



Economic Outlook 2025-27: 10 Top-of-Mind Questions, Answered

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Executive Summary

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1. Who truly bears the cost of the ongoing trade war? Primarily exporters for now, but US consumers will also be hit through higher inflation (up by 0.6pp by mid-2026). While global trade routes have shifted, allowing exporters to mitigate the impact, downside risks remain high as sectorial investigations are ongoing and the trade deal with China is still pending. Export losses could in theory range from -0.3% of GDP (EU) to -1.3% of GDP (Vietnam) compared to a pre-trade war scenario. The cost for the US is estimated at -0.3%. FDI pledges in the US, if realized, would amount to 6% of US GDP by 2026-2028, and look very costly for source countries. Overall, growth in global trade of goods and services is expected to slow down to +0.6% in 2026 from +2% in 2025 in volume terms.

2. Has stagflation transitioned from a looming risk to an undeniable reality? Yes, but it is stagflation light for now. Inflation remains above target in many advanced economies – such as the UK, US and Japan – while growth stays lackluster. This combination marks a mild stagflationary phase by historic standards. For most economies, we expect inflation to gradually return toward the 2% target by 2027. While the UK currently stands out with particularly high inflation, the US is likely to see the most prolonged overshoot. A mix of tariffs, continued fiscal stimulus and immigration-driven labor shortages is keeping the US economy mildly overheated and price pressures elevated.

3. Can central banks untangle their complex dilemmas? Central banks in developed markets are navigating a threefold challenge: weak growth, lingering inflation and rising fiscal deficits that are pushing up long-term yields and intensifying focus on global quantitative tightening (QT). We expect the Fed to deliver just three more rate cuts by mid-2026, reaching a terminal rate of 3.25–3.50%, notably above current market pricing. The ECB is done cutting, while the BoE is likely to ease further, lowering rates to 3.0% by 2027 – below current market pricing – as inflation will decline and the economy needs less monetary restrictiveness. In contrast, the BoJ will move in the opposite direction, continuing to hike toward a 1.0% terminal rate, with core inflation still too high to ignore. QT will continue at the ECB, BoE and BoJ – provided bond markets remain orderly. The Fed, however, is largely done with its balance sheet reduction, taking some pressure off longer-term yields.

4. Is the USD's dominance facing a new era of uncertainty? Yes – but don't write it off yet. Despite the strong de-dollarization narrative, most of the year-to-date weakness in EUR/USD reflects markets pricing in a more dovish Fed relative to the ECB, driven by signs of economic softness in the US rather than doubts about Fed independence. Long-term inflation expectations remain well anchored and near-term price pressures have eased more than expected. However, around a third of the dollar's decline can indeed be linked to post-“Liberation Day” de-dollarization, primarily via increased FX hedging rather than outright capital outflows. Crucially, the US continues to attract strong

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foreign investment. Looking ahead, we expect EUR/USD to remain broadly stable as the mild ongoing de-dollarization is likely to be offset by a more hawkish Fed. However, risks are skewed to a weaker USD: political developments – such as more direct interference in monetary policy or renewed “Mar-a-Lago Accord” proposals – could accelerate de-dollarization beyond our baseline.

5. How far can fiscal dominance propel long-term interest rates? Truss-style moments globally cannot be excluded but central bank “puts” remain in place. Rising net bond supply amid high fiscal deficits have pushed long-term yields higher, with UK 30-year yields, for example, hitting their highest levels since the 1990s. Politics will determine the path in France and the US. But central banks remain key players in the game. The pace of quantitative tightening is adding supply on a scale comparable to fiscal deficits in many markets. If needed, they can slow QT – or even restart QE – to stabilize markets.

6. Will the EU finally ramp up defense spending in 2026-27? The EU’s “Rearm Europe Plan” allocates EUR800bn over four years, including EUR150bn for military procurement. However, despite substantial funding, Europe faces hurdles in rapidly boosting military capacities due to production constraints, as defense firms have a record backlog (~ EUR350bn) and do not seem likely to increase their capex (~5%). Additionally, low intra-European cooperation and a focus on domestic procurement may hinder long-term projects like the France-German fighter jet initiative. Europe’s attempt to reduce reliance on US military imports will be challenged by geopolitical developments in Ukraine and the US-EU trade deal. Consequently, a moderate spending increase of +10-20% until 2027, reaching a defense spending share of 2.3-2.5% of GDP, seems more realistic. This would translate to an impact of around +0.2pp on European GDP growth by then.

