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What to watch: 2025 capital market themes, riding the China-Europe train and energy crisis in Europe, season 2?

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In summary

This week we look at three critical issues:

- **Capital markets themes 2025 – lessons from the first quarter of the century.** As we enter the second quarter of the century, markets grapple with critical questions shaped by recent economic and geopolitical shifts. Central bank rate cuts will continue on both sides of the Atlantic, aligning again with falling 10-year yields, though the pace will slow in the US due to renewed inflationary pressures. France's fiscal challenges will likely keep its bond yields above those of Greece, Portugal and Spain – a novum since last year. US equities will maintain their global leadership, supported by structural advantages (AI, reshoring, defense) and despite valuation concerns. Corporate spreads will stay near historic lows backed by strong fundamentals and a decent sectorial mix, which should offset risks from geopolitics. Last but not least, Chinese government bond yields are poised to dip below Japan's for the first time, driven by deflationary pressures and persistent economic headwinds.
- **Riding the China-Europe train: an increasingly credible route for trade.** As maritime shipping has become lengthier, more costly and riskier, rail transportation between Europe and China through Central Asia is becoming more and more competitive and attractive. Although capacity remains low, with transportation time more than 50% shorter and costs currently nearly 10% cheaper than maritime freight, rail is a credible and relevant transportation mode for time-sensitive industries such as electronics, auto, pharma and luxury/fashion. Europe needs to seize the opportunity, collaborate with China and Central Asian countries to develop these routes, avoid the pitfalls of the Belt and Road Initiative and increase its supply-chain resilience.
- **Energy crisis in Europe, season 2?** Gas prices in Europe are surging again to levels unseen since fall 2023. This surge is not only due to the halt of Russian gas flows to the EU since the new year but mostly because of high gas consumption as the continent is facing a "normal" winter after two consecutive mild ones. On top of higher gas consumption, the weather is also leading to lower renewable electricity production, compounding issues for the bloc. Should consumption and drawdowns on storage continue at the current pace, the EU could end the winter season with low inventories (30-40% vs 56% in late March 2024). This could make gas prices 30% higher in spring 2025 compared to a year ago, which would pose inflationary risks for 2026 as regulated retail prices for electricity are scheduled to decrease in 2025 in many countries. The recent developments are a reminder that energy prices will remain higher for longer in the EU, at least 50% above pre-war in Ukraine levels. Policies should address this matter if Europe means to revive its industry.

Capital markets themes 2025 – lessons from the first quarter of the century

As we enter the second quarter of the century, markets grapple with critical questions shaped by recent economic and geopolitical shifts. We highlight five topical questions for 2025 for markets and provide answers reflecting on what has happened in the first quarter of this century. Long-held assumptions have been pushed upside down lately, making these unusual times both exciting and challenging for market analysis.

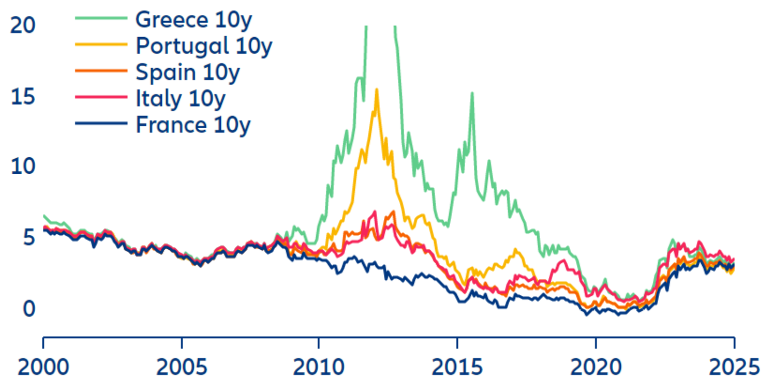
Will 10y yields and central bank policy rates diverge again in 2025? No. Last year, most major central banks initiated their long-awaited policy pivot. The Fed and the ECB each delivered 100bps of cuts while the BoE delivered 50bps. Nevertheless, 10y government bond yields increased by more than 30bps in Germany in 2024 and 70bps in the US. This diverging pattern is not unusual though (Figure 1). Long-term bond yields largely comove with the expected future policy rate – not the current one. Unless there is a significant economic shock, such as in 2008 or 2022, where central banks abruptly adjust their monetary policy stance and government bond markets follow suit, a divergence or even opposite movement between short-term and long-term rates is common. Just like in 2024, when bond traders had priced in much stronger cuts by central banks, expecting a hard landing. As this scenario did not materialize, government bond yields rose amidst cautious monetary easing. For 2025, we expect a positive correlation again, with 10y yields falling both in Europe and the US, while the ECB is expected to deliver another 100bps of cuts and the Fed another 25bps. For the Fed, the expected amount of rate cuts was scaled back over the past months as renewed inflationary pressures from tariffs and fiscal expansion announced by the new US administration prompt a cautious approach.

Figure 1: Annual policy rate and 10y government bond yield deltas since 2000, bps

Sources: LSEG Datastream, Allianz Research

Will France government bond yields remain above those of Greece in 2025? Yes. Last year's French election resulted in a political deadlock, with no parliamentary faction securing a majority. Consequently, the minority government has struggled to address France's persistently high fiscal deficit. Markets have reacted by demanding higher yields on French government bonds than on those of Spain, Portugal and even Greece – a situation unimaginable just a few years ago (Figure 2). During the Eurozone debt crisis, southern European countries saw their yields surge due to high-risk premia. However, many of these nations have since made significant fiscal improvements, with lower primary deficits and declining debt-to-GDP ratios and support from international institutions such as the ECB and the IMF. In contrast, France's debt stock has risen sharply, and its deficit is now the largest among Europe's major economies. With no resolution to France's fiscal challenges in sight, we expect its bond yields to remain above those of Spain, Portugal and Greece in 2025, although they should remain below those of Italy.

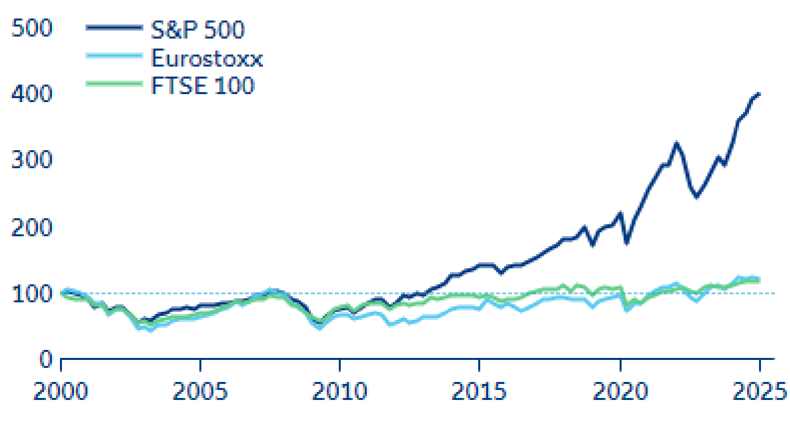
Figure 2: Selected 10y government bond yields in the Eurozone, %

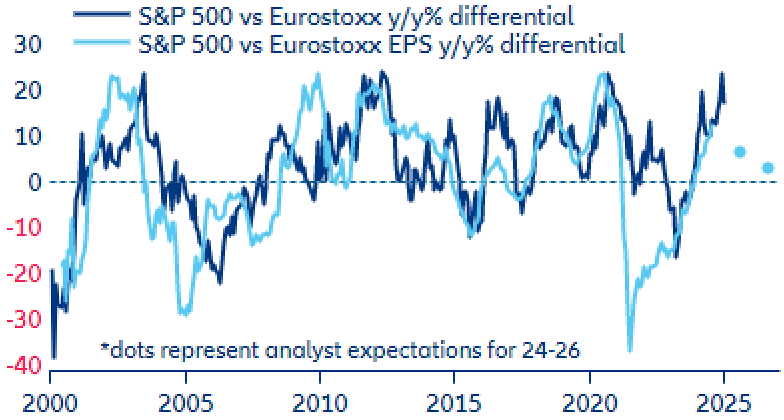


Sources: LSEG Datastream, Allianz Research. Note: Scale is cut off at 20% for better visibility as Greece's bond yields went up to 39% in 2012.

