

What to watch: The Fed's very political cut, BoE forced to pause and Munich Auto Show blues for European car makers

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In summary

Fed: A very political cut. As the Fed shifts focus to the labor market and faces increasing pressure to lower rates, we now expect frontloaded back-to-back 25bps rate cuts at its next two meetings (16-17 September and 28-29 October), followed by two others in H1 2026 (taking the Fed Funds Rate to 3.5%, in line with our previous scenario). But while job creation has weakened, tighter immigration has also drastically reduced labor supply, keeping the labor market relatively balanced. We expect unemployment to peak at 4.9% by Q1 2026, slightly above the equilibrium rate. Moreover, combined with monetary easing, the Big Beautiful Bill should also support GDP growth by +0.5pp next year (to +1.6%). And above all, inflation will remain above target (at 2.9% in 2026) as around three-fourths of the costs of tariffs are likely to be passed on to consumers by end-2026. In addition, medium-term household inflation expectations remain high, feeding further into inflation risks, which could even force the Fed to re-hike interest rates. In this context, market expectations of a terminal rate at 3% by July 2026 look too ambitious.

Bank of England: Forced to pause and slow its quantitative tightening program. As inflation remains stubbornly high, the BoE's strategy of one rate cut per quarter is looking increasingly untenable, with the policy rate currently 70-90bps lower than it should be considering inflation and economic slack. To restore its inflation-fighting credentials, we expect the BoE to enter a prolonged pause at its next meeting on 18 September, lasting until Spring 2026, with inflation not likely to fall convincingly below 3% before then. But to prevent long-term yields from rising further, the BoE will slow down its quantitative tightening (QT) from GBP100bn to GBP60-70bn annually. Nevertheless, we see limited scope for the 10-year Gilt yields to go below 4.5% as the fiscal deficit will remain close to -5% of GDP in 2026 (from -5.7% in 2025) and public debt will rise further to 105% of GDP. In this context, markets will be paying close attention to fiscal discipline in the Autumn Budget, in which we expect the government to announce at least GBP20bn of fiscal consolidation measures.

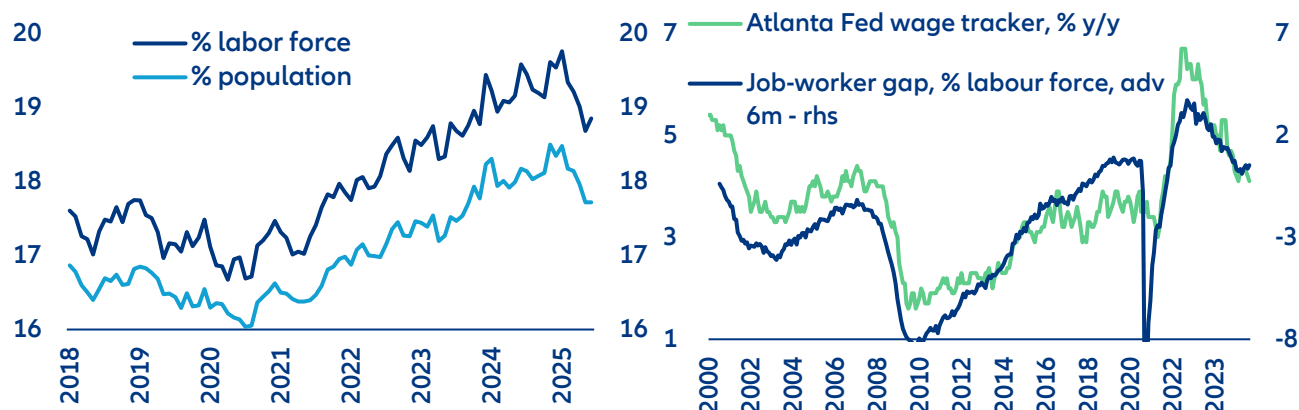
Munich Auto Show blues for European car makers. As the biennial auto fair kicks off, the European car sector is facing growing pressure on its domestic and export sales. European new car registrations are down -0.7% year-to-date and Germany, France and Italy are shrinking by -2%, -8% and -4% respectively. Overall, domestic sales remain roughly -25% below their 2019 level and the upside risks from electric-vehicle adoption remain limited: in nearly 60 % of EU countries, EV penetration is under 15%. Price gaps, high electricity costs and patchy charging infrastructure continue to favor hybrids, where Chinese competition is getting stronger. They have doubled their European market share to about 6% and undercutting incumbents with models priced below EUR30,000 could push this to 10-11 % of Europe's hybrid/EV segments by year-end. The shift of powertrain priority is biting margins, contributing to the over 200bps squeeze reported by European automakers in H1 2025. Meanwhile, Chinese competitors are now also dominating their home market (70% market share) and regaining market shares from European brands. This is expected to result in at least EUR4bn in potential revenue losses for the sector this year. To add to this, trade tensions with the US threaten up to EUR5bn in revenues for the European auto sector. With operating margins already down to a medium-low single digit, manufacturers must balance cost-cutting with urgent investment in batteries, software and autonomous technology.