7. How are firms navigating the challenge of persistently high financing costs? Despite lower policy rates, corporate demand for loans remains muted in the Eurozone. In the US, corporate loans are picking up despite tighter credit standards. Firms are navigating the challenge of persistently high financing costs by implementing strategic adjustments such as enhancing operational efficiency, renegotiating supplier contracts and investing in automation to reduce expenses. Many large companies are extending debt maturities, deleveraging or raising capital on bond markets where yields are still benign to minimize interest burdens, while also exploring alternative financing sources like private credit or strategic partnerships due to tight/expensive traditional bank lending. The peak in global business insolvencies is expected only in 2027: we expect an increase of +6% and +4% in 2025 and 2026, respectively, before a limited decrease thereafter.

8. Is a capital market bubble on the horizon? No, but the AI boom looks fully priced in, leaving limited near-term upside. While equity markets, especially in the US, trade at high price-earnings valuations, strong long-term earnings growth – projected at 15% annually, compared with 10% in Europe – keeps price-to-earnings-to-growth ratios (PEG) in check. Still, the rally is narrowly concentrated in a few mega-cap tech firms, making the market highly dependent on the delivery of AI expectations.

9. Which emerging markets are grappling with rising imbalances? EMs overall are still in an expansionary cycle, in part thanks to supportive external demand until now. Asian exporters have gained market shares in the US, with Taiwan, Vietnam, Thailand and Indonesia even retaining spare manufacturing capacity. As the economic outlook turns grimmer, with contained inflation and a lower USD, most EM central banks have accelerated policy rate cuts, and the cycle should slow down by mid-2026. More than half of EMs are also easing fiscal policies. Markets do not seem concerned at this stage, but valuation is a growing concern, and some require close monitoring (e.g. Argentina, Brazil, Egypt, Indonesia). Most of Latam and CEE (and some in Southeast Asia and Africa) would also be vulnerable to a risk-off shift, being net debtors with current account deficits. The Chinese economy will slow into 2026, given likely contracting exports and still soft domestic demand. One of the challenges is to restore private confidence and contain deflationary pressures – further policy support will likely be delivered by Q1 2026.

10. What events could steer us towards a downside scenario? Heightened protectionism, with a 45% probability, may lead to a global trade recession driven by US tariff escalations, negatively affecting growth and inflation, while pressuring developed market interest rates and equities. Meanwhile, a de-dollarization policy shock, with a 35% probability, could push the EURUSD above 1.25. A sovereign debt crisis, with a 20% probability, might arise from high debt levels and interest rates, constraining fiscal policies in France, Italy, the UK and the US. Geopolitical tensions could rise further, with a NATO-Russia conflict, an escalation in the Middle East and open conflict between China and Taiwan as potential risks. As upside risks, we see a Ukraine-Russia ceasefire boosting growth and European industrials, and US exceptionalism driving economic expansion through AI advancements and the success of Trumponomics, which would lead to increased growth and positive impacts on DM equities.



1 Who truly bears the cost of the ongoing trade war?

The cost of the US trade war is primarily being borne by exporters for now, but the US economy itself is also expected to be hit into 2026. While global trade routes have shifted, allowing exporters to mitigate the impact, downside risks remain high as sectorial investigations are ongoing and the trade deal with China is still pending. Vietnam, Canada and Mexico could in theory see their 2026 GDP growth hit by -0.4pp to -1.3pp due to the latest tariff hikes announced by the US. The cost for the US is estimated at -0.4pp. FDI pledges in the US amount to 6% of US GDP by 2026-2028 and look very costly for source countries. Despite rerouting and diversification efforts, such as through India and Vietnam, and moderating prices by Chinese exporters, the contribution of tariffs to US inflation is expected to rise and reach +0.6pp by mid-2026. Companies will continue to pursue mitigation strategies to avoid a further profitability squeeze: only a third of global sectors may see improved turnover growth by 2026.

Global trade of goods and services is expected to slow down to +0.6% in 2026, from +2% in 2025 in volume terms as the trade war impact is delayed. We have revised up our 2025 forecast by +1pp. Global exporters were first movers as US imports increased by +7% during H1 2025 compared to the previous year. This frontloading of shipments turned out larger and lasted for longer than previously expected, contributing to +0.4pp of the upwards revision in global trade growth in 2025. Rerouting and trade diversification have also played a central role in reducing the impact of the trade war so far as exporters found new routes to enter the US market at lower tariff

rates, notably via Vietnam and other Southeast Asian countries, as well as Mexico. Such rerouting meant that the effective US tariff rate reached 10% in July, lower than the theoretical 13%. However, the rate is expected to increase to 14% by year-end, given limited room for further diversification and higher tariffs kicking in. Finally, the AI investment boom experienced in 2025 is also keeping global trade higher than previously expected, contributing a +0.2pp to our upwards revision in the 2025 global trade growth forecast. However, our forecast for 2026 has been revised to the downside to +0.6% (from +0.9% previously), accounting for the delayed impact of the trade war. In 2027, we forecast a very mild rebound to +1.8%.

