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What to watch: Who's paying for the trade war, the BoJ's daring game of patience and equity markets – bubble or boom?

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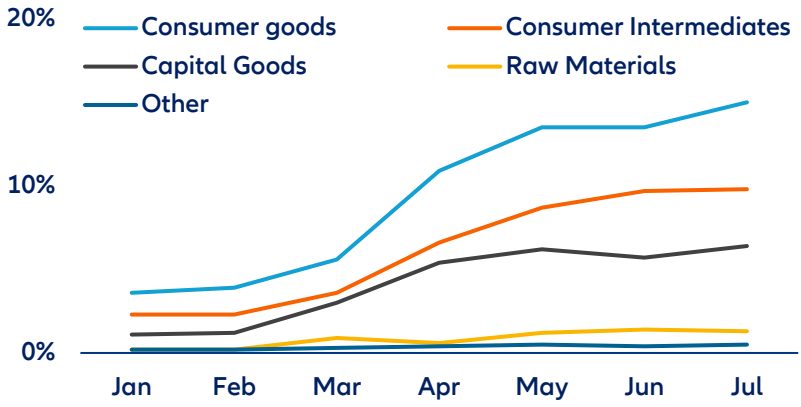
In summary

Who's paying for the trade war? Our analysis suggests that US manufacturers are absorbing higher costs for less than 25% of products (and mainly in the agrifood sector), likely due to strong domestic competition and price-sensitive consumers in those categories. Meanwhile, US retailers and wholesalers have maintained sales and margins at fair levels, implying that they have not been supporting tariffs whatsoever. Foreign producers have been squeezing their margins to some extent. Indeed, though the overall US import price index was at the same level as a year before in August 2025, import prices were down for about a third of products, including computers and electronics, suggesting price moderation, especially in consumer goods mostly sourced in Asia. Lastly, we find that the US consumer is also feeling the pass-through of tariffs and potential opportunistic price hikes as we estimate that tariffs and other domestic factors added roughly 0.1pp to CPI inflation between March and August 2025. In particular, we estimate that consumers have been paying an extra 3.6% for goods like furniture, and an extra 1.2%-2.3% on cars, apparel, jewelry and footwear. Looking forward, price pressures will continue to build and permanent tariffs on goods and key inputs will make it hard for retailers and US manufacturers to hold the line on cars, electronics, furniture and textiles in H2 2025. Retail sales growth is expected to slow to just under +2% next year and retail volumes to expand by only 1–3% as more pass-through to consumer prices is underway. The Zen Gambit: The Bank of Japan**'s daring game of patience.** We expect the Bank of Japan to stay put at this week's monetary policy meeting, with the next move in its cautious rate-hiking cycle likely in January 2026. By then, it will gain further visibility on the negative impact of US tariff hikes, next year's wage increase momentum and the domestic political situation. We expect the LDP-Komeito coalition to continue leading a minority government and a new Prime Minister should be appointed by mid-October. Meanwhile, uncertainty and the BoJ's balance sheet reduction fueled the recent surge in Japanese government bond yields: +240bps for 30y and +150bps for 10y (resulting in an unprecedented 10y30y steepness of 160bps). With uncertainty now largely priced in (and likely receding) and QT exerting barely an additional pressure of c.25bps in the next two years, we expect the 10-year yield to hover around 1.6% and the 10y30y steepness to return to 120bps in the coming months. But if Japanese yields spike (e.g. another +100bps in the 10-year yield), global markets could be at risk of a liquidity squeeze and meltdowns. We believe that the BoJ has the means and credibility to prevent this, but the potential for a policy mistake is one of the biggest risks to financial markets right now. Bubble or boom? Equity markets ride high PEs with PEGs still in check. US equity markets are at record highs and so are valuations at first sight. The S&P 500 is trading at elevated price-to-earnings multiples (PE) not seen in years. On the surface, valuations appear lofty, fuelling the debate about a potential bubble. Yet, strong earnings growth expectations over the long run provide crucial context: earnings are projected to rise around +15% annually in the US, well above Europe's +10%, bringing price-to-earnings-to-growth ratios (PEG) to historically reasonable levels. But the US rally is concentrated among a handful of mega-cap technology firms, which are driving both revenue growth and an unprecedented AI-driven investment boom – 18 times the average S&P 500 firm. This suggests a boom underpinned by fundamentals rather than a bubble, albeit one that is fragile and critically dependent on the durability of the AI trade and a few companies involved.

Who's paying for the trade war?

Consumer goods make up the bulk of the increased tariff bounty. Following the tariff hikes, US customs has already collected USD165bn in revenues so far this year, compared to just USD69bn in the same period last year. The weakened US dollar is also making imported goods more expensive, as seen in the sharp increase in tariffs paid on imported consumer goods and intermediates. In just a few months, the share of tariff revenue relative to the value of imported consumer goods has jumped from roughly 4% to about 15% (see Figure 1), an unprecedented surge that is expected to pile pressure on households, even though impacts on demand have been relatively muted so far. This could also fuel a wedge between what US consumers and firms pay and what foreign suppliers receive. When pricing power allows, domestic firms can pass the levy straight onto buyers, further increasing pressure on households' budgets.