Fed: A very political cut

The Fed is tilting dovish as the labor market weakens: We now expect back-to-back 25bps cuts at its September and October meetings. Payroll gains stalled through the summer, with the three-month moving average dipping from 127,000 in April to only 29,000 in September. With price pressures from tariffs contained so far, Fed policymakers are increasingly worried that the balance of risks is leaning toward the employment part of their mandate, giving room to shift focus toward supporting jobs. Against this backdrop, we now expect the Fed to deliver back-to-back 25bps cuts at its next meetings on 16-17 September and 28-29 October, compared to our previous forecast of only one 25bps cut in December.

However, the loosening of the labor market is being driven as much by demand as supply... Many commentators have argued that rapidly weakening job creation and the number of unemployed rising above the number of job vacancies should prompt the Fed to act decisively. However, the Fed is not targeting absolute job creation or “growth” variables (such as GDP). The real gauge for the Fed is capacity utilization variables, i.e. the balance between demand and supply – especially the unemployment rate – since they measure the capacity of the economy to grow or to create jobs *relative* to its capacity. Higher capacity utilization means upside risks for inflation and vice versa. Labor demand has clearly weakened but so has supply as immigration – a key source of workers until recently – slows down sharply amid intensifying crackdowns against unauthorized immigrants (both at the border and in the interior). The foreign labor force dipped by 1mn between April and August, and foreign-born individuals’ share of the labor force and the total population have decreased rapidly (see Figure 1, left). As a result, the job-worker gap¹, a gauge of labor balance, has ticked higher in recent months (Figure 1, right), suggesting intensifying pressure on labor supply. Meanwhile, the unemployment rate has risen only slightly (to 4.3% in August, from 4.2%). With fewer people entering the job market, low hiring is not translating into a large increase in the unemployment rate.

Figure 1: Foreigners’ share in population and labor force, % (left); job-workers gap & wage growth (right)



Sources: LSGE Datastream, Allianz Research

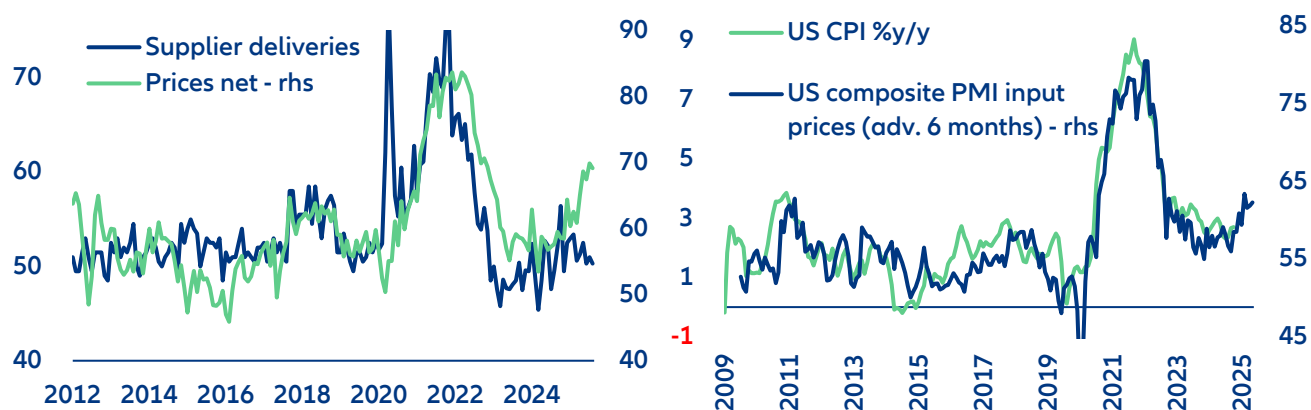
...while inflation pressures are likely to persist or even intensify. The impact of tariffs on inflation has been more modest than widely expected so far, thanks to margins squeezing and a lower-than-feared rise in the effective tariff rate². However, this does not mean that price pressures are fading. In fact, business surveys still report elevated input cost pressures tied to tariffs (Figure 2 left), even in sectors only indirectly exposed, which is more concerning since it means that tariff-induced pressures may start to bleed into domestic prices more thoroughly (the “supercore” measure of price which is services prices excluding rents). More broadly, input cost pressures remain high and point to US inflation picking up in the next couple of months (Figure 2, right). We expect CPI inflation to hover between 3% and 3.2% between end-2025 and the summer of 2026 as corporates gradually pass on the costs of tariffs to the consumers. By the end of 2026, we expect around three-fourths of the costs of tariff will have been passed on to