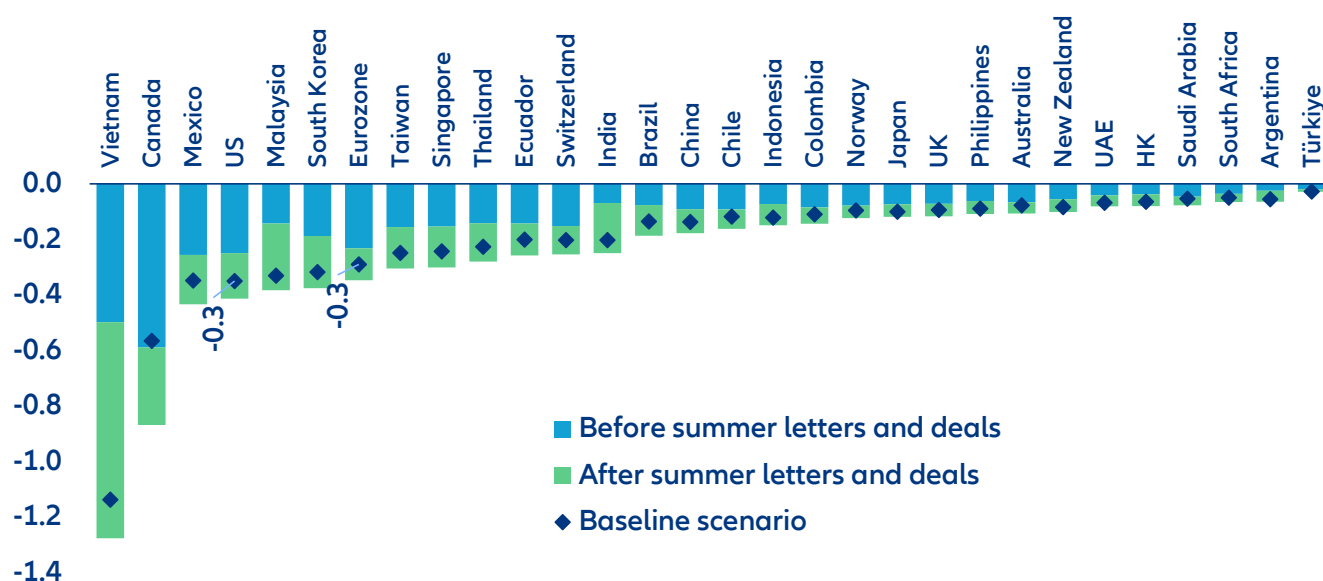
The latest Section 232 investigations resulted in higher tariffs on robotics, industrial machines, medical equipment and some wood-based furniture, affecting sectors across countries such as Costa Rica or Mexico. Mexico's truck sector and Canada's commodities such as minerals and lumber could be particularly hit if ongoing Section 232 investigations result in higher tariffs. That said, tariffs on these sectors will also be highly painful to US consumers due to the high import dependence. Switzerland could face the largest export losses in Europe relative to GDP (-1.4%), mainly due to the exposure of its pharmaceutical sector to the US, followed by South Korea, Taiwan (semiconductors) and South Africa (minerals).

With most tariff announcements behind us, the level of uncertainty has reduced, but upcoming court decisions could ramp it up again. The US Supreme Court is scheduled to start hearings on the Administration's use of International Emergency Economic Power Act to impose bilateral tariffs in November 2025. A negative ruling could bring the effective tariff rate down to 7% from the current 17%. However, even in that scenario, the US Administration would still be able to use Section 232 investigations to increase sectorial tariffs, as well as Section 122 of the 1974 Trade Act to impose tariffs for 155 days without investigation against countries with significant balance-of-payment deficits.

We estimate that in about 77 % of imported goods, tariffs are absorbed downstream by export-side margin compression or passed through to US consumers, while only 23 % of products see importers (i.e. US firms) directly absorbing the tariff cost¹. Sectors especially affected include furniture, where consumers are estimated to be paying about +3.6% extra, automobiles, apparel, footwear and jewelry, which see tariff pass-through in the 1.2–2.3% range. Meanwhile, retailers and wholesalers appear to be maintaining margins, particularly those not engaged in razor-thin price competition, suggesting they are not absorbing much of the tariff burden. On the supply side, electronics and tech have seen US import prices decline, indicating some exporters are compressing margins and moderating prices to remain competitive. Overall, the cost of the trade war is borne unevenly: household goods, autos, apparel, furniture and other consumer imports see the heaviest pass-through to US buyers, while foreign exporters tend to sacrifice margin to stay in the US market in segments like electronics or computers.

US trade partners are also asked to pay in the form of investment pledges – though if they will actually follow through remains to be seen. Tariffs have increasingly been used as a bargaining chip: by threatening very high duties, the US administration creates room for negotiation, lowering rates only in exchange for large investment pledges and other concessions. The EU pledged around USD600bn in investments, with tariffs on its exports reduced from the initially threatened 30% to 15%. Japan committed USD1trn, while the UK, South Korea, Saudi Arabia, the UAE and Qatar followed suit with pledges ranging from USD205bn to USD1.4trn. If fully realized, FDI inflows into the US could accelerate from around USD160bn in 2024 to roughly USD1.5trn annually by 2026–2028 – rising from 0.7% to 6% of US GDP. For the pledging economies, such diversion could imply significant opportunity costs as capital deployed abroad might otherwise have supported domestic priorities. In fact, the burden of diverting capital may prove more damaging in the longer term than tariffs themselves as it interferes with structural change. In particular, if EU investments in the US nearly double between 2026 and 2028 as a result of trade deal commitments, the additional capital outflows, relative to EU GDP, could reduce EU GDP growth by between -0.1pp and -0.3pp. This would come on top of the estimated -0.3pp annual reduction in GDP growth due to tariffs. However, the credibility of the pledges, particularly for Europe, may be questioned. A surge of FDI to such levels would have major implications for the US economy, yet none of this is currently priced in by investors. Framed more as political promises than binding contracts, the commitments are treated largely as only signals.

Figure 1: Impact from US tariff hikes on 2026 GDP growth (pp)



Sources: CPB, Allianz Research

¹See our previous research : [What to Watch | 18 September 2025](#)



2 Has stagflation transitioned from a looming risk to an undeniable reality?

Stagflation concerns are materializing as global GDP is expected to grow at +2.7% in 2025 and +2.5% in 2026, with inflation remaining elevated at 3.9% and 3.5%, respectively. Despite the ongoing trade war, the current outlook is less stagflationary compared to 2022, when the Ukraine war shock significantly impacted global economies. This resilience is largely driven by the services sector, which is cushioning the impact of the ongoing trade war that is predominantly affecting manufacturing. Major economies are experiencing their lowest growth levels since 2008, excluding recession periods (2008 and 2020). The trade war is anticipated to have a larger negative impact on growth through 2026 due to delayed tariff implementations, frontloading and rerouting. The US economy is projected to grow by +1.8% in 2025 and +1.6% in 2026, among the lowest growth rates since the start of the century, and below its potential. The Eurozone is expected to see a further deceleration in growth to +0.9% in 2026, down from +1.2% in 2025. Meanwhile, China's growth is projected to slowdown from +4.8% in 2025 to

+4.2% in 2026. In contrast, countries in Central and Eastern Europe, Latin America and Africa are either maintaining or accelerating their growth rates during this period.

Above-target inflation is expected to persist in the US and the UK, contrasting with normalization in the Eurozone. In both the US and the UK, central banks have not achieved their 2% target since February 2021 and July 2021, respectively (except a brief dip below 2% in September 2024 in the UK). Against this backdrop, there are signs that the private sector is increasingly skeptical about the ability – or the commitment – of the Fed and the BoE to deliver on their inflation targets. Some measures of households and corporates' medium-term inflation expectations have drifted up, increasing the risk of a sustained wage-price loop as the private sector changes its price- and wage-setting behavior. In this environment, we expect UK inflation to remain above 3% through the spring of 2026, before starting to soften thanks to tight macro policy and a re-focus of the BoE on its inflation-

fighting credentials. We see UK inflation settling around target by the spring of 2027. However, in the US, we expect persistently above-target inflation through 2027. Elevated tariffs are expected to increasingly pass through to consumer prices through 2026. Meanwhile, an erosion of perceived Fed independence is likely to lead to persistently higher inflation expectations, challenging the return to actual inflation to 2% within the forecasting horizon in 2027. We forecast US CPI inflation around 2.8-3.0% on average in 2026-27. In contrast, in the Eurozone, inflation has been hovering around the ECB's 2% target since Q2 2025. Against the backdrop of moderate growth but a resilient labor market, we expect inflation to settle around this level going forward, with a slight undershoot expected in 2026.

Consumption remains weak in most regions. Persistent uncertainty and a slowdown of wages will limit a consumer-driven acceleration of growth. Consumer confidence has been persistently weak in most western economies for the last two to three years. Households have yet to swallow elevated mortgage rates and high prices compared to the pre-pandemic norm. In this environment, European households have accumulated large savings buffers, with no signs that they are starting to normalize their saving behavior just yet, despite elevated real wage growth in economies such as Germany and the UK. Lower interest rates on savings accounts and fading uncertainty should support consumption growth a bit from 2026, but we expect the recovery to be underwhelming. High asset market valuations provide an incentive to continue saving rather than consuming. Meanwