India

Money, Military and Markets-IX

Is Europe on its own? It appears so

- The US foreign policy is signalling that Europe must take more responsibility for its security & defence spending. +ve USD, -ve gold, & +ve US bonds.
- The US is focusing on building a supply chain for semiconductors. China will wait for Taiwan to become irrelevant for US chip security and then attack it.
- NATO will have to spend more on defence. Ex-UK and France, NATO needs to invest US$170bn immediately, stretching its already bad balance sheet.

Trump-Zelensky open spat clarifies that Europe is on its own

The public confrontation between the duo in the Oval Office signals a major shift in US foreign policy. The US is prioritizing its own interests over traditional alliances, compelling European nations to take greater responsibility for their own security and economic stability. This shift could weaken NATO's cohesion, force European countries to increase defence spending and explore independent geopolitical strategies. Assuming NATO's defence expenditure guidelines are based on sound principles and will adequately support the alliance, any long-lasting peace in Europe would require sufficient investment in defence equipment. Based on NATO guidelines, we estimate that the military alliance's members (excluding the US, UK, & France) need to invest US$170bn within a very short span.

US wants to build an alternate supply chain for semiconductors

The recent advancements in computing and artificial intelligence, along with the ~US$100 bn investment committed by private companies to capitalize on the Chips Act of 2022, mean that the US needs a robust supply chain for rare earth metals. However, the US lacks sufficient rare earth metal reserves, which are critical for semiconductors. Currently, 49% of known reserves are in China, 23% in Brazil, 8% in India, 4% in Russia and 2% in Greenland. The US holds only 2% of the global reserves. Ukraine appears to have significant undeclared reserves, which explains why the US was pursuing a rare earth deal with Zelensky, although he denied it. Now, the US is turning its attention to Russia, with plans to invest there. This move could have multi-pronged effects: 1) Turning a so-called enemy nation into a partner. 2) De-risking its supply chain from Taiwan and China.

Gold may retreat & US bond yields may soften - good for equities

The new American stance of not fighting others' wars means the US may not poke its military nose everywhere in world. If US President Donald Trump does what he says about Ukraine (and after the arguments made in a full public spat with Zelensky), market will assume so, which will mean that intensity of gold buying by global central banks may reduce. Also, expenditure like funding the Russia-Ukraine war by donating US$350bn when Europe was granting loans to Ukraine is taken out of the window, then deficit concerns may reduce, which will be positive for US bonds as yields will fall. This may take out the biggest headwind for Indian equities.

Europe must invest heavily in defence equipment (-ve for Euro)

While it's not possible to estimate the exact increase in European defence expenditure, it must rise significantly. The low expenditure on defence equipment for decades must be reversed within the next four-to-five years. Assuming NATO guidelines are the right benchmark, the EU needs to spend US$70bn on equipment to address historical shortfalls relative to NATO standards. Until now, the US, UK, & France have borne the major costs of keeping NATO equipment. However, other countries must increase their defence spending by US$170bn over the next few years, just to correct their historical neglect.

China may delay Taiwan invasion by a decade or so

It appears inevitable that China will invade Taiwan. However, the correct strategy is to wait and let the US build its supply chain for chips, so that the strategic importance of TSMC goes down significantly. Please note that no major country in the world renounces One China policy and peace is agreed to by Ukraine (which will eventually, as the US won't back Ukraine anymore) and Russian President Vladimir Putin achieves, even if only a few per cent in Ukraine of what he had promised, then it will set a precedent as well. So, the best policy for China is to wait, and the Chinese are known for their patience.

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Is Europe on its own? It appears so

The drama in the Oval Office and the resulting cancellation of the press conference with the Ukraine president present an interesting case in global politics. Never before have we seen a US president being shown fingers and spoken to in such a harsh tone in front of the media. At the same time, Trump appears to be making progress with Putin. The idea of the US strengthening its ties with Russia while Europe is being sidelined was unimaginable long ago, but it now seems to be unfolding. This development forces us to question many long-held beliefs about the world order. New questions will arise now – Does North Atlantic Treaty Organization (NATO) even exist? NATO has relied heavily on the US, but with this shift, its role is uncertain. What happens to Taiwan? In this evolving world order, will the trade war even last for a month? As Putin claims the US will invest in Russia, what happens to China-Russia ties? If the US aligns more with Russia, who becomes the new enemy where dollars will be pumped in?

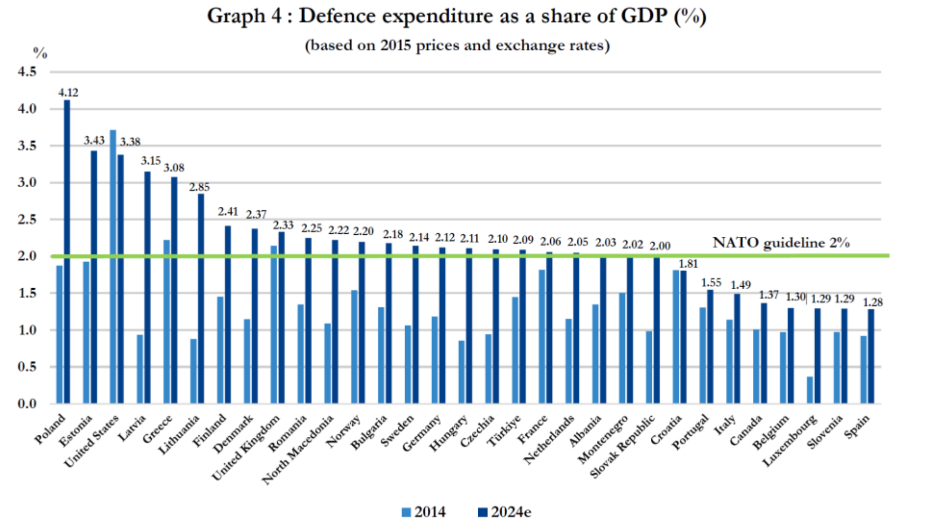
NATO is too dependent on the US, and the shifting stance of the US poses major problems for European members