Will US equities keep outperforming in 2025? Yes. Following a +23% gain in 2024, marking the second consecutive year of +20% returns, US equities continue to exhibit strong momentum. This resilience is underpinned by the country's leadership in transformative global trends, including artificial intelligence, reshoring, geopolitics and defense investments. However, this outperformance is not just a recent phenomenon; the US equity market has maintained its dominance for over a quarter of a century (Figure 3), consistently delivering superior returns compared to global peers. That said, the valuation premium of US stocks relative to the rest of the world raises concerns about future performance. With higher price-to-earnings ratios, US equities appear expensive, potentially signaling lower forward-looking returns. Traditionally, such valuation gaps might suggest a rotation toward more attractively priced international markets. However, structural factors suggest that this premium is justified and sustainable in the short run. The "America First" economic transition, technological leadership, strong capital markets and the resilience of the American consumer provide solid foundations for continued outperformance.

Figure 3: Stock market performance since 2000 (rebased to 100) and Price-vs-EPS growth differential (%)

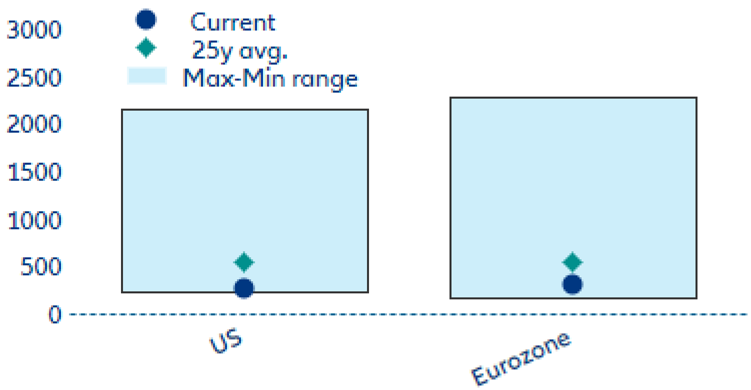




Sources: LSEG Datastream, Allianz Research

Will corporate spreads continue to widen significantly from historic lows? No. In 2024, corporate credit markets demonstrated remarkable resilience, maintaining historically low spreads in both investment-grade (IG) and high-yield (HY) segments. This stability reflects strong fundamentals and robust investor demand, even amid stretched valuations. That said, tight spreads raise concerns about future performance, especially as global growth faces headwinds from geopolitical risks, potential tariff escalations, and a structurally more restrictive monetary environment over the long run. However, credit markets – particularly IG credit – are expected to remain resilient, supported by the sector's high concentration in financials and defensive industries, which provide a natural buffer against macroeconomic uncertainty (Figure 4). Moreover, corporate credit continues to offer attractive risk-adjusted returns. Even in the event of an unexpected deflationary shock, any widening of credit spreads could be offset by a decline in mid- to long-term bond yields, preserving positive total returns for the asset class despite a potential drag on excess returns.

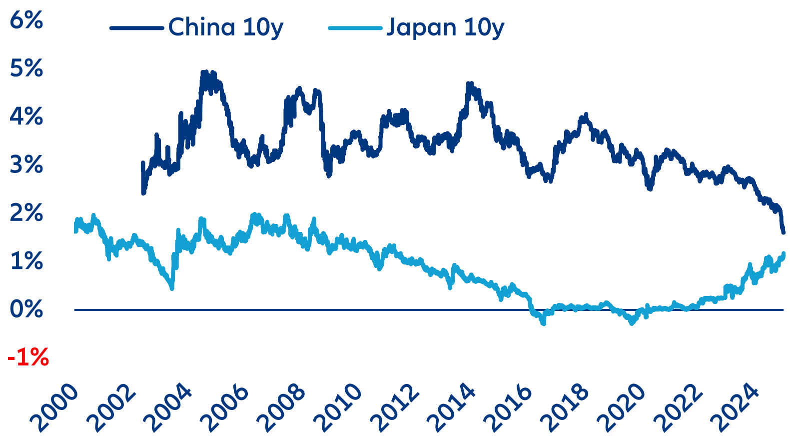
Figure 4: Corporate spreads history in bps



