C-PMI & NM-PMI 53.0 & 53.6; China Caixin NM/PMI 52.5. (Source: FX Street)

Strategy Indicators

Global Stock Markets (US$ Performance) (*link*): The US MSCI index edged down 0.1% during the August 29 week and closed 0.7% below its August 13 record high. The AC World ex-US fell 1.0% for the week and ended 1.1% below its August 25 record high. The AC World ex-US has been hitting new record highs since May 14 for the first time since June 15, 2021. Despite its strength in recent weeks, the US MSCI has outperformed the AC World ex-US in only 11 of the past 31 weeks. EM Latin America was the best performing region last week, with a gain of 1.1%, followed by EM Asia (-0.5%), EM (-0.6), and the AC World ex-US. EMU was the worst regional performer, with a decline of 2.6%, followed by EMEA (-2.3), Europe (-2.0), and EAFE (-1.5). The Brazil MSCI index, with a gain of 2.6%, performed the best among country indexes, ahead of Taiwan (1.7), Canada (1.6), Australia (0.5), and Korea (0.3). The France MSCI index was the worst performer w/w, with a decline of 3.5%, followed by Spain (-3.2), India (-3.1), South Africa (-2.4), and Germany (-2.0). In terms of ytd performance rankings, the US MSCI index is up 10.0% ytd, but ranks as the second worst country performer and trails the 19.4% gain for the AC World ex-US. Among the regional indexes outperforming the AC World ex-US ytd, EM Latin America leads with a gain of 29.5%, followed by EMU (26.7), Europe (22.3), EAFE (20.4), and the AC World ex-US. EM Asia is the worst ytd performer, albeit with a gain of 16.1%, followed by EMEA (16.4) and EM (17.0). Looking at the major selected country markets that we follow, Spain is the best ytd performer, with a gain of 51.9%, followed by Korea (40.2), South Africa (36.6), Mexico (31.4), and Germany (31.0). The worst performing countries ytd: India (-2.0), the US (10.0), Taiwan (13.2), Australia (13.8), and Japan (16.5).

US Stock Indexes (*link*): Twelve of the 48 major US stock indexes that we follow rose during the week ended August 29, down from 40 rising a week earlier. The S&P 600 SmallCap Pure Value index was the best performer for the week, rising 1.0%, ahead of Russell MidCap Growth (0.8%), S&P 500 LargeCap Pure Growth (0.4), S&P 400 MidCap Pure Value (0.3), and Russell 2000 Value (0.3). The S&P 500 Transportation index was the worst performer, with a decline of 2.2%, followed by Dow Jones 15 Utilities (-1.9), Dow Jones 20 Transports (-1.2), Nasdaq Industrials (-0.7), and Dow Jones 65 Composite (-0.6). All 48 indexes are higher ytd for a second straight week, up from 44 the week before that. With a gain of 13.8%, the S&P 500 LargeCap Pure Growth index is in the top spot as the best performer so far in 2025, ahead of S&P 500 LargeCap Growth (13.0), Russell MidCap

Growth (12.0), Nasdaq 100 (11.4), and Nasdaq Composite (11.1). The worst performing major US stock indexes ytd: Dow Jones 20 Transports (0.1), S&P 600 SmallCap Value (0.7), S&P 600 SmallCap Equal Weighted (1.8), S&P 600 SmallCap (2.1), and S&P 600 SmallCap Growth (3.8).

S&P 500 Sectors Performance (*link*): Three of the 11 S&P 500 sectors rose during the week ended August 29, and five were ahead of the S&P 500's 0.1% decline. That compares to nine S&P 500 sectors rising a week earlier, when the same nine were ahead of the S&P 500's 0.3% gain. The outperformers last week: Energy (2.5%), Financials (0.7), Communication Services (0.7), Materials (0.0), and Information Technology (-0.1). The underperformers last week: Utilities (-2.1), Consumer Staples (-1.7), Industrials (-0.8), Health Care (-0.6), Consumer Discretionary (-0.5), and Real Estate (-0.1). The S&P 500 is now up 9.8% ytd, with 10 of the 11 sectors positive ytd and six ahead of the index. During the June 20 week, Consumer Discretionary and Health Care were trailing so far behind ytd that they were the only sectors trailing the index. Communication Services still wears the crown as the best ytd performer with a gain of 17.2%, followed by Industrials (15.1), Information Technology (13.6), Financials (11.4), Utilities (10.7), and Materials (10.3). These five sectors are lagging the S&P 500 so far in 2025: Health Care (-0.4), Consumer Discretionary (1.6), Real Estate (3.6), Consumer Staples (3.9), and Energy (4.8).

US Economic Indicators

Personal Income & Consumption (*link*): Both *personal income* and *spending* in July were in line with expectations. Personal income climbed 0.4%, following a 0.3% gain in June and a 0.4% loss in May, with *disposable income* following a similar path, climbing 0.4% in July, following a 0.3% gain in June and a 0.5% drop in May. *Personal consumption expenditures* rose 0.5% last month, a four-month high, following a 0.4% gain in June and no change in May. *Goods consumption* rose a solid 0.8% in July, driven by a 1.9% jump in durable goods spending; nondurable goods consumption edged up 0.1%. *Services consumption* continued to climb, rising 0.4% in July and 2.4% year to date. *Adjusted for inflation*, consumer spending advanced 0.3%, following a 0.1% gain and a 0.2% loss the prior two months—the strongest since March's 0.7% increase. *Real goods consumption* rebounded 0.9%, erasing the prior three months' 0.9% decline. *Real durable goods* spending soared 2.0%, after falling 3.3% during the three months through June, while *real nondurable goods* spending climbed 0.9% during the two months through July. Real *services* consumption increased for the fourth time in five months, by 0.1% in July and 0.6% over the period. *Personal saving* fell $17 billion in July to $985.6 billion, with the *personal saving rate* holding at 4.4% in July, down from April's 5.0% rate. *Turning to prices*, both the headline and core PCEDs matched consensus expectations on both a monthly and yearly basis. The headline PCED climbed 0.2% during July, slowing from June's 0.3%, while the core rate rose 0.3%, matching June's pace. The *headline PCED* remained at 2.6% in July; it had eased from 2.7% in February to 2.2% in April, while the *core rate* climbed for the third month, from 2.6% in April to 2.9% in July—back up at February's recent high. The *headline and core rates* peaked at 7.2% and 5.6%, respectively, during June 2022 and September 2022.