¹ The job-worker gap is the difference between labor demand (measured by payrolls + job openings) and labor supply (labor force), expressed as a percentage of the labor force.

² Around 10% in July. The effective tariff rate is lower than expected since US businesses have taken strategies to import lowered tariffed goods and from lowered tariffed locations: see [Allianz / What to watch / September 5, 2025](#)

consumers. Tight labor supply also means that wage growth is not showing convincing signs of slowing down (Figure 1, right). Meanwhile, households' medium-term inflation expectations remain high in the University of Michigan survey. The longer they remain elevated, the larger the risk of second-round effects of high inflation expectations starting to spill over onto price- and wage-setting mechanisms.

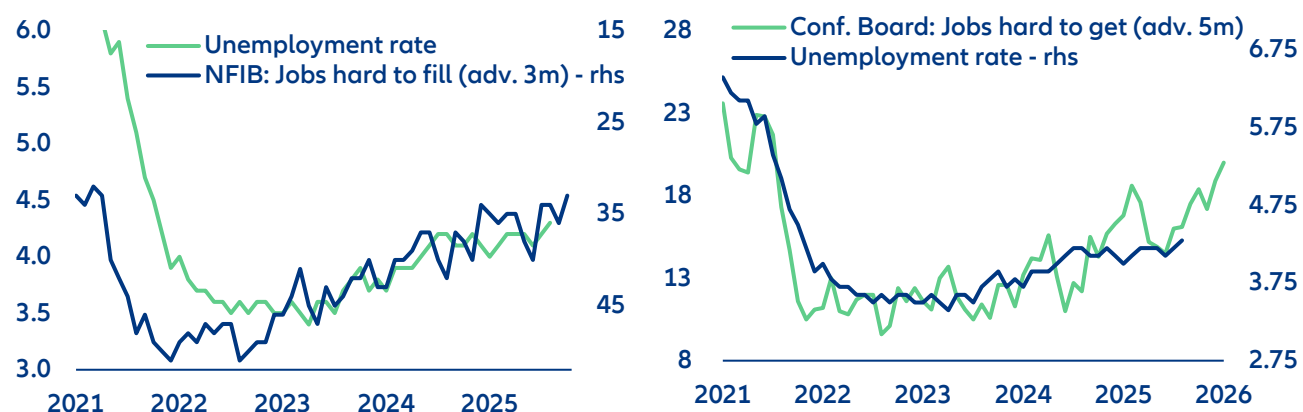
Figure 2: ISM non-manufacturing price and supplier deliveries index (left); CPI inflation & Composite PMI input prices (right)



Sources: LSGE Datastream, Allianz Research

With persistently above-target inflation, the US economy is expected to muddle through. Falling policy rates combined with sticky inflation mean real rates will drop in the next couple of months, delivering short-term monetary stimulus. Add to that a fiscal boost from the One Big Beautiful Bill expected in 2026 and the U.S. economy looks set for support from both policy fronts. This will limit downside risks to an otherwise softening, yet resilient economy, hit by the slow burning effects of tariffs and tight immigration policy. With the unemployment rate likely to continue ticking up (we expect a peak at 4.9% in Q1 2026) (Figure 3), the Fed will continue to lean dovish, though political pressure could put its inflation-fighting credibility at risk. We now expect inflation to persist above target through 2026-27. In this environment, the Fed will likely cap how far easing goes – our mid-2026 policy rate forecast remains 3.5% (implying an additional 50bps cut in the first half of 2026), but our implied forecast of the real rate is lower.

Figure 3: Unemployment rate and forward-looking indicators



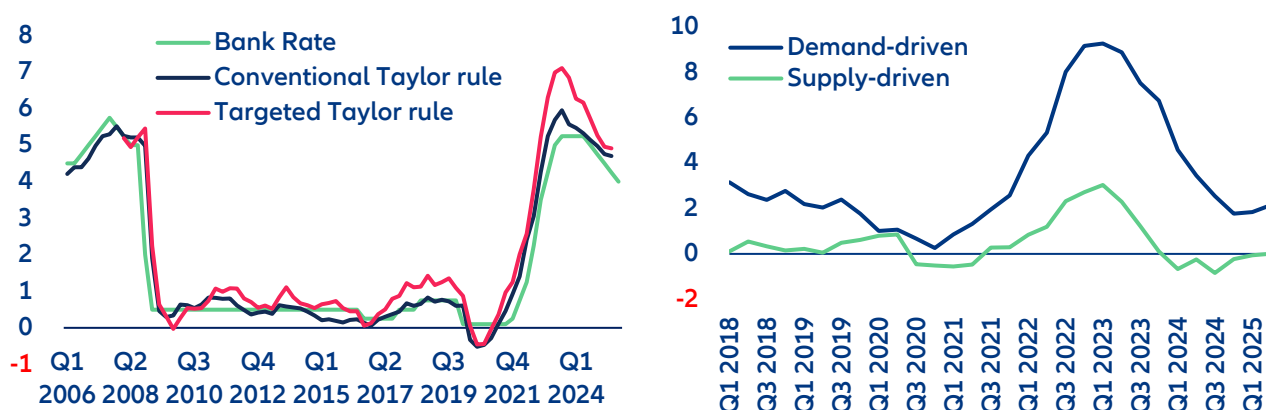
Sources: LSGE Datastream, Allianz Research

Bank of England: Forced to pause and slow quantitative tightening

With inflation showing no sign of cooling down, we expect the Bank of England (BoE) to go into a prolonged pause from its next meeting on 18 September. The BoE started cutting rates in August 2024, when the Bank Rate was at a historical high of 5% following a surge in inflation in 2022-23. Since then, it has adopted a cautious approach of 25bps rate cuts once every quarter, which have taken the Bank Rate down to 4%. Initially this was

justified by rapidly cooling headline inflation, which reached a trough of +1.7% in September 2024, though persistent stickiness in core inflation and wage growth were already a cause for concern in 2024. Headline price pressures started to build again in end-2024 but the BoE has maintained its strategy, even as inflation reached +3.8% in July 2025 (core and headline) – way above its 2% target. But now with wage growth still high and households' inflation expectations drifting up, uneasiness is growing. Four out of the nine MPC members voted against the 25bps cut in August. At 4%, the current Bank Rate is lower than that prescribed by the Taylor rule – both a “conventional Taylor rule” (4.7% in Q2-2025) or a “targeted” one (4.9%) in which the central bank responds more to demand-driven inflation than supply-driven inflation (Figure 4, right)³. In all, we think that persistently high inflation, combined with growth surprising on the upside in the first half of 2025, will be enough to convince a majority of the MPC members to keep interest rates on hold for the next few months – a noticeable change of strategy. With headline inflation likely to hover between 3% and 3.5% through next Spring, the MPC will have to be patient. We would expect the next cut in April 2026, followed by a cut in Q3 2026 and another one in Q4 2026, bringing the Bank Rate to 3.25% by end-2026.

Figure 4: Bank of England policy rate vs prescribed by Taylor rule (left, %); Inflation decomposition (% year-on-year, right)