Sources: LSEG Datastream, Allianz Research

Will Chinese government bonds yields dip below those of Japan? Yes. 2024 marked the historic moment of China's 10y government bond yield falling below 2% for the first time. Despite the government's efforts to lift market confidence and steer fund flows towards the equity market, the yield continues to hit record lows owning to expectations of prolonged weak economic fundamentals, persistent deflationary pressure and an increasingly accommodative liquidity environment amid further monetary easing – reminiscent of the dynamics seen in Japan's economy during its "lost decades". Meanwhile, Japan's 10y government bond yield is on an opposite trajectory as the economy is on track to further recover from its recessionary periods, resulting in the narrowest gap with China ever – an unprecedented development (Figure 5). We expect deflationary pressure in China to continue this year as overcapacity issues are likely to worsen under Trump's new tariffs and elevated geopolitical tensions, while domestic demand is expected to remain weak, given that the property crisis shows no clear signs of ending anytime soon. Although the government has pledged greater efforts on the demand side, the measures have had limited effect so far. Investment in manufacturing remains the centerpiece of the government's strategy, which only exacerbates the overcapacity issue and exerts further deflationary pressure. After 30y Chinese government bond yields already undershot Japanese ones in 2024 for the first time, we expect 10y government bond yields to follow suit in 2025.

Figure 5: China and Japan 10y government bond yields



Sources: LSEG Datastream, Allianz Research. Note: Data as of 8 January 2025.

Riding the China-Europe train: an increasingly credible route for trade

As the initial logistical impacts of the war in Ukraine are fading and maritime shipping remains vulnerable to the geopolitics in the Middle East, China-Europe rail is gaining traction. The recent signing of the China-Kyrgyzstan-Uzbekistan railway agreement emphasizes the ongoing interest and the rapid development of rail freight between mainland China and Europe. This project, which spans 523 kilometers through Central Asia's Fergana Valley, aims at enhancing connectivity in the middle corridor and complements the well-established northern corridor that passes through Kazakhstan, Russia and Belarus (Figure 6). Overland rail freight on the Eurasian continent has expanded significantly over the past decade, both in terms of infrastructure and traffic volumes: according to China Railway Container Transport, the total volume of goods transported by train from and to China reached 2.7mn twenty-foot equivalent units (TEUs) between January and November 2024 (up from 1.9mn TEUs in 2023). Data from the Eurasian Rail Alliance Index provide more details on the volume of goods transported by rail between China and the EU, through the Northern corridor that goes through Kazakhstan, Russia and Belarus: from 273,000 TEUs in 2018, a peak of 628,000 TEUs was reached in 2021. Disruptions related to the war in Ukraine led the volume to decline to 211,000 TEUs in 2023, but the first six months of 2024 already reached 189,000 TEUs (+66% y/y). While rail accounted for just 3-4% of total trade in volume between China and Europe in 2023, its share is steadily climbing as volumes growth saw a compound annual growth rate of over +25% between 2016 and 2023. Countries such as Poland, Germany and Kazakhstan have invested heavily in transshipment hubs and rail infrastructure to sustain this growth. For example, improvements at the Khorgos Gateway and Poland's Malaszewicze hub have reduced transit times and increased handling capacities. Such projects are signaling increased commitment to developing seamless logistics for the growing demand on these corridors.