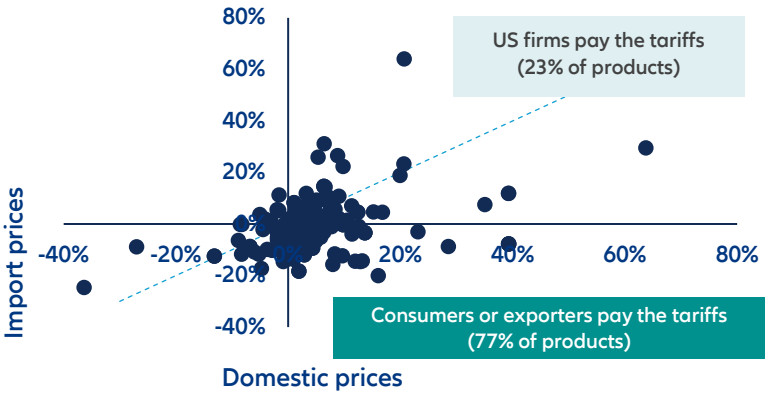
Figure 1: US monthly tariff revenue as % of total import value, by major product category



Sources: USITC, Allianz Research

Domestic producer prices are outpacing import prices for a vast majority of products and product categories. While it is usually the importer who pays for tariffs, the higher costs can ultimately be shared or absorbed across the entire supply chain, either by exporters reducing their prices, importers keeping prices unchanged or US consumers paying more for the same good. When comparing import and domestic producer prices across the range of products that the US imports, we find that it is mostly US consumers and/or foreign exporters that are bearing the cost of higher tariffs (77% of products – see Figure 2) as domestic prices have been increasing more than import prices (as seen with coffee, beverages, consumer electronics, apparel, sporting goods, toys and jewelry) or import prices have declined (animal food, sugar, paper, snacks, frozen food and pasta). US importers are absorbing the tariff costs themselves for the remaining 23% of products (breakfast cereals, candies and cookies, dairy products), likely due to strong domestic competition and price-sensitive consumers.

Figure 2: US import prices vs domestic producer prices in August 2025 (y/y %) by product and product category



Sources: BLS, Allianz Research

The extra costs related to tariffs contributed to +0.1pp of additional consumer inflation in the US between March and August 2025. Using pre-March 2025 relationships between import price inflation and consumer prices, we estimate the expected year-to-year change in each product category and compare it with the actual change through August[1]. The difference between the actual and expected price levels is the extra costs consumers paid because of tariff passthrough and other domestic factors. Furniture and related products showed an extra cost of 3.6%; while consumers paid an extra cost between 1.2% and 2.3% for cars, apparel, jewelry and footwear (see Table 1). Even seemingly niche categories like wine saw consumers pay nearly a full percent more than suggested by import prices. However, not all sectors exhibited an extra cost. In some cases, the combination of fierce competition and cost absorption by importers meant that actual price increases undershot predictions. For instance, pharmaceuticals and confectionery products cost less than what would be suggested by import prices inflation. These exceptions underscore that tariff passthrough is uneven: where consumers have abundant domestic alternatives or where pricing power is weak, sellers may swallow some or all of the tariff to preserve market share. Overall, we estimate that these extra costs (whether positive or negative) contributed to about +0.1pp of CPI inflation between March and August 2025.

Table 1: Estimates of the US "domestic premium" by product categories between March and August 2025

Products	Import price implied CPI growth (%)	Actual CPI growth (%)	Extra cost (%)	Impact on CPI (bps)
Furniture	-0.58	2.95	3.6%	3.0
Apparel	-1.52	0.75	2.3%	4.0
Jewelry	4.49	6.40	1.8%	0.5
Footwear	-0.81	0.58	1.4%	1.0
Motor vehicle	-1.46	-0.25	1.2%	5.5
Wines	-2.10	-1.15	1.0%	0.2
Appliances	2.25	2.98	0.7%	0.2
Spirits	1.84	2.23	0.4%	-
Motor vehicle parts	2.66	2.75	0.1%	-
Food manufacturing	1.64	1.48	-0.2%	- 1.3
Audio, video, computers etc.	-0.08	-0.38	-0.3%	- 0.3
Sporting goods	2.56	2.22	-0.3%	- 0.1
Pharmaceuticals	1.26	-0.75	-2.0%	- 3.0
			Total	9.7