NATO has always been heavily dependent on the US for both funding and military capability. The alliance was originally designed during the Cold War to counter the Soviet Union. However, since then, most European members have relied on the US security umbrella without significantly increasing their own defence spending. The European model of a leisurely 38-hour work week, excessive social welfare spending, and defence budget cuts has come at the expense of US taxpayers. Trump's focus on economic cooperation with Russia could shake the foundations of European security, destabilizing NATO and leading to strategic realignments across the continent. It could also cause volatility in energy markets, trade relationships, and global defence sectors. In the long run, this shift could fundamentally alter how Europe engages with both the US and Russia, driving market fragmentation and increasing geopolitical risk.

Most NATO countries don't spend 2% of their GDP on defence

The US consistently spent more on defence than all other NATO members combined. Many European nations failed to meet the 2% of GDP defence spending target until recent pressure from the US (especially under Trump).

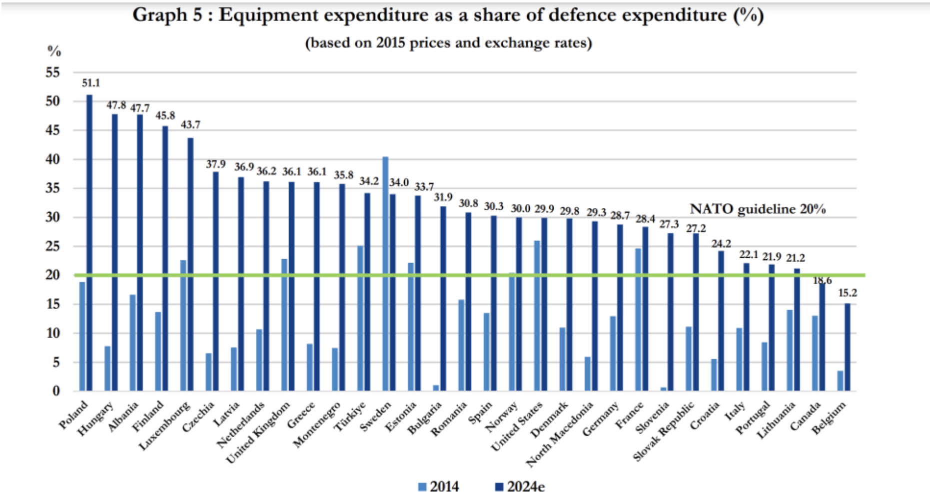
Figure 1: While it may appear that many countries spent more than 2% of their GDP in 2024E, this increase only started in the last two-to-three years



SOURCE: INCRED RESEARCH, HTTPS://WWW.NATO.INT/NATO_STATIC_FL2014/ASSETS/PDF/2024/6/PDF/240617-DEF-EXP-2024-EN.PDF

Equipment spending is much lower for all countries compared to NATO guidelines ➤

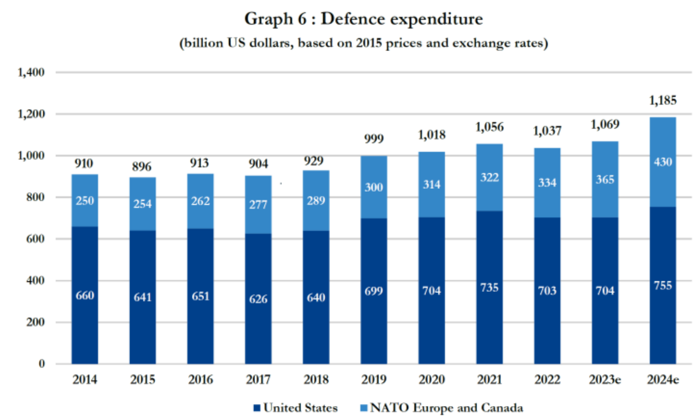
Figure 2: Most of the spending goes towards salaries, pensions, etc; equipment spending is much less than NATO's guideline of 20% of defence expenditure



SOURCE: INCRED RESEARCH, COMPANY REPORTS

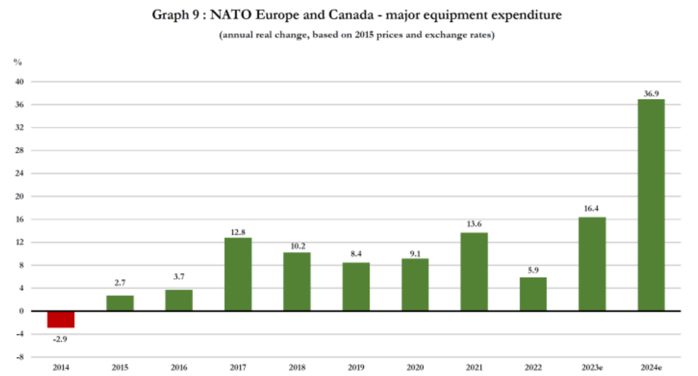
As a result, excluding the US, NATO lags far behind in defence expenditure ➤

Figure 3: The US has been the major contributor to NATO's defense expenditure



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 4: Excluding the US, NATO equipment spending has always fallen well short of target; other countries started increasing their spending only in 2024



SOURCE: INCRED RESEARCH, COMPANY REPORTS

That's why Europe cannot even sustain a proxy battle with Russia through Ukraine ➤

The lower defence expenditure by Europe, coupled with an even lower percentage allocated to equipment, means that Europe cannot sustain the fight against Russia through Ukraine. Without active US support in providing equipment—amounting to US$350bn over the last three years, according to the US president—Ukraine would not have been able to sustain the war.

