Flash Economics

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What are the biggest risks for financial markets?

So far, stock market indices and long-term interest rates in the United States and the eurozone have not reacted negatively in a lasting way to the bad news (tariffs, expected slowdown in growth, very high public deficits in some countries, war between Israel and Iran). What are the biggest risks for financial markets, that could cause stock markets to decline and long-term interest rates to rise? They include:

- A drop in household consumption, for example due to a surge in inflation, leading to a recession in the United States;
- A closure of the Strait of Hormuz resulting in a sharp increase in oil prices;
- A sizeable reduction in capital inflows into the United States, following a reaction from investors and businesses in the rest of the world to uncertainty over economic policies (tariff, fiscal), and to the threat of over-taxation of income stemming from holding U.S. assets;
- A declared intention to significantly depreciate the dollar, which would also discourage non-residents from holding U.S. assets;
- Disappointment in the United States regarding the impact of artificial intelligence investments on profits, and in Europe regarding the scale of the increase in military spending.

Patrick Artus
Senior Economic Advisor
patrick.artus-ext@ossiam.com
@PatrickArtus
Patrick Artus

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A resilience of stock market indices and long-term interest rates to bad news

Bad news has been piling up since the beginning of 2025:

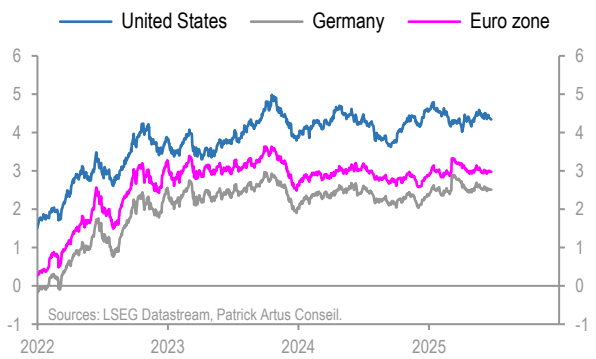
- Instability in Donald Trump's economic policy decisions, particularly regarding tariffs;
- A slowdown in growth expectations;
- War between Israel and Iran;
- Very high public deficits in the United States and France.

One might have expected stock markets to decline (due to slower growth, tariffs, the war between Israel and Iran) **and long-term interest rates to rise** (due to anticipated inflation and public deficits). But **stock indices and long-term interest rates**—aside from a short-lived reaction in April 2025 following the announcement of very high tariffs—have remained very stable, reverting to their early 2025 levels (**Charts 1 and 2**).

Chart 1
Stock market indices (01.01.2024 = 100)



Chart 2
Interest rate on 10-year government bonds (as %)



This resilience of financial markets in the United States and Europe raises questions regarding **the types of risks that could trigger either a significant decline in stock indices or a sharp rise in long-term interest rates.**

First risk: decline in household consumption and recession in the United States

If the inflation surge anticipated by American households (**Chart 3**), mainly resulting from the increase in tariffs, materializes in measured inflation in the United States, **there will be a decline in household consumption** (**Chart 4**) **and a risk of recession in the U.S.**, which would lead to **a sharp drop in stock markets**.

Chart 3
United States: Consumer's inflation expectations for the year ahead (as %, Conference Board)

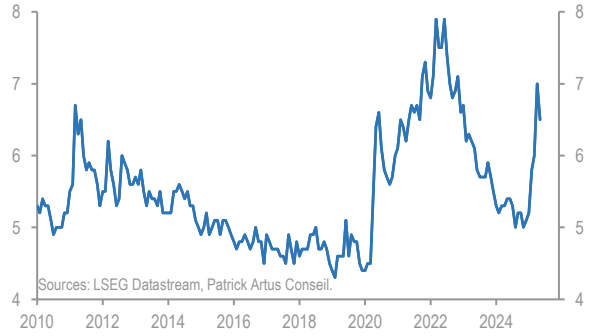
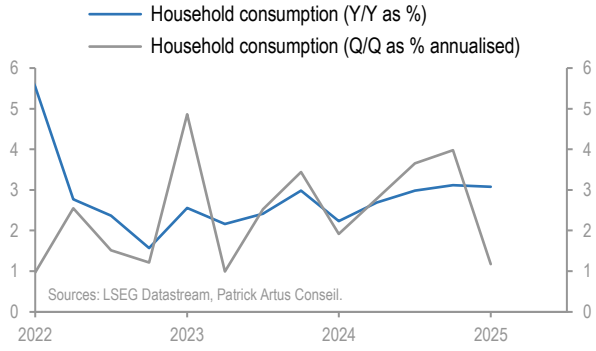


Chart 4
United States : Household consumption (in volume terms)



Second risk: closure of the Strait of Hormuz and sharp rise in oil prices

If the war between Israel and Iran leads to the closure of the Strait of Hormuz, and consequently to a significant increase in oil prices (**Chart 5**), this would result in **a major drop in stock indices** and **a sharp rise in inflation**—therefore, normally, in a rise in long-term interest rates.

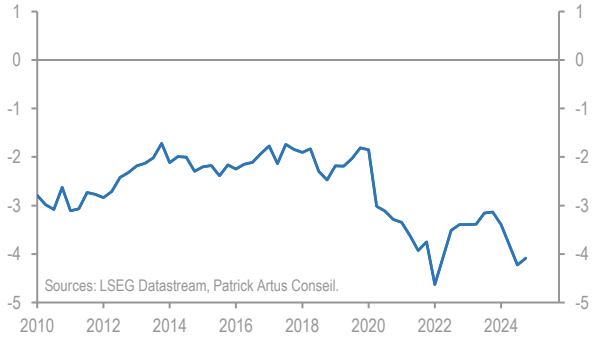
Chart 5
Oil price (Brent, $/bbl)



Third risk: sharp reduction in capital inflows to the United States

The United States needs to attract capital from the rest of the world to finance its current account deficit (Chart 6).

Chart 6
United States: Current account balance
(as % of nominal GDP)

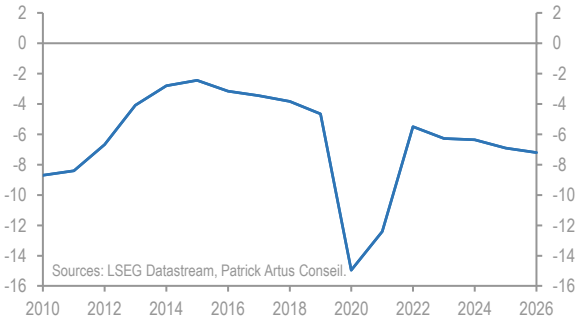


If these capital inflows decrease, a sharp downward adjustment of the external deficit will be necessary, leading to a recession, a drop in stock indices, and a rise in long-term interest rates.

However, non-residents may hesitate to invest in the United States due to uncertainty over economic policies and the threat of over-taxation (Section 899 of the Big Beautiful Bill) of income earned by foreigners (whether individuals, companies, or investors) on their holdings of U.S. assets.

Non-residents may also be concerned about the U.S. fiscal situation, as tax cuts are expected to result in a public deficit exceeding 7% of GDP for fiscal 2026 (Chart 7).

Chart 7
United States: Budget deficit (as % of nominal GDP)



A slowdown in Treasury purchases by non-residents would cause a sharp rise in long-term interest rates.

Fourth risk: intention to sharply depreciate the dollar

Stephen Miran's thesis is well known: if the United States has deindustrialized, it is because the dollar's role as a reserve currency increases global demand for greenbacks and leads to an overvaluation of the American currency; consequently, the reindustrialization of the United States would require a depreciation of the dollar. If this thesis were put into practice (for example, through the threat of tariffs on countries that do not sell their dollars), or simply if Jerome Powell's successor at the Federal Reserve adopted a much more expansionary monetary policy, there would be **a strong observed and anticipated depreciation of the dollar** (**Chart 8**), which would discourage non-residents from holding U.S. assets.

Chart 8
Euro/dollar exchange rate (EUR 1 = USD...)



Fifth risk: disappointment regarding artificial intelligence in the United States, and disappointment about military spending in Europe

Investors have **high expectations for the future profitability of investments in artificial intelligence**, which explains the strong rise in the stock prices of companies linked to artificial intelligence (**Chart 9**).

Chart 9
Stock index of the Magnificent Seven (01.06.2012 = 100)



However, there is a very strong growth in investments in artificial intelligence (for the most involved technology companies, $405 billion in 2026) without a parallel increase in profits derived from artificial intelligence. Disappointment regarding the profitability of AI investments would cause a significant decline in U.S. stock indices.

Investors also have **high hopes for increased public military spending in Europe**, with the relaxation of budgetary rules in the sector. This has resulted in a considerable rise in the stock indices of defense and aerospace companies (**Charts 10A/B**).

Chart 10A
Rheinmetall stock price (01.01.2010 = 100)

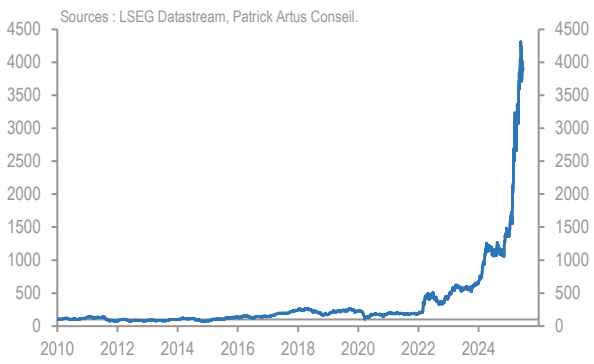
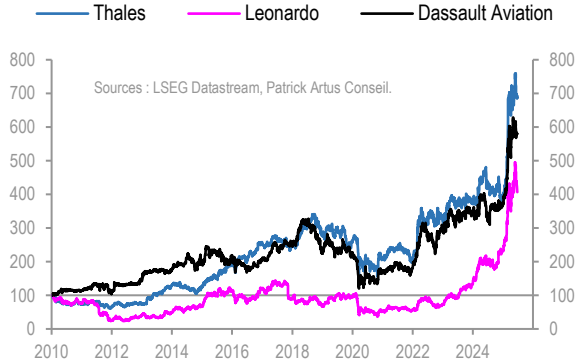


Chart 10B
Stock prices (01.01.2010 = 100)



But there is a clear risk that the rise in stock prices of defense companies is due to an overestimation of the increase in military spending, which will be gradual, and subdued in some European countries (Italy, Spain).

Summary: two types of risk

The first type of risk relates to **the potential decline in stock indices**. This decline could result from a recession in the United States, a sharp rise in oil prices, a decrease in capital inflows to the U.S., a strong depreciation of the dollar, or disappointment regarding the impact of investments in artificial intelligence or military spending on corporate earnings.

The second type of risk relates to **the potential sharp rise in long-term interest rates**. This increase could result from rising oil prices, a reduction in Treasury purchases by non-residents, or the depreciation of the dollar.

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