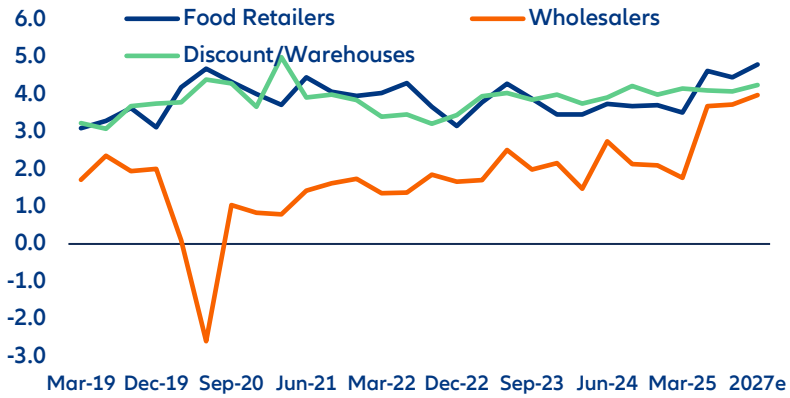
Sources: BLS, Allianz Research

The retail sector shows how higher tariffs can feed corporate profits. Wholesalers' operating margins jumped to 3.7% in Q2 2025, up from 1.8% in Q1, while food retailers' margins rose to 4.6% from 3.5% (see Figure 3). In contrast, discount chains such as Walmart and Costco saw little change in profitability in the past quarter. This suggests that companies not focused on razor thin pricing – or those serving business clients rather than consumers – were better able to pass through higher costs. In effect, parts of the supply chain are banking on the new tariffs to increase costs,

[1] *For each product category (i), we estimate the following regression :* $CPI_{i,t-l} = \alpha + \beta * import\_prices_{i,t-l} + \varepsilon_t$, *with l being the optimal lag for each product category, over the full historical sample up until February 2025. We then compute the expected CPI for each product and compare it with the actual value. This difference indicates extra price pressures from tariffs and other domestic factors (e.g. pricing strategies of domestic firms)* which we call the *"domestic premium".*

a trend some analysts have dubbed "Greedflation 2.0". Wholesalers operate in a less competitive environment and the twin forces of buyers' inelasticity and concentrated market structure will allow them to sustain elevated margins for longer.

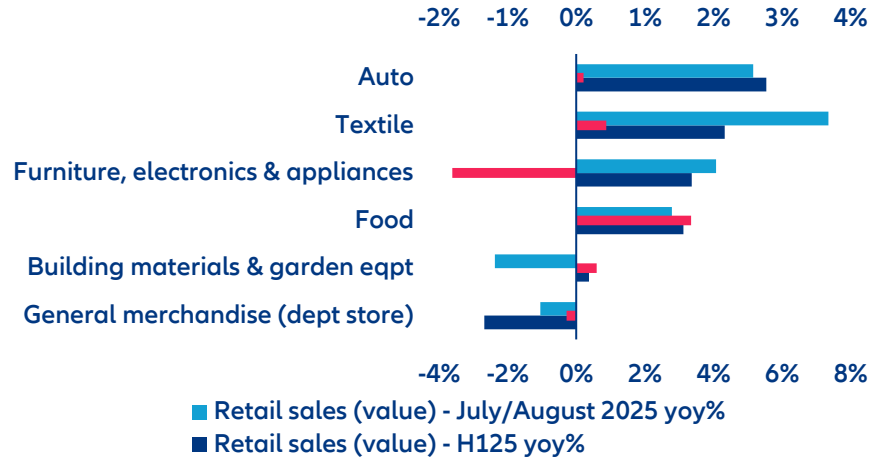
Figure 3: Operating margins (%) in the US distribution ecosystem



Sources: Bloomberg (median value by category), Allianz Research

Overall price moderation allowed US retail to record solid growth in the first half of 2025. Retail sales posted solid growth of +2.5% ytd as of July, thanks largely to higher volumes rather than higher prices. Tariff exemptions, a judicious use of inventories and cost absorption by exporters helped keep inflation at bay. Consumers became more cautious, reflecting a steep drop in confidence – around 15% below last year's peak and 25% below pre-pandemic levels – but steady prices kept them spending. A robust labor market and hopes of a Fed rate cut further bolstered consumption, even as tariffs were temporarily frozen for 90 days before being lifted sharply in early summer. By June the freeze had expired, and price pressures began to reemerge while volumes dipped to a six-month low. In the second half of 2025 the sectors most dependent on imported inputs – automobiles, electronics, furniture and textiles – are likely to lift prices further (see Figure 4). So far, many retailers have maintained margins by trimming overhead costs, leaning on ecommerce and riding on strong volumes. Yet with permanent tariffs of around 19% on goods from major Asian trading partners, the price of many household goods cannot stay flat indefinitely. Electronics companies face rising costs for high performance chips and the integration of AI functions. Early adopters may accept a price jump, but lukewarm consumer enthusiasm suggests that higher tags will dampen demand. Apparel and soft goods present a similar story: Inventory was frontloaded in early 2025 and discounting kept volumes high, but new country-specific tariffs will inevitably feed into clothing prices. The auto sector is also vulnerable: Sales were pulled forward as buyers raced ahead of tariff hikes, meaning a weaker pipeline.