It now appears that the US will pull back its equipment support to Ukraine, which would mean game over (certainly not overnight) for Ukraine ➤

If the US pulls back its military equipment support to Ukraine, it would be a massive blow to Kyiv, but it might not mean an immediate end to the war. Several key factors come into play:

1. **European support** – Europe is trying to ramp up its defence production and financial aid, but its capacity to replace US weapon supplies is questionable. The EU recently approved a €50bn aid package for Ukraine, but that's more financial than military aid.
2. **Ukraine's own capabilities** – Ukraine has improved its domestic drone and missile production, but it still relies heavily on Western air defence systems, artillery, and ammunition. A US pullback would severely impact its ability to hold the front lines.
3. **Russia's momentum** – With increased military spending and production, Russia has been gaining ground. Without continued US support, Ukraine would likely struggle to maintain its defences, let alone go on the offensive.
4. **A gradual decline but not instant collapse** – Ukraine won't immediately surrender, but it may have to shift strategies—defensive entrenchment, more asymmetric warfare, or reliance on European military supplies.

So while it's not "game over" overnight, a US pullback could lead to Ukraine's slow but steady weakening, making a negotiated settlement more likely on less favourable terms.

Trump appears to be headed in that direction ➤

It looks like Trump is heading in that direction. He's already voiced scepticism about the amount of US aid to Ukraine, preferring to focus on domestic issues and a more isolationist foreign policy.

The final nail in the coffin is the Zelensky show in full media glare. Pointing fingers at POTUS is a laughable act, especially after his public spat with Vice President JD Vance in front of the media.

Figure 5: The ugly spat before the media between Zelensky and POTUS has left little room for negotiations between the US and Ukraine

SOURCES: INCRED RESEARCH, HTTPS://WWW.YOUTUBE.COM/WATCH?V=S_YTXWVFKJE

At the same time, in a major blow to European members of NATO, Trump seems to focusing on economic coorperation with Russia ➤

Trump's focus on economic cooperation with Russia could shake the foundations of European security, destabilizing NATO and leading to strategic realignments across the continent. It could also cause volatility in energy markets, trade relationships, and global defence sectors. In the long run, this shift could fundamentally alter how Europe engages with both the US and Russia, driving market fragmentation and increasing geopolitical risk.

This will mean that Europe will be standing alone in the fight against Russia, creating major problems for Europe ➤

We have the following major concerns regarding European countries in the near- to medium-term:

NATO's unity and European security

1. Weakening of NATO solidarity: Trump's prioritization of economic cooperation with Russia could undermine the cohesion of NATO. European members, especially those in Eastern Europe, are already wary of Russia's expansionist policies, and a closer relationship between the US and Russia might erode the sense of security they derive from NATO's collective defence clause.
2. Security concerns: Countries like Poland, the Baltic states (Estonia, Latvia, and Lithuania), and others along Russia's border may feel increasingly vulnerable without the US fully backing NATO's deterrence posture. European NATO members could feel the need to strengthen their own defence capabilities, possibly leading to higher defence spending across the continent. This, in turn, could impact European fiscal policy and defence industries.
3. Diplomatic tensions: A US-Russia rapprochement could lead to strained relations between the US and some European powers, particularly the UK, Germany, and France, which have had a more adversarial stance towards Russia due to its actions in Ukraine and its broader geopolitical manoeuvres.

Impact on global energy markets

1. Energy leverage: Russia is a major energy supplier to Europe, particularly natural gas and oil. If the US and Russia form a closer economic partnership, it could create a shift in Europe's energy security. For example, Russia might leverage its energy resources to extract concessions from Europe, such as limiting supplies or changing pricing terms. This could drive up energy prices, especially in Europe.
2. European energy diversification: European countries, particularly those dependent on Russian gas, might accelerate their efforts to diversify their energy sources, such as by investing more heavily in renewable energy or alternative suppliers. However, this transition would take time and might lead to economic instability in the short term.

European geopolitical alignment

1. Shift in alliances: Trump's shift towards Russia could drive some European countries, especially those with more nationalist or Eurosceptic governments (e.g., Hungary, Italy), closer to Russia economically and diplomatically. This would further divide Europe's stance on key issues related to Russia, Ukraine, and NATO, leading to a more fragmented European Union or EU.
2. Strained EU-US relations: Economic cooperation with Russia could strain the broader transatlantic relationship between the US and the European Union. EU members might be wary of US actions that seem to diminish NATO's role or undermine sanctions on Russia. This could lead to tensions over trade policies, economic sanctions, and diplomatic initiatives.

Economic implications

1. Trade and investment opportunities: Closer US-Russia economic ties might open up new opportunities for US businesses in Russia, particularly in energy, infrastructure, and technology sectors. However, this could also provoke resistance from European companies, which may fear being caught in the middle of competing US and EU economic interests.
2. Sanctions and counter-sanctions: If the US engages more economically with Russia, it could potentially reduce or lift some of the sanctions currently imposed on Russia, which could have significant consequences for industries like defence, banking, and energy. However, if Europe maintains its sanctions, this could create a situation where different parts of the world follow different

economic policies towards Russia, leading to trade fragmentation and uncertainty in global markets.

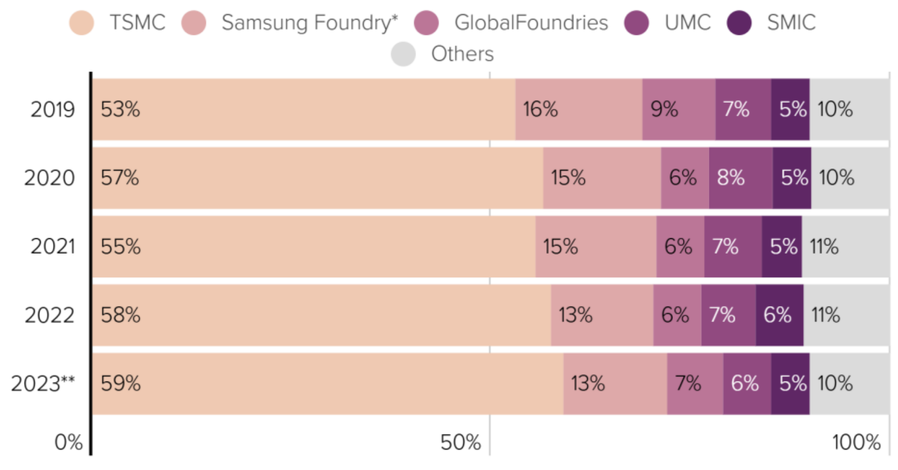
3. Volatility in Eastern Europe: Investors in East European markets could see increased volatility if a US-Russia rapprochement leads to economic realignment in the region. Countries that rely on US support might face heightened risks, leading to a potential sell-off in equities, currency devaluation, and higher capital flight from these regions.

What happens to Taiwan and Ukraine now? Zelensky will be out soon and Xi will see a window, alternate supply chain for chips may develop

The way geopolitics is playing out, it now appears that the US will want someone more amenable to head Ukraine, so a much-vaunted peace deal with Russia can happen. While it may not happen exactly on Putin's terms, we will likely see an end to the war. Putin is offering US companies the opportunity to mine Russian rare earth minerals, which are key to America's tech ambitions and its rapidly declining stature in emerging technologies. If Russia is able to retain some of the acquired land in Ukraine, it will set a precedent for Chinese President Xi Jinping to follow in Taiwan. In fact, a Russia-US peace deal, along with an alternative US supply chain for chips, could give China an opportunity to replicate a "Hong Kong scenario" in Taiwan as well.

Taiwanese chipmaker TSMC dominates the global semiconductor market ➤

Figure 6: Taiwanese chipmaker TSMC dominates the global semiconductor market, accounting for over half of the total semiconductor foundry market share



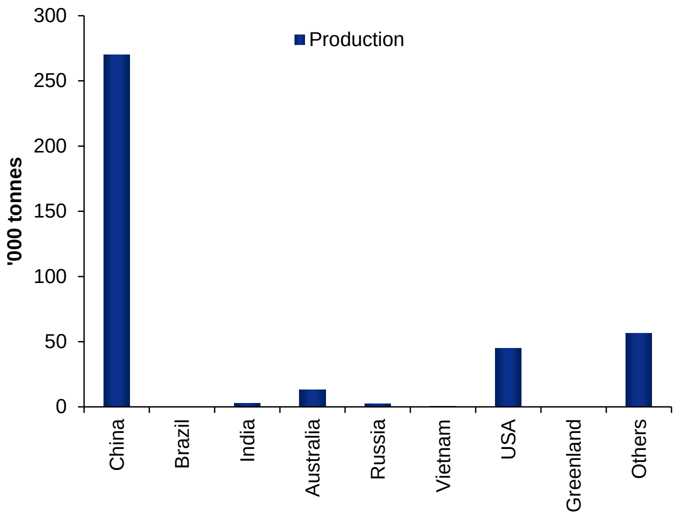
SOURCE: INCRED RESEARCH, HTTPS://WWW.POLITICO.EU/ARTICLE/TAIWAN-ELECTION-CHINA-INDEPENDENCE-MICROCHIPS-INDUSTRY-GEOPOLITICS/#:~:TEXT=OVER%20THE%20PAST%20DECADE%2C%20TAIWAN,OF%20THE%20GLOBAL%20PRODUCTION%20CAPACITY.

However, Taiwan's ability to make semiconductors depends on rare earth minerals from mainland China ➤

Taiwan imports nearly all its rare earth minerals from China. While other sources of rare earth minerals do exist globally, mining operations in these regions are not yet fully developed or scaled to meet the demand. China has a significant monopoly over the global rare earth supply chain, both in terms of extraction and processing capabilities.

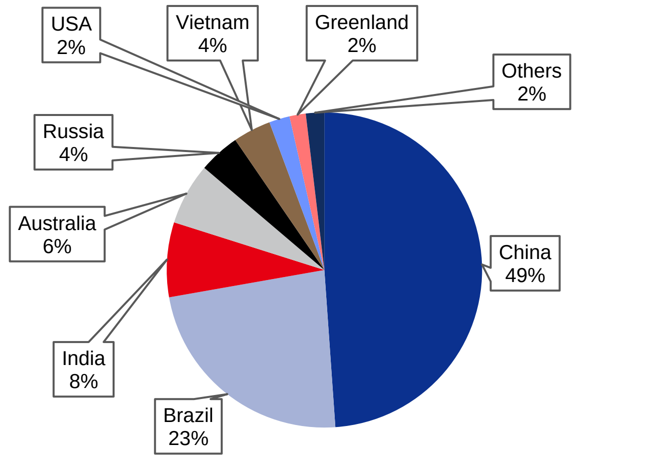
Countries like the US, Australia, and some African nations have rare earth deposits, but the mining and refining infrastructure in these regions is either underdeveloped or less competitive compared to China's well-established operations. As a result, Taiwan remains vulnerable to any disruption in the supply of these critical materials from China, which could affect its semiconductor production capabilities.

Figure 7: China is the biggest producer of rare earth metals



SOURCE: INCRED RESEARCH, USGS

Figure 8: China has the largest global reserves (total reserves – 90mt)



SOURCE: INCRED RESEARCH, USGS

The US is investing in chip manufacturing capacity; however, rare earth minerals remain a problem for them

While the US is making significant investments in chip manufacturing capacity, particularly through initiatives like the **CHIPS Act**, the problem of securing a stable supply of rare earth minerals remains a major challenge. The US has limited domestic production of these critical materials, and it still depends heavily on imports, particularly from China, for rare earths essential for semiconductor production.

Although there are efforts to diversify sources, such as mining projects in countries like **Australia** and **Canada**, and even the development of recycling methods, it will take time to build the necessary infrastructure and supply chains to reduce reliance on China. In the meantime, the US will continue to face supply chain vulnerabilities, especially as global demand for semiconductors grows.

After CHIPS Act, the US has seen multiple investments in fabrication capacity

The **CHIPS Act** (Creating Helpful Incentives to Produce Semiconductors for America Act) is a US federal law passed in **2022** aimed at boosting domestic semiconductor manufacturing and reducing reliance on foreign sources, particularly China. The act provides significant incentives and funding for US semiconductor companies to build new manufacturing plants, research and development facilities, and expand existing operations.

Key components of the CHIPS Act include:

1. **$52bn in subsidies** for semiconductor research, development, and manufacturing in the US.
2. Tax credits for companies that build semiconductor manufacturing facilities.
3. Investment in workforce development to address the skills gap in the semiconductor industry.
4. Support for advanced semiconductor research and innovation to keep the US competitive in global markets.

Since the passage of the **CHIPS Act** in 2022, several major semiconductor companies have announced plans to build new manufacturing facilities in the US. The Act has spurred significant investments, although many of these projects are still in the planning or early construction stages. Some of the most notable developments include:

1. **Intel**:
   - Intel announced a US$20bn investment to build two new semiconductor manufacturing plants in Ohio. These plants, part of the 'Chipzilla' expansion, are expected to create thousands of jobs and bolster domestic chip production.
   - Intel has also committed to expanding its semiconductor manufacturing operations in Arizona and New Mexico.
2. **TSMC (Taiwan Semiconductor Manufacturing Company)**:
   - TSMC is constructing a US$12bn semiconductor manufacturing plant in Phoenix, Arizona. This facility will focus on producing advanced 5m chips and is expected to be operational by 2024-25F.
3. **Samsung**:
   - Samsung announced a US$17bn investment to build a new semiconductor plant in Taylor, Texas, which was expected to start production by 2024. The plant will focus on producing advanced logic chips.
4. **Micron Technology**:
   - Micron Technology announced its plan to invest up to US$40bn by 2030F to build semiconductor manufacturing facilities in the US. The company is expected to break ground on a US$15bn DRAM manufacturing facility in New York soon.
5. **GlobalFoundries**:
   - GlobalFoundries has committed to expanding its production capacity in the US with a US$1.4bn investment in its existing facilities in Upstate New York.

These projects are a direct result of the **CHIPS Act**, which has incentivized companies to establish or expand semiconductor manufacturing within the US. While some plants are still under construction or in the planning stage, the CHIPS Act is expected to contribute significantly to reshoring chip production and reducing dependence on overseas facilities, particularly in Asia.

The US cannot depend on China for rare earth supplies and hence, it is searching for captive mines in other countries

The US recognizes the strategic importance of rare earth minerals, and the risks associated with depending heavily on China for these materials. China controls around 60-70% of global rare earth production and has significant influence over the supply chain, especially in terms of refining and processing. This dependency has raised concerns about potential supply disruption, especially considering the ongoing geopolitical tensions with China.

As a result, the US is actively seeking alternative sources of rare earth minerals by exploring mining opportunities in other countries and developing its own domestic supply chain. Some of the efforts include:

1. **Investment in domestic mining projects**: The US has been investing in the development of rare earth mining projects within its own borders. For example, MP Materials, based in Mountain Pass, California, is the only rare earth mining operation in the US that produces a significant quantity of these materials. The US government has been supporting MP Materials and other companies to expand their operations and build processing facilities.
2. **Mining partnerships with allied countries**: The US is also working with allied countries like Australia, Canada, and Brazil to secure rare earth supplies. For example, Australia has some of the world's largest, rare-earth reserves, and US companies have been investing in mining operations there.
3. The US plans to invest in Russia to develop mining assets. This will help them in two ways: they will eliminate the most troublesome country of the last few decades and cement their presence in the country. At the same time, they are separating China and Russia.

Trump's so-called rants must be seen in this perspective

Trump's "rants" are often best understood within this framework of realpolitik and transactional diplomacy. Whether or not these ideas will materialize into formal policy, his comments reflect his belief in redefining US foreign policy priorities, focusing on economic self-sufficiency, national interest, and shifting alliances. While controversial, they can be interpreted as attempts to reshape global power dynamics in a way that benefits US economic and strategic goals, particularly concerning rare earth minerals, energy, and competing with China.

As the US de-risks chip supply chain, Taiwan is becoming more vulnerable to China's attack

As the US de-risks its semiconductor supply chain, Taiwan's geopolitical vulnerability to a Chinese attack increase. While the US is working to diversify its chip production and decrease reliance on Taiwan, the latter remains a critical piece in the global semiconductor puzzle. China, with its longstanding ambitions, is watching closely and may view a weakened or distracted Taiwan as an opportunity to assert its control, which would have far-reaching consequences not only for the region but for the global economy and technological landscape.

1. Taiwan is home to Taiwan Semiconductor Manufacturing Company (TSMC), the world leader in advanced semiconductor manufacturing. Taiwan produces cutting-edge chips that are crucial to sectors like electronics, defence, artificial intelligence or AI, and automotive. While the US and other countries are trying to diversify semiconductor production (e.g., through the CHIPS Act), no country has yet managed to replicate Taiwan's expertise in advanced semiconductor nodes like the 5nm and 3nm processes.
2. The US is making efforts to diversify the chip supply chain, especially through investments in domestic chip production. Companies like TSMC, Intel, and Samsung are building fabs in the US. However, even with these efforts, the advanced chip manufacturing capabilities of Taiwan cannot be fully replicated in a short time frame. Taiwan still dominates in producing the most advanced chips, making its chip industry a strategic asset for the US and other economies.
3. China sees Taiwan as a breakaway province and has consistently pressured Taiwan through military posturing and diplomatic means. Taiwan is one of the last remaining obstacles in China's pursuit of reunification. Its high-tech industry, particularly semiconductors, is an incredibly valuable strategic asset for Taiwan, making it an important target for China. The longer Taiwan remains a semiconductor powerhouse, the more it remains a strategic flashpoint for China's territorial and economic ambitions.
4. As the US works to de-risk its supply chain by moving some semiconductor production capacity to domestic or other allied nations, Taiwan's geopolitical vulnerability only increases. If China sees a weakening in Taiwan's semiconductor dominance, it may feel emboldened to take military action. With growing tensions in the Taiwan Strait and China's ongoing military exercises, the likelihood of escalation becomes more palpable.
5. Despite the US's efforts to diversify the chip supply chain, it is still highly dependent on Taiwan for the most advanced semiconductor technology. If Taiwan were to fall under Chinese control or its chip production were disrupted, it could have a devastating impact on the global supply chain. This risk is why the US, and its allies continue to bolster defence and support for Taiwan.
6. China has been investing heavily in developing its own semiconductor capabilities, with the Chinese government backing domestic companies like SMIC (Semiconductor Manufacturing International Corporation). However, China still lags Taiwan in the most advanced chip production technologies. That said, if Taiwan is destabilized or occupied, China's access to Taiwan's semiconductor infrastructure could accelerate its ability to dominate the global semiconductor industry, exerting further pressure on the US and its allies.

7. The US-China rivalry is intensifying, and Taiwan is one of the key flashpoints. If the US de-risks its semiconductor supply chain too much, there is a risk that Taiwan becomes more exposed to Chinese military action. The US and its allies, while attempting to create a more resilient supply chain, are simultaneously sending signals to China that they may not have the capacity or will to defend Taiwan in a conflict, especially if the strategic importance of Taiwan's chip production is diminished.
8. If Taiwan were to fall under Chinese control, China would not just gain territory but would also acquire world-leading semiconductor manufacturing capabilities. This would allow China to control the global tech supply chain, especially in areas like AI, defence technology, and consumer electronics, giving it a significant geopolitical advantage. China's ambitions in Taiwan are not only territorial but are also focused on securing technological dominance.

Europe to remain energy-starved, China will savour the NATO friction and Taiwan attack risk pushed down the road

The energy crisis in Europe, combined with NATO's internal friction and a shift in US's priorities, creates a geopolitical vacuum that China can exploit. If the US develops an alternative supply chain for its semiconductors, it may not need to engage China in China-Taiwan clashes. China will understand this well. Known for planning decades ahead, it will grasp the current situation much better than anyone else. Xi will buy time, and during that period, China will strengthen itself both militarily and economically. China will develop gas pipelines from Russia and become self-sufficient in gas as well as food production.

Europe is too much embedded with the moral idea of defending Ukraine

Europe's commitment to supporting Ukraine is deeply intertwined with moral and ideological considerations. For many European countries, especially those in Eastern Europe, defending Ukraine is seen as a stand against Russian aggression and a defence of democratic values, sovereignty, and international order. The moral dimension is strong because the war in Ukraine is not just a territorial dispute but is also framed as a broader struggle between autocracy and democracy.

There is also a strategic dimension. European nations are concerned about the implications of Russian expansionism for their own security. For some countries, particularly those on NATO's eastern flank, the invasion of Ukraine is seen as a direct threat to European security. So, the response is also driven by a desire to deter future aggression from Russia and maintain regional stability.

Europe also carries the historical baggage of Hitler's appeasement

Europe's historical baggage, particularly related to Adolf Hitler's appeasement, has profound implications for its contemporary geopolitical stance and foreign policy decisions. The lessons from World War II and the appeasement policies adopted by European powers like Britain and France still resonate in European decision-making today. This historical context influences Europe's actions, especially when facing current threats such as Russia's aggression and China's rising power.

1. **The historical context of appeasement:**
   - In the 1930s, European powers, particularly Britain and France, followed a policy of appeasement toward Nazi Germany. This was seen as an effort to avoid another devastating war after the trauma of World War I. They allowed Hitler to make territorial demands, including the occupation of Austria and Czechoslovakia, in the hope of preventing further escalation.
   - Appeasement ultimately failed as Hitler's expansionism grew unchecked, leading to World War II. The war resulted in immense destruction, with millions dead and the reshaping of global political structures. The failure to confront Nazi Germany early on is a cautionary tale about the dangers of not taking aggressive action in the face of clear threats.
2. **Impact on Europe's modern foreign policy:**
   - Reluctance to confront aggression: The memory of appeasement still haunts Europe. Many European policymakers are cautious about confrontation and may seek diplomatic avenues first, even when faced with clear signs of aggression (such as Russia's invasion of Ukraine). The hesitation to confront threats directly stems from the historical experience of misjudging Hitler's intentions, leading to catastrophic consequences.
   - Fear of escalation: This caution is amplified by the understanding that any major conflict, especially with a power like Russia, could quickly escalate into something uncontrollable and devastating. The trauma of the two world

wars and the fear of a nuclear conflict keeps many in Europe from taking a strong stance against aggressors, especially without full support from NATO or the US.