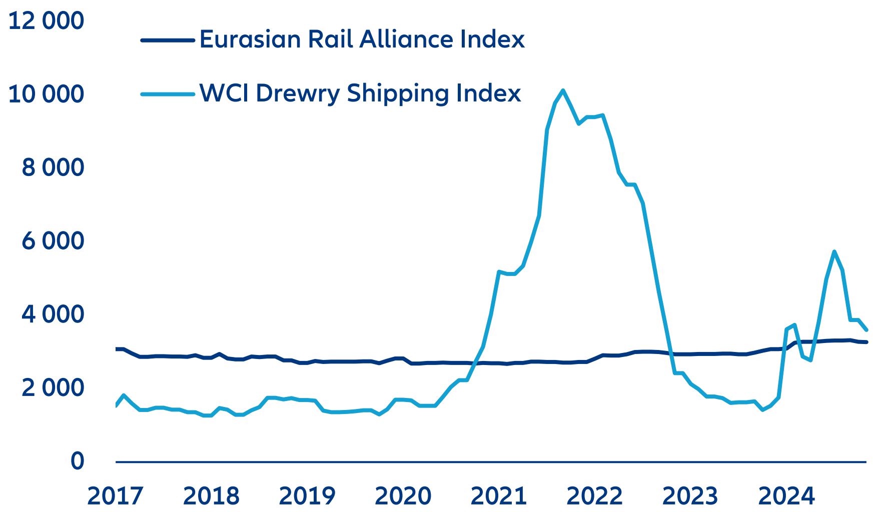
Figure 6: China Railway Express routes

Sources: SCMP, China Railway Express Construction and Development Plan (2016-20), Trans-Caspian International Transport Route

Rail freight is becoming competitive in terms of delivery time and price, thereby offering an interesting alternative for time-sensitive manufacturing sectors. As maritime shipping rates have seen bouts of sharp increases over the past years and remain prone to volatility amid heightened geopolitical risks, rail freight has positioned itself as a competitive alternative. Shipping goods via rail from China to Germany typically takes 10-20 days, significantly faster than the 30-40 days required for maritime transport, providing a time-sensitive solution for high-value cargo. Only air freight is faster, but rail costs are generally 30-50% lower than air freight. Rail freight rates are historically relatively stable and are currently around USD0.15-0.25 per ton-kilometer or less than USD3300 per forty-foot equivalent unit (FEU)[1], compared with USD3600/FEU for maritime freight rates (Figure 7). Rail is thus an increasingly attractive and cost-effective option for high-value, time-sensitive products and businesses needing to balance cost and speed. Consequently, it is best suited for industries such as electronics, automotive, pharmaceuticals and luxury/fashion, where faster transit times translate into strategic advantages. These sectors are already among the top 10 present on rail lines between China-Germany and China-Poland (see Figure 8). That said, the limited capacity of rail networks means they cannot fully replace maritime shipping. Maritime shipping remains a more realistic option and cheaper per unit for bulk goods as a containership can carry 10,000 FEUs while a typical train can only carry the equivalent of about 55 FEUs (and a plane about 7 FEUs). Rail is carving out a niche that could become the preferred mode for industries that value faster lead times and lower inventory costs, especially amid ongoing supply-chain disruptions.

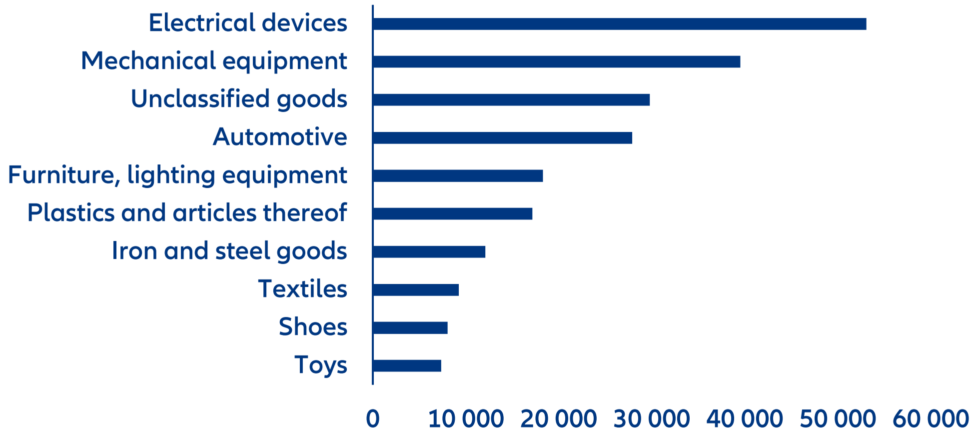
[1] *For the Northern corridor going through Kazakhstan, Russia and Belarus, according to the Eurasian Rail Alliance Index.*

Figure 7: Rail vs. maritime shipping price indices (USD/FEU)



Sources: Eurasian Rail Alliance Index, Allianz Research

Figure 8: Top 10 sectors transported by rail between China-Germany and China-Poland (through the Northern corridor through Kazakhstan, Russia and Belarus), January to November 2024 (volume in TEU)



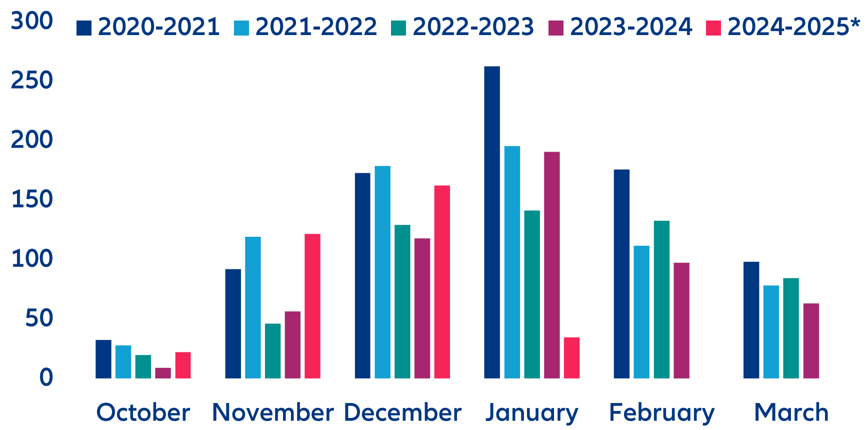
Sources: Eurasian Rail Alliance Index, Allianz Research

Europe must seize this opportunity and avoid the pitfalls of the Belt and Road Initiative to increase supply-chain security. Amid rising geopolitical tensions and vulnerabilities in maritime shipping lanes, rail freight offers a critical opportunity for supply-chain diversification. The conflict in Ukraine has disrupted the northern rail corridor, and the middle corridor, which bypasses Russia through Central Asia and Turkey, will grow. These developments underscore the need for redundancy and alternative routes in global trade networks. Companies increasingly see rail as a hedge against reliance on any single mode or route, particularly as geopolitical risks intensify. The diversification provided by rail also aligns with European priorities to bolster trade resilience. However, Europe's involvement in financing rail infrastructure projects will be essential to avoid the pitfalls of China's Belt and Road Initiative. Heavy reliance on Chinese financing in past projects has raised concerns about debt traps and imbalances in governance. Collaborative models, emphasizing transparency, shared ownership and sustainable financing, can ensure that rail freight development between China and Europe supports balanced economic growth rather than further geopolitical dependence and risks.

Energy crisis in Europe, season 2?

The end of gas flows through Ukraine is the tip of the iceberg. Natural gas prices have been increasing steadily since the beginning of the winter season in Europe. They reached the threshold of 50 EUR/MWh during the new year, a level unsee since October 2023. A significant and much commented-on catalyst for the price surge has been the end of Russian gas flows through Ukraine and the Brotherhood pipeline. Halting this corridor has particularly impacted countries like Hungary and Slovakia which were heavily reliant on this route for their gas supplies as they benefited from an exemption from EU sanctions and were continuing to import Russian gas. However, we must underline that Russian gas flows through Brotherhood were marginal in terms of volume; the main driver behind the price surge is the cold weather that Europe has been experiencing over the last few months. Gas consumption in Europe has been high since November and withdrawals from storage have been much higher than over the last couple of years (Figure 9), more in line with withdrawals seen before the war in Ukraine. In other words, after two mild winters, Europe is now going through a "normal" winter, burning gas as if it did not have any supply or price issues, and this has made traders nervous. Indeed, until this winter, the continent managed to close the supply gap by reducing consumption and sourcing liquified natural gas (LNG) from other suppliers (i.e. the US, Qatar, Algeria etc.), but the recent consumption pattern has been deviating from the last couple of years. As a result, as of 6 January 2025, storage levels stood at 69% at the EU level; a year ago, storage was full at 84% and it was at 83% two years ago.