Consumer Sentiment Index (*link*): Consumer sentiment fell in August on inflation concerns. *Consumer sentiment* fell to 58.2 during August, after climbing from 50.8 in April and May to 61.7 in July. The University of Michigan notes that sentiment now stands roughly 11% higher than readings during April and May but is at least 10% below readings six and 12 months ago. Both the *current conditions* (to 61.7 from 68.0) and expectations (55.9 from 57.7) components fell during the month. "Perceptions of many aspects of the economy slipped," according to Joanne Hsu, director of the consumer survey, with buying conditions for durable goods dropping to their lowest reading in a year, while perceptions of personal finances fell 7%, driven by concerns about higher prices. *Turning to inflation*, year-ahead inflation expectations climbed to 4.8% in August after dropping 6.6% in May to 4.5% in July.

Regional M-PMIs (*link*): Five regional Fed banks now have reported on manufacturing activity for August: *New York, Philadelphia, Dallas, Richmond,* and *Kansas City*. The New York and Dallas regions showed increases in activity, while the Philadelphia and Kansas City regions were at a standstill, and Richmond's continued to contract. *New York's headline general business activity index* rose from 5.5 in July to 11.9 in August—to its highest level since November 2024. *New orders* (to 15.4 from 2.0) accelerated this month, while *shipments* (12.2 from 11.5) continued to expand at a solid pace. Meanwhile, *delivery times* (17.4 from 8.3) lengthened significantly, and *supply availability* (-5.5 from -11.0) worsened a bit. *Employment* (4.4 from 9.2) climbed slightly higher, while the *average workweek* (0.2 from 4.2) held steady. As for pricing, the *prices-paid* (54.1 from 56.0) measure was little changed this month but remained elevated, while *prices-received* (22.9 from 25.7) showed moderate selling pressure. *Turning to the Dallas region*, its *production index*—a key measure of state manufacturing conditions—was 15.3 in August, down from July's 21.3 though still well above average. *New orders* (to 5.8 from -6.3) showed growth for the first time since January, while *shipments* (14.2 from 2.7) shot up to its highest reading in more than three years. *Capacity utilization* (13.7 from 17.3) eased a bit, though remained elevated. The *employment* (8.8 from 8.4) measure held fairly stable, while *hours worked* (15.0 from 7.7) climbed to its highest reading in more than three years. Turning to pricing, *prices paid for raw materials* (43.7 from 41.7) was well above its average reading of 27.4, while *prices received for finished goods* (15.1 from 11.1) was also elevated. The *Philadelphia survey's general business activity* (-0.3 from 15.9) measure was at a standstill in August. *New orders* (to -1.9 from 18.4) dipped into negative territory, while *shipments* (4.5 from 23.7) slowed considerably, though remained in positive territory. *Employment* (5.9 from 10.3) continued to register job gains, though at a slower pace, while the *average work week* (4.7 from 0.4) rose during the month. Turning to pricing, both measures remain elevated, though Philadelphia's *price-paid* (66.8 from 58.8) measure accelerated sharply—posting its highest reading since May 2022. *Prices-received* (36.1 from 34.8) accelerated, though was more subdued. *Turning to the Kansas City region*, its composite index was unchanged at 1.0 in August, though up slightly from June's -2.0. Both the shipments (6 from 3) and new orders (5 from 2) measures improved, while both the production (0 from -3) and employment (0 from -11) measures moved out of negative territory, to the breakeven point. Meanwhile, the average workweek (3 from -9) improved. Price increases for raw materials (43 from 47) eased modestly, while finished goods prices (21 from 18) edged up slightly. *Turning to the Richmond region*, its composite manufacturing (to -7 from -20) index continued to contract, though at a slower rate, with all three of its component indexes—employment (-11 from -16), new orders (-6 from -25), and shipments (-5 from -18)—continuing to contract, though at slower rates. Price indexes in the Richmond region are yearly percent changes. The prices-paid (to 7.24% from 5.65%) measure shows an acceleration in inflation this month, while prices-received (3.14 from 3.16) held steady.

Global Economic Indicators

Eurozone Economic Sentiment Indicators (*link*): Europe's economic sentiment fell in August, with ESIs in both the EU (-0.3 points to 94.9) and Eurozone (-0.5 points to 95.2) falling during the month and remaining below their long-term average of 100. *ESIs among the six largest EU economies* were a mixed bag, with three moving lower, two moving higher, and France's (+0.1 to 92.0) little changed. Moving higher were ESIs for the Netherlands (+3.5 points to 100.7) and Poland (+0.5 to 99.8), while Spain (-2.6 to 101.7) posted the largest decline, with Germany (-1.0 to 90.9) and Italy (-1.0 to 98.4) showing identical declines. *By sector*, ESIs were lower except for retail trade's (+0.2 to -5.3). ESIs fell for consumer (-0.3 to -14.8), construction (-0.3 to -5.7), services (-0.3 to 3.8), and industry (-0.2 to -10.6) confidence.

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