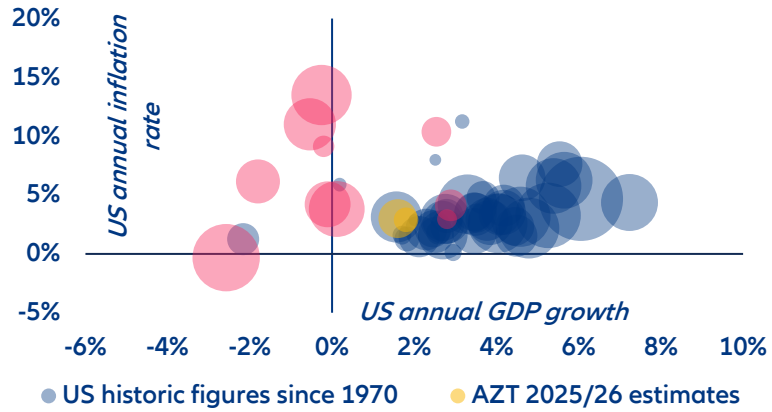
Figure 4: US retail sales value & price deflator



Sources: US Census bureau, Allianz Research

The rotation of supply chains will eventually feed into higher prices and slow down US consumption, leading to +1% to +3% retail volume growth in the second half of the year. US imports from China fell -19% ytd, reducing China's share of US imports to about 9% from 13% a year earlier. Demand for consumer electronics plunged -36.5%, furniture imports were down 25.5% and apparel imports fell 21%. Yet this does not mean American companies reshored production. Instead, they turned to Vietnam, India and Thailand for computers, telephones, apparel and shoes, boosting volumes from those countries by 20% or more. Vietnam overtook China as the biggest footwear supplier, taking 35% of the US market. These shifts show that tariffs do not necessarily reduce dependence on foreign sources, they simply reallocate it and raise costs along the way. Looking ahead, as we expect US growth to slow down just below +2% in 2025 and 2026, consumer price increases to remain modest (i.e. below +3% by 2026) and US rates to remain tight, we forecast retail volumes to grow modestly – by around +1-3% in the second half of 2025 and into 2026 (see Figure 5) – as wage growth and a stable job market support spending even as tariffs push up prices. Effective tariff rates are set to climb, implying additional pressures that will test retailers' ability to absorb costs. Corporate supply chains will continue to diversify within Asia rather than onshore, balancing cost reduction against geopolitical risk. For consumers, that means a slower pace of price increases in some categories and further sticker shock in others. The domestic premium is the hidden tax of the current trade regime.

Figure 5: US annual GDP growth vs inflation rate and retail trade volume annual growth (bubble size)



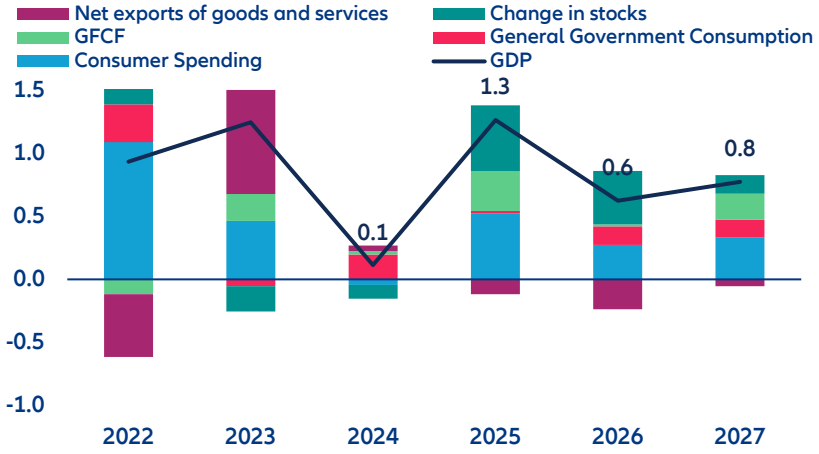
Sources: US BEA, Allianz Research. Red bubble = Retail volume contraction, blue bubble = retail volume expansion.

The Zen Gambit – The Bank of Japan**'s daring game of patience**

Japan is caught in political turmoil: An LDP-Komeito minority government is likely to remain in place, with a new Prime Minister possibly by mid-October. Fiscal policy is likely to retain a more expansionary bias. The ruling coalition (Liberal Democratic Party-Komeito) has suffered major electoral blows over the past year, losing its majority in both the lower house (in October 2024) and the upper house (in July 2025) of the National Diet. Prime Minister Ishiba announced his resignation in early September (after less than a year in tenure). An LDP presidential election will take place on 4 October, with official campaigning starting on 22 September. The official list of candidates is not complete yet, but as of mid-September polls suggest that the frontrunners are Takaichi (considered comparatively more conservative and favoring more fiscal stimulus) and Koizumi (considered comparatively more liberal and promising reforms, currently serving as Minister of Agriculture). After the election, a new Prime Minister and Cabinet should be chosen within a few days. Given significant fragmentation among other parties, the most likely scenario – and probably regardless of who wins the LDP leadership race – is that Japan will continue to be ruled by an LDP-Komeito minority government. This means that cooperation with opposition parties will be essential, and that fiscal policy will likely have a more expansionary bias than under Prime Minister Ishiba, who is known for his stricter stance on fiscal discipline.