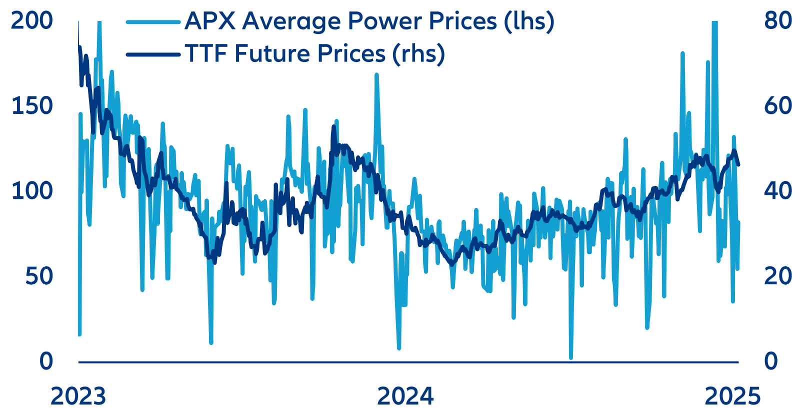
Figure 9: Monthly withdrawals in EU gas storage (TWh)



** As of 6 January 2025*
Sources: LSEG Datastream, Allianz Research

Upward risk for natural gas and power prices going forward. In 2023 and 2024, the bloc's storage level stood at 56% and 58%, respectively, at the end of March. Should Europe continue to go through a cold winter and consume gas at the current pace, the continent could end the season with levels of storage much lower, likely between 30% and 40%. This would mean that Europe would need to buy massive volumes of gas and especially LNG to restore storage levels before winter 2025-2056. With a higher level of uncertainty regarding the Trump administration's stance on LNG exports and competition from Asian buyers, Europe could have to pay a higher price for gas than it did in 2023 and 2024. Prices are unlikely to increase to the above 100 EUR/MWh levels seen in 2022 but an increase to prices close to EUR40/MWh would imply a +30% year-on-year surge as prices were hovering around EUR30/MWh in spring and summer 2024. This compares to our forecast of EUR30/MWh and EUR32/MWh on average for Q2 Q2025 and Q3 2025, respectively. Furthermore, the past couple of winters were mild and windy, allowing renewable production to deliver cheap electricity while currently generation through wind and solar have been volatile and delivering little, increasing overall pressure on electricity prices (Figure 10).

Figure 10: Power and gas prices in Europe (EUR/MWh)



Sources: LSEG Datastream, Allianz Research

Energy prices: higher (and more volatile) for longer. The ongoing developments are a vivid reminder that Europe is not done with its energy crisis. The achievements from the bloc over the last couple of years in terms of consumption and supply diversification are fragile and market participants remain on the edge and any small event from a cold snap to a strike in an LNG facility anywhere in the world can knock prices up. As many hoped for power and natural gas prices to normalize in Europe in the coming months and years, Europe will have to deal with higher prices for longer and with increased volatility. This also mean increased volatility on the inflation front: As retail prices for electricity – regulated in most countries – are set to decrease in 2025, the recent developments on wholesale markets might lead to prices increasing again in late 2025 or in 2026 for consumers. Likewise, firms remain vulnerable to ups and downs. Most of all, in level terms, prices are likely to remain higher in Europe than in other parts of the world in the next couple of years and policymakers need to find a solution if they mean to boost the industrial competitiveness of European firms. This is an even more pressing matter as it is also leading to tensions and divergences inside the EU as illustrated by the recent threat by Slovakia to stop providing electricity to Ukraine if it does not resume gas transit.

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