- European defence weakness: Historically, Europe's defence capacity has been seen as insufficient in comparison to global powers like the US and Russia. The reluctance to invest in military power, coupled with a preference for diplomatic engagement, has contributed to NATO's dependence on the US military umbrella. The EU and many European nations have prioritized economic cooperation and peacebuilding over military deterrence, largely due to the legacy of the wars of the 20th century.

3. **The resurgence of appeasement dilemma:**
    - Russia and the Ukraine conflict: The situation with Russia's invasion of Ukraine has drawn comparisons to the appeasement policies of the past. Some argue that Europe initially underestimated Putin's ambitions and, like the appeasers of the 1930s, thought that diplomatic concessions or economic sanctions would prevent escalation. This miscalculation, however, has led to one of the worst crises in Europe since World War II.
    - The EU's strategic vulnerabilities: Europe's historical inclination towards negotiations over confrontation plays into its vulnerabilities today. Russia has exploited these weaknesses, particularly Europe's energy dependence on Russian gas and oil. European leaders, fearing economic collapse or widespread discontent, have been slow to sever ties with Russia despite the ongoing war in Ukraine, which risks continuing the appeasement cycle.

The general population of Europe is also totally in sync with the idea of defeating Putin ➤

The general population in Europe, while divided on some specific aspects of the conflict, is largely aligned on the fundamental issue of **supporting Ukraine** in its struggle against Russian aggression. However, the war's economic and social impacts are leading to rising pressure on European governments to find a solution. The historical context of European unity, combined with public support for Ukraine, provides a strong foundation for continued European involvement in the conflict, even as internal challenges—such as economic instability—remain a key concern.

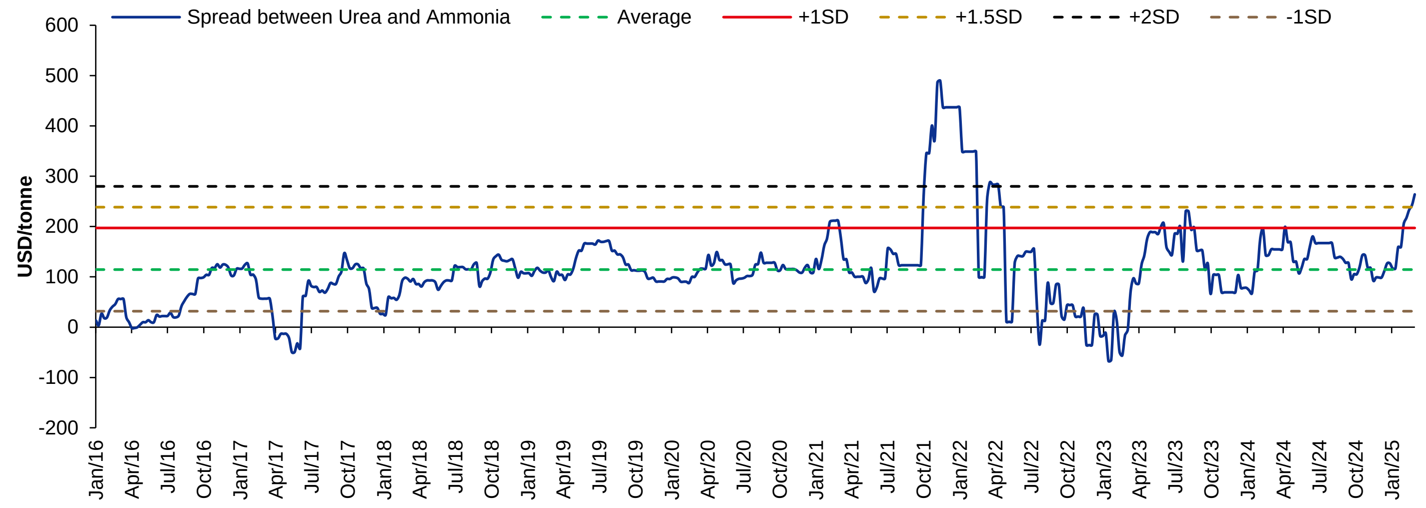
So, expect Europe to remain in an energy-deficit stage and keep buying gas at high prices ➤

Europe is likely to remain in an energy-deficit stage in the short- to medium-term, and high energy prices will continue to be a reality, particularly for natural gas and electricity. The shift away from Russian energy supplies has left a significant gap that will take time to fill. Europe's efforts to diversify its energy sources and invest in renewable energy are essential for its long-term energy security, but the geopolitical situation, reliance on LNG, and the pace of the energy transition all contribute to the continued vulnerability of Europe's energy supply.

We expect Europe to start buying urea and ammonia in big quantities from global market, thus raising the prices of ammonia and urea ➤

The global urea and ammonia markets are undergoing significant changes due to various geopolitical and economic factors. China has ceased urea exports, leading to tight supplies and higher prices globally. The reduction in China's exports is compounded by the rise in both Indian and European demand. Please note that Europe was a traditional importer of urea from Russia; however, due to geopolitical problems it has imposed heavy tariffs on Russian imports. High gas prices and energy costs in Europe mean that the production cost of urea (without carbon taxes) exceeds US$525/t. As a result, demand for urea from the Middle East is rising, which has led to the FOB urea spreads over ammonia reaching a nine-year high (barring the brief, chaotic post-Covid pandemic period) at US$220/t. This high urea spread will lead to more urea exports from the Middle East. Consequently, spot NH_3 shipments are likely to decrease, forcing a rise in the prices of ammonia. Urea spreads over ammonia is anyway rising and it's a matter of time before ammonia also starts to rise.