The Japanese economy should slow in the coming quarters, following likely above-trend growth in 2025 (+1.3%). We forecast GDP growth to reach +0.6% in 2026 and +0.8% in 2027. The Japanese economy is performing well, with private consumption growing for five consecutive quarters and investment for three quarters in a row, as of Q2 2025. Looking forward, despite resilient domestic demand, we expect weaker external demand to weigh on the economy. The latest data releases suggest that the impact of higher US tariffs may be starting to show, with new export orders in the manufacturing PMI reaching the lowest level in nearly a year and a half in August, overall export volumes likely declining and shipments to the US falling by nearly -14% y/y (the largest decline since early-2021). After likely rising by around +2.5% through 2025, real exports of goods and services is expected to contract in 2026, leading to a negative contribution to overall growth from net exports (see Figure 6), while investment is also expected to soften.

Figure 6: Japan GDP growth (%) and contributions

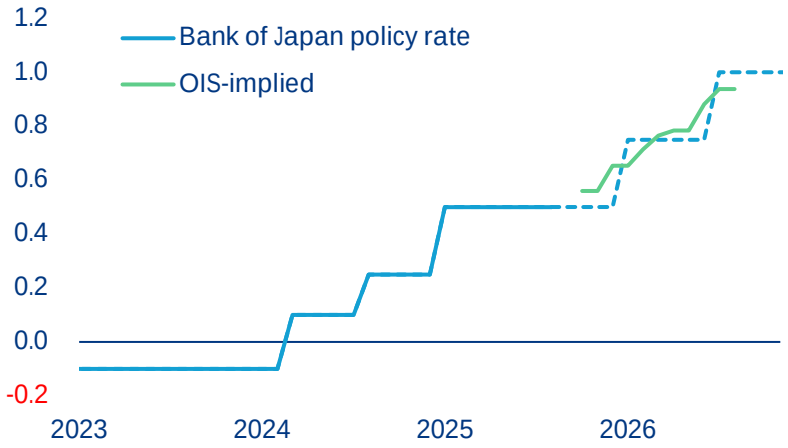


Sources: LSEG Datastream, Allianz Research

In this context, the Bank of Japan is likely **to leave its policy rate unchanged at this week's meeting**, with the next move likely in January 2026 as the central bank cautiously continues its rate-hiking cycle. Since its last monetary policy meeting in July, data have suggested that the US trade war may be starting to weigh on the Japanese economy, while domestic political uncertainty has increased. As a result, the Bank of Japan is likely to leave its policy rate unchanged at this week's monetary policy meeting. That said, the central bank should eventually continue its rate-hiking cycle. Indeed, inflation indicators remain above its 2% target. While headline inflation has been softening this year (from 4% in January to 3% in July) and is likely to return below the central bank's target next year (we expect 1.5% on average in 2026, after 3% in 2025), this is mainly the result of lower energy and food prices. In parallel, core inflation rose from 2.6% in January to 3.4% in July and should remain around 2% on average in 2026. We expect the Bank of Japan's next policy rate hike to come in January 2026, when the

central bank will update its quarterly outlook, having gathered information on next year's wage increase momentum (with companies starting to announce their wage hike stance by the end of the year). All in all, we expect the Bank of Japan policy rate to stay at 0.50% by end-2025 and to increase to 1.00% by end-2026 and 1.50% by end-2027.

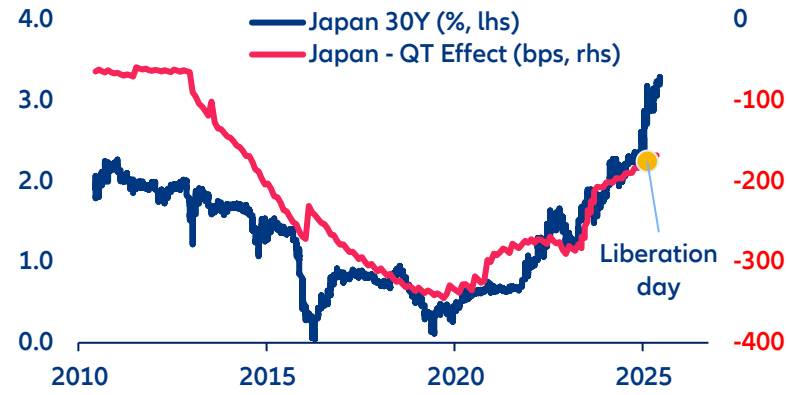
Figure 7: Bank of Japan policy rate (%)



Sources: LSEG Datastream, Bloomberg, Allianz Research

Surging Japanese yields: A product of Quantitative Tightening (QT) and uncertainty. 10y yields on Japanese Government Bonds (JGB) have reached their highest level since 1995 (currently 1.5%), and the 30y is trading at its highest level ever (currently 3.5%). At first the yield increase was driven by a repricing of inflation risk and a rebalancing of supply and demand in a context of Quantitative Tightening (QT). But the "Liberation Day" shock marked the decoupling of JGB long-term yields from the managed QT path (Figure 8). Now they are being driven by the uncertainty about trade and its fiscal and monetary implications. For the coming months, we expect the 10y yield to hover around 1.6% and the 10y30y steepness to return to 120bps since much of the uncertainty is now priced in, inflation expectations have stabilized around 1.5% and the real neutral rate has remained unchanged at around 0%. With regard to QT, we do not expect the BoJ to significantly deviate from the current balance-sheet reduction path of JPY3trn (i.e. -0.3 % of holdings) per month. By reducing its share in the JGB market from the peak of 55% to currently 50%, the BoJ has contributed 40bps to the 240bps rise in 30y JGB yield since 2022, i.e. 15% of the total increase. Over the next two years, we expect the BoJ to reduce its JGB holdings to 47% of the total amount outstanding. QT will thus exert additional upward pressure of around 25bps on the long end of the Japanese yield curve.