Sources: LSGE Datastream, BIS, Allianz Research

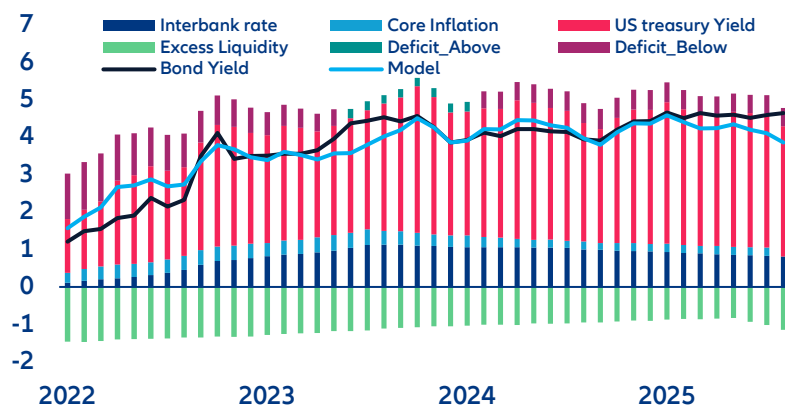
Long-end rates remain at very high levels, but it's not only a UK story but a global one. Over the summer, 30-year government bond yields reached notable peaks: UK Gilts climbed to 5.7%, the highest since 1998, while Japan's 30-year JGBs reached 3.2%, the highest since inception in 1999. These moves reflect a confluence of domestic policy developments and global structural factors. In the UK, high fiscal deficits, lingering concerns about another “Truss moment,” a hawkish Bank of England meeting in August and ongoing quantitative tightening have all contributed to upward pressure on yields. In the US, challenges to Fed independence have lowered short-term rates but prevented long-term yields from following suit as inflation expectations inched upwards. For this reason, the US showed the only bull-steepening dynamics among global markets, whereas the rest of the world was characterized by a bear-steepening move. In Europe, the ECB's ongoing fast-paced quantitative tightening, combined with fiscal slippage – most notably in Germany – as well as political risk premia in France, have supported the bear steepening of yield curves. Similarly, Japan has seen 30-year yields climb due to an ongoing hawkish BoJ stance and expectations of further rate hikes amid persistent inflation, even as the central bank moves counter to global trends. Structural developments are reinforcing these trends. The upcoming implementation of the Dutch pension reform, starting on 1 January, represents a major shift for Europe's largest pension system – with over EUR2trn in assets, around half of all Eurozone pension savings – potentially reducing demand for long-dated bonds.

The BoE is also likely to slow the pace of quantitative tightening (QT) at next week's meeting. UK bond yields have risen rapidly over the summer. Our model decamping the drivers of 10-yr Gilt bond yield indicate that UK interest rates are mostly driven by US interest rates (3.5pps contribution in August 2025), though the Bank Rate

³ We compute supply vs demand-driven inflation using Shapiro (2022)'s framework. We rely on estimated coefficients from the BIS (Quarterly Review, December 2024) to build our targeted Taylor rule.

(0.8pp) and the fiscal deficit (0.5pp) also matter. On the other hand, the BoE's balance sheet (through excess liquidity) contributes to push down UK yields, though with the BoE trimming its balance sheet the contribution has steadily decreased from -1.4pp in 2022 to -0.8pp currently. With upward pressures on UK bond yields, we expect the BoE to announce a slowing of QT from GBP100bn annually to around GBP60-70bn for the September 2025-September 2026 period.

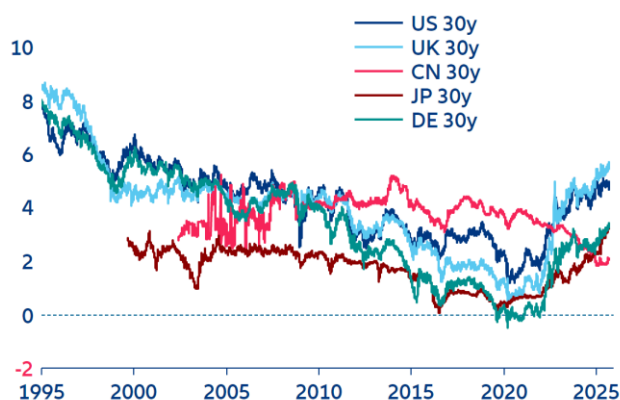
Figure 5: UK 10-yr Gilt yield decomposition (%)



Sources: LSGE Datastream, BIS, Allianz Research

Note: we account for a higher effect of the fiscal deficit on bond yield when the fiscal deficit rises above our estimated 5% of GDP threshold ("Deficit_Above").

Figure 6: 30y government bond yields, %

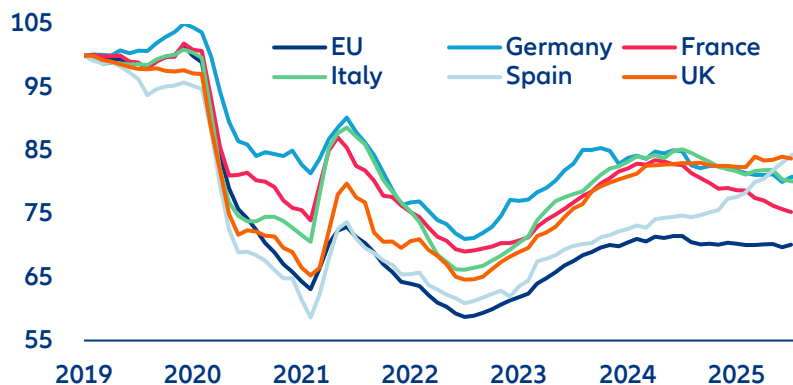


Sources: LSGE Datastream, BIS, Allianz Research

Munich Auto Show blues for European car makers

The Munich Auto Show normally celebrates European engineering, but this year it casts a harsh light on a struggling industry. Car registrations are falling, electric-vehicle adoption is lagging and Chinese rivals are challenging European brands both in Asia and at home. Tariffs and trade tensions add to the pain just as companies must pour resources into batteries, software and autonomy. The mood is sombre and introspective. After a brief post-pandemic rebound, new car registrations slipped -0.3% in the second half of 2024 and are down -0.7% as of July 2025. Germany, France and Italy are contracting by -2%, -8% and -4%. Spain, Poland and the UK have grown, but overall sales remain roughly 20-30% below 2019 levels (see Figure 7) and are unlikely to return to their pre-Covid peak.

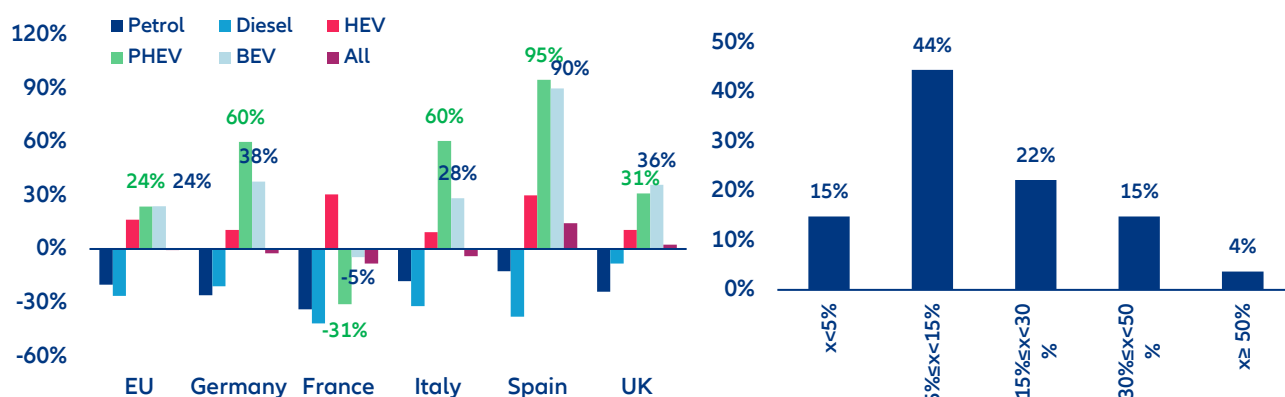
Figure 7: New car registrations, 12-month rolling cumulated (100 = January 2019)



Data as of July 2025. Sources: ACEA, Allianz Research

Electric cars were meant to revive the market, yet adoption is slow and uneven. Battery-electric and plug-in hybrid vehicle registrations have grown +24% year-to-date and now account for roughly one in four new registrations (see Figure 8). Pure battery cars hold a 15.6% share, up +3pps from a year ago, behind hybrids at 34.7% and ICE cars at 28.3%. Wealthy western and Nordic countries account for two-thirds of EV sales. However, in nearly 60% of EU countries the electric share in sales is below 15%; in more than half it is under 10%. Italy, Spain and Poland languish in single digits. Progress is insufficient to meet Europe's goal of making EVs 20% of new sales by the end of the decade. Price and infrastructure explain much of the gap. Competition from Chinese manufacturers has narrowed the price premium for battery cars, but electricity prices and patchy charging networks make ownership costly and inconvenient. Hybrids and plug-in hybrids together command roughly 43% of registrations because they are cheaper and do not require dedicated charging. Without a steep change in public investment and a stable framework for electricity pricing, Europe risks falling short of its own targets for electrification.

Figure 8: YTD new registration per powertrain / Distribution of EV market share among EU-27 in 2025

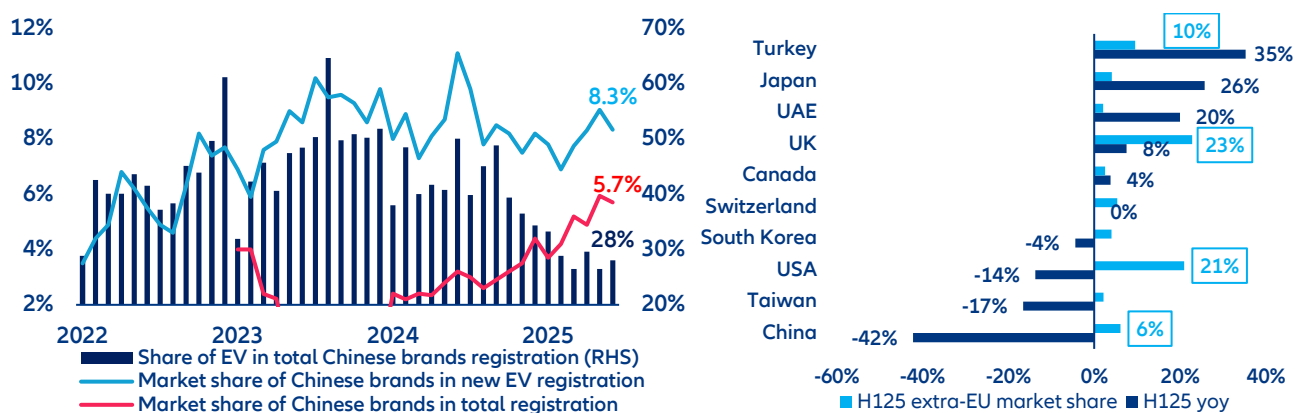


Data as of July 2025. Sources: ACEA, Allianz Research

China's manufacturers are rising fast, both in Asia and in Europe, piling up pressure on European car makers.

Domestic brands now control nearly 70% of their home market, roughly double the share five years ago, and European brands have lost ground. Exports of European cars to China have dropped about 40% this year. Sales of German brands in China contracted by -7.5%, with their passenger vehicle market share declining by -13% to 10%. In the US, exports are down and Europe's share of extra-EU car sales has fallen. Chinese makers are also gaining in Europe: their combined share across all powertrains has almost doubled to about 6% (see Figure 8). Only 28% of those sales are pure battery cars – the rest are hybrids and plug-in hybrids – but low prices allow them to undercut competitors. They have launched models priced under EUR30,000 and are showcasing incoming models in Munich. Analysts think Chinese brands could capture roughly 10–11% of Europe's hybrid and EV segments by year-end.

Figure 9: Chinese car brands penetration in Europe / EU-27 car exports in H1 2025 (top 10 partners)



Sources: JATO, Eurostat, Allianz Research

Geopolitics and change in policies add to the uncertainty. The US has signalled that electric cars from the EU could face a 15% tariff instead of punitive rates (see Figure 10), bringing them in line with imports from Japan and South Korea. But the relief is conditional on how and where materials are sourced. It does not remove tariffs on metals, and Europe's supply chains are less flexible than those of Asian rivals, so companies cannot easily shift production to avoid duties. The effects of the trade war are now also clearly visible in European car exports to the US, which declined by -14% in the first half of the year. About 20%-25% of German carmakers' global revenue comes from the US, making the industry vulnerable to any escalation in tariffs. The premium positioning of brands like BMW, Mercedes-Benz and Audi may offer some insulation against price sensitivity in the US market, but there is a risk both on sales volumes and margins. The lower retail prices of South Korean and Japanese models could be an advantage in a period of economic downturn. At home, carmakers won a reprieve when regulators agreed to calculate carbon footprints over the 2025-27 period rather than a single year, giving them more time. Nevertheless, executives continue to lobby for flexibility around the 2035 ban on petrol and diesel cars, warning that the electric market is

not profitable enough to replace the margins from internal-combustion models. Without coherent plans for electricity pricing, charging networks, recycling and raw-material supply, the transition could stall.

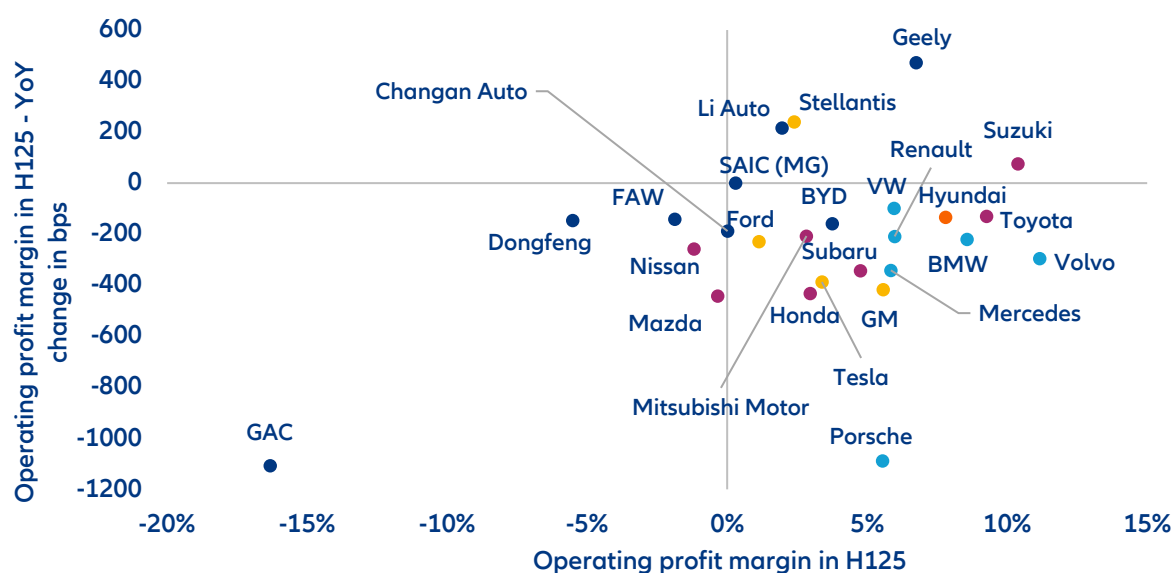
Figure 10: Top US import markets in auto

Top US partners for Auto	Total auto trade (in USD bn)	Auto exposure of section 232 steel & aluminium derivatives tariff (in USD bn)	Section 232 steel & aluminium derivatives average tariff (in %)	Auto steel & aluminium derivatives trade ratio (vs. Total auto trade)	Total auto trade - Average tariff (in %)
Mexico	136,6	30,8	44,0	23%	35,1
Canada	50,4	10,8	58,1	21%	29,7
Japan	50,1	3,8	42,3	8%	28,3
South Korea	44,5	4,0	37,2	9%	28,4
Germany	34,4	4,8	44,9	14%	29,8
China	16,9	6,6	84,6	39%	75,2
United Kingdom	11,5	0,6	21,6	5%	10,6
Slovakia	6,4	0,1	37,0	1%	27,6
Italy	5,4	0,9	47,1	17%	30,4
Sweden	4,2	0,1	38,2	2%	27,3

Source: Allianz Research

Margins are shrinking. Average operating profitability has fallen by more than 2pps this year. Forecasts have been cut from double-digit to mid-single-digit figures. Companies are closing plants, shedding staff and pooling platforms to save costs. Yet they cannot stop investing in technology. Software-defined vehicles, battery development and autonomous driving require heavy spending and Chinese competitors hold a lead. Carmakers must focus on projects with the highest potential returns and form partnerships with battery and software specialists. Any delay in the shift to electric power may provide short-term breathing space but would undermine Europe's credibility on climate policy and deter investment. Rivals such as Ford have signalled their intent with multibillion-dollar commitments to electric production. European automakers will need to be more selective in their innovation focus – concentrating on areas that promise the highest return on investment – while finding ways to reduce costs in other areas without sacrificing product quality or consumer satisfaction. The road ahead will demand precision in resource allocation and strategic partnerships, and an unwavering commitment to advancing new automotive technologies. Beyond the short-term challenges of tariffs and carbon regulations, there are other critical challenges ahead, including securing rare earth supplies to cut the dependency on China, investing into a recycling industry for batteries to develop a second-hand EV market and allocating capital in autonomous mobility solutions to maintain the current technology lead (two out of three manufacturers proposing level 3 autonomous technology are European).

Figure 11: Top global car manufacturers operating profit margin in H1 2025



Colour code: Black blue = China, Light blue = Europe, Purple = Japan, Orange = South Korea, Yellow = US.

Sources: Corporate filings, Allianz Research

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