Figure 9: Urea spreads over ammonia are rising, which means the rise in ammonia is imminent



SOURCE: COMPANY REPORTS, INCRED RESEARCH

Europe will have to spend a lot on defence equipment, resulting in rising deficits

While it is not possible to estimate the exact increase in European defence expenditure, it's clear that it must rise significantly. The low expenditure on equipment for decades must be reversed within the next four-to-five years. Assuming NATO guidelines are the right benchmark, the EU will need to spend US$70bn on equipment to address historical shortfalls relative to NATO standards. Until now, the US, UK, and France have borne the major costs of keeping NATO equipment up to date. However, other countries must increase their defence spending by US$170bn over the next two-to-three years just to correct their historical neglect.

Europe will have to spend a lot on defence equipment, resulting in rising deficits; Canada will be the worst-hit

Barring France and the UK who are exceeding their capital equipment expenditure guidelines, other European nations as well as Canada will have to invest 1% of their 2024 gross domestic product or GDP just to fulfil the shortfall of the last decade. Canada will be worst-hit as its defence expenditure needed to fund the historical under-investment is 2% of its 2024 GDP.

Euro must fall even more

The euro is under pressure and likely has a further downside. Several factors point to a weaker euro in the coming months:

Key drivers for a weaker Euro (€):

1. **Divergence in interest rate policy** –
   - **The European Central Bank or ECB is likely to cut rates before the US Federal Reserve**, especially with weak growth in Germany and the Eurozone.
   - The Fed, on the other hand, remains hawkish due to persistent US inflation.
   - This widening rate differential will drive capital flows into the **higher-yielding US dollar**, weakening the euro.
2. **Eurozone's economic weakness** –
   - Germany, the Eurozone's largest economy, is struggling with **manufacturing weakness, high energy costs, and a slowing China.**
   - **Fiscal constraints** in France, Italy, and Germany limit their ability to boost growth through government spending.
   - The EU is expected to **underperform the US**, keeping the euro weak.

3. **Geopolitical uncertainty** –
    - The **Ukraine war and European defence spending needs** add uncertainty and pressure on EU budgets.
    - Higher energy costs, due to dependence on LNG instead of Russian pipeline gas, will keep inflation sticky in Europe.
4. **US economic resilience** –
    - US GDP growth remains **stronger than that of the Eurozone**.
    - The **dollar benefits from global risk aversion**, especially with geopolitical tensions rising.

Gold prices may retreat from their historical high ➤

Gold prices have been on an upswing due to policy uncertainty surrounding the Biden administration. The USD, as a reserve currency, was losing its status as countries questioned whether they could actually rely on it in times of need. However, the recent unequivocal stance of the US—delivered openly in front of the media—signals a shift. The US is now signalling a more pragmatic, interest-driven approach rather than moralistic or interventionist policies, which could have significant implications for global markets, particularly in terms of gold, the US dollar, and broader financial stability.

Gold has been rising due to concerns over policy uncertainty, geopolitical tensions, and the perceived weakening of the US dollar's reliability as a reserve currency. The new US stance is seen as reducing the uncertainty and reinforcing confidence in the dollar, with gold's appeal as a hedge against instability weakening, leading to some profit-taking.

USD will stabilize and the trend of de-dollarization may decelerate for the time being ➤

The dollar's role as a reserve currency has been questioned due to rising US debt levels, the use of sanctions as a financial weapon, and geopolitical fragmentation.

If the US pursues policies that reinforce economic stability and reduce erratic decision-making, investors could regain confidence in the dollar. Higher US yields and improved economic outlooks could also support demand for USD assets.

The fall in fiscal deficit in the US as it cuts wasteful expenditure and stop fighting others' wars will be bad for bond yields but good for equities ➤

A clearer stance that prioritizes domestic interests could provide stability to Wall Street in the short term, especially if it means tax cuts, reduced intervention, and more business-friendly policies.

Crude oil prices to stabilize and falling yields will be good for Indian equities ➤

The open spat between Zelensky and POTUS highlights one important fact – the US is not going fight others' wars and USD will not be thrown to fulfil highly moralistic agendas. All world wars have emanated from Europe and Europe has never fought a war with its own resources. England fought World War-1 and II with Indian resources and manpower. In fact, Asia was always dragged into European wars because of the colonization of Asia. If the US doesn't back Europe's highly impractical stance of hating Putin because of its historical Hitler baggage, then the USD will return to prominence, crude oil prices will stabilize, and US bond yields will fall - all of which is good for Indian equities.

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Stock Ratings	Definition:
Add	The stock's total return is expected to exceed 10% over the next 12 months.
Hold	The stock's total return is expected to be between 0% and positive 10% over the next 12 months.
Reduce	The stock's total return is expected to fall below 0% or more over the next 12 months.

The total expected return of a stock is defined as the sum of the: (i) percentage difference between the target price and the current price and (ii) the forward net dividend yields of the stock. Stock price targets have an investment horizon of 12 months.

Sector Ratings	Definition:
Overweight	An Overweight rating means stocks in the sector have, on a market cap-weighted basis, a positive absolute recommendation.
Neutral	A Neutral rating means stocks in the sector have, on a market cap-weighted basis, a neutral absolute recommendation.
Underweight	An Underweight rating means stocks in the sector have, on a market cap-weighted basis, a negative absolute recommendation.

Country Ratings	Definition:
Overweight	An Overweight rating means investors should be positioned with an above-market weight in this country relative to benchmark.
Neutral	A Neutral rating means investors should be positioned with a neutral weight in this country relative to benchmark.
Underweight	An Underweight rating means investors should be positioned with a below-market weight in this country relative to benchmark.