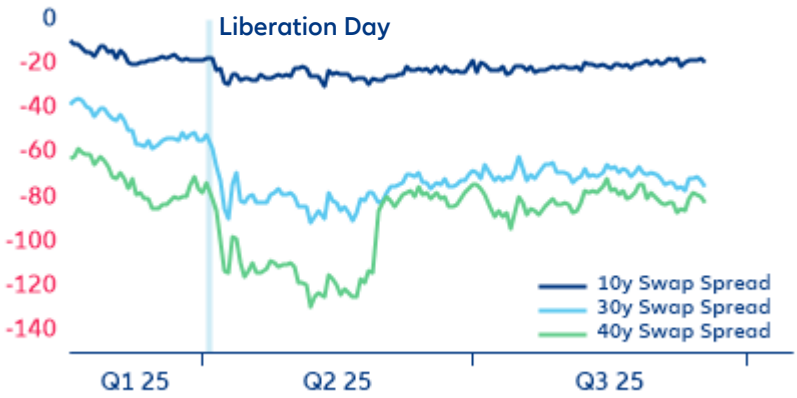
Figure 8: Decoupling from Japanese 30y yields starts with "Liberation Day"



QT effect estimate based on Li and Wei (2013)
Sources: Bank of Japan, LSEG Datastream, Allianz Research

Tolerated steepness: Stealth support for the yen? The dynamics of the recent JGB yield increase, with 30y yields rising by 240bps compared to just 150bps for 10y yields, have resulted in an unprecedented 10y30y steepness of 160bps. Given the BoJ's dominant position in the JGB market (50% of amount outstanding), we do not view this as an unintended outcome or a loss of control. Instead, we interpret it as a development that the central bank is, at a minimum, tolerating to achieve secondary policy objectives. That view is supported by the evolution of swap spreads that have stayed controlled for the 10y tenor while slipping for the tenors above (Figure 9). We see it as a strategy to provide support for the JPY by incentivizing capital inflows (repatriation from insurer and pension funds) to support the exchange rate without requiring the BoJ to intervene directly and expend foreign exchange reserves. Recent auction data for long JGBs (30y+), already showed solid demand with bid-to-cover ratios above 2. After decades of absence, we also expect some inflows from foreign investors into the JGB market as they now obtain currency-hedged yields similar to their home market or even above (i.e. Japan 30y hedged in EUR yields 4.9% versus 3.2% locally).

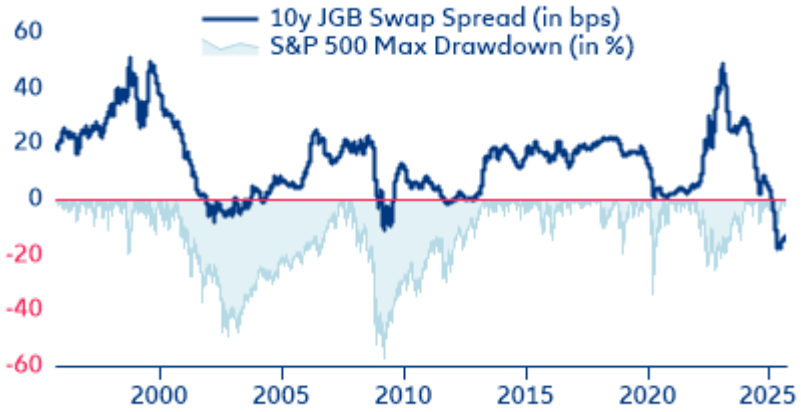
Figure 9: BoJ maintains control on 10y but tolerates decoupling of 30y and above



Sources: LSEG Datastream, Allianz Research

Japan's role as global liquidity provider and suppressor of global volatility is beginning to reverse, raising risks of spillover effects on global markets. The structural change in the JGB market away from a deflationary narrative towards one where risk premia are determinant carries significant implications for global financial stability. For decades, the BoJ's policy of Yield Curve Control (YCC) positioned Japan as a primary source of cheap liquidity, leverage and a structural suppressor of global volatility. This role is now beginning to reverse and Japan is becoming a source of cross-asset volatility. The primary transmission channel involves large-scale repatriation of Japanese-held foreign assets. A sudden shift by Japanese investors out of USD and EUR denominated bonds would exert direct upward pressure on global yields and cause a sharp appreciation of the yen. Such a move could trigger a rapid unwinding of global carry trades, leading to a significant tightening of global liquidity and financial conditions that would negatively impact equity and credit markets worldwide. In the past, tighter JPY funding conditions (as captured by JGB swap spreads) always coincided with significant drawdowns in risky assets (Figure 10).

Figure 10: Tighter JPY funding conditions usually coincide with corrections of risky assets



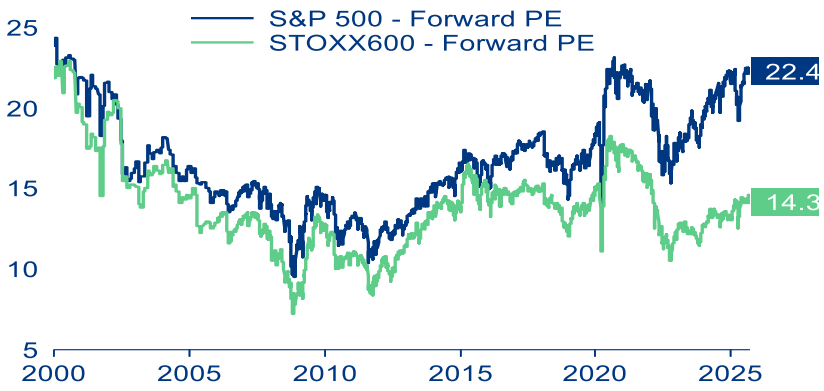
Sources: LSEG Datastream, Allianz Research

The equity market correction this spring can be seen in that context. However, given the tightness of JPY funding (negative swap spread), the drawdown was much milder than in previous episodes. Risky assets might have become more resilient to this liquidity fluctuations (due to their AI exposure and broadening of their investor base to the retail segment) and/or widespread unwind has not yet materialized. However, should Japanese yields rise disorderly (e.g. another 100bps for the 10y maturity) we would still expect a global liquidity squeeze with major market meltdowns. But the JGB market is a managed market and the BoJ will certainty intervene to prevent a systemic crisis and preserve its credibility. The major risk for financial markets is the BoJ's reactivity: its recent history of unpredictable policy adjustments introduces the risk of a miscalculation or a delayed response.

Bubble or boom? Equity markets ride high PEs with PEGs still in check

Global equity markets have surged to record highs, with the US market standing out with particularly elevated valuations. The S&P 500's 12-month forward price-to-earnings ratio (P/E) currently sits around 23, well above its 20-year average of roughly 16. By contrast, Europe's STOXX 600 trades at about 14, broadly in line with its historical norm (Figure 11). From that perspective, US equities appear expensive, prompting concern that the market may be overstretched. These high P/Es, however, do not take into account longer-term expectations of significant earnings growth.

Figure 11: Forward price-to-earnings (P/E) ratios for US and European equities over time

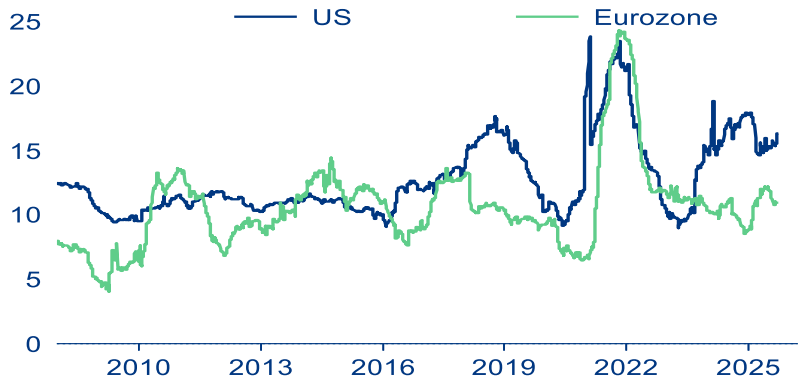


Sources: LSEG Datastream, Allianz Research

The valuation gap is partly explained by differences in earnings expectations. Analysts expect S&P 500 earnings to expand at an average rate of around +15% per year for the next five years, well above Europe's more subdued +10% growth projection (Figure 12). This divergence partly explains the valuation gap between regions. US investors

are pricing in strong future earnings, particularly in the technology sector, where optimism around artificial intelligence and productivity gains has been a major driver. Recent easing of trade tensions and new trade deals have further boosted confidence, supporting higher corporate investment and raising earnings guidance.

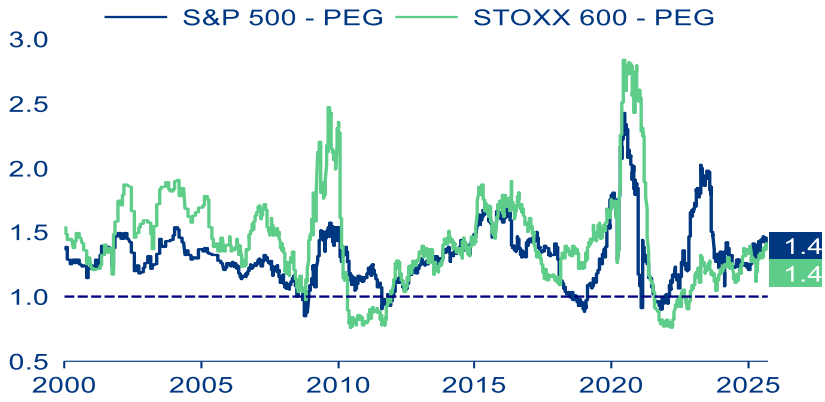
Figure 12: Long-term EPS growth forecast for US and Eurozone



Sources: LSEG Datastream, Allianz Research

Once growth expectations are factored in, US equity valuations appear less extreme. The S&P 500's price-to-earnings-to-growth ratio (PEG), which adjusts for expected earnings expansion, is currently around 1.4x, a level historically consistent with periods of sustainable, albeit optimistic, growth. In other words, high P/Es are, at least partially, justified by strong EPS forecasts in the US. And while headline multiples suggest a stark difference relative to Europe, PEG-adjusted valuations paint a more balanced picture across the Atlantic. Investors are betting that earnings will "grow into" current prices rather than assuming valuations are purely speculative.

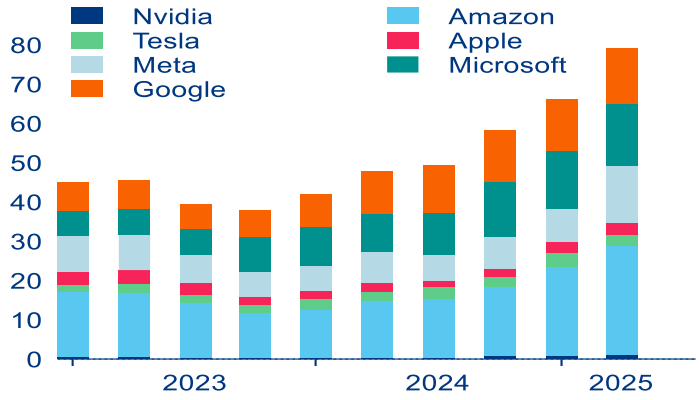
Figure 13: Price-to-earnings growth (PEG) ratios for US and European equities



Sources: LSEG Datastream, Allianz Research

A closer look at the US rally shows how heavily it rests on a handful of mega-cap technology firms, namely the **"Magnificent Seven."** Companies like NVIDIA, Microsoft, Amazon and Alphabet are leading the AI build-out, driving both revenue expectations and market valuations. Their dominance is underpinned by an unprecedented surge in capital expenditure: The Magnificent Seven have deployed roughly USD36bn each on average over the past four quarters, with capex growth accelerating to +70% y/y in Q2 2025 (Figure 14). To put this into perspective, the average quarterly capex for a company in the S&P 500 is only around USD2bn. These investments, concentrated in cloud infrastructure and AI capacity, have not only boosted semiconductor and hardware suppliers but have also lifted power and utility companies tied to the AI infrastructure boom.

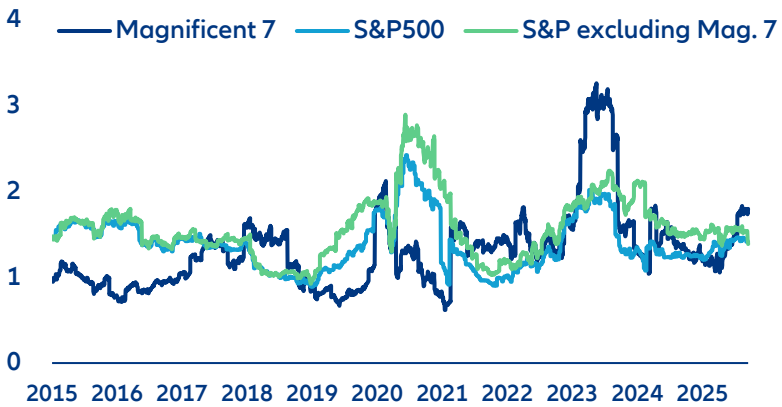
Figure 14: Capital expenditure has increased over the years for the Magnificent Seven



Sources: LSEG Datastream, Allianz Research

Rather a boom than a bubble but risks remain. Performance has been strongest in firms with clear near-term earnings visibility from AI infrastructure (semiconductors, equipment and cloud), while sectors further down the adoption curve – software firms seeking to monetize AI features or companies using AI for productivity – have lagged. This reflects investor caution: while optimism is firmly priced into infrastructure plays, tangible earnings contributions remain scarce among companies seeking to embed AI into their products and services, where results so far have been mixed and uneven. Valuations tell a similar story. The largest US tech stocks trade at forward multiples well above the broader market, though still below the extremes of the dot-com era or 2021 peak. Yet, expectations for sustained strong spending have been repeatedly revised higher, raising questions about how long such momentum can be maintained. A sharp slowdown in capex growth, should it materialize, could ripple across both tech and adjacent sectors, trimming earnings projections and testing current multiples. Against this backdrop, PEG ratios underline the gap between the Magnificent Seven and the rest of the market (Figure 15). This concentration leaves markets exposed to any slowdown in their spending or shortfall in earnings delivery. In this context, today's US market looks less like a bubble and more like a boom underpinned by fundamentals, albeit one that is fragile and critically dependent on the durability of the AI trade.

Figure 15: PEG Ratios in the US: Magnificent Seven vs. broader market



Sources: LSEG Datastream, Allianz Research

These assessments are, as always, subject to the disclaimer provided below.

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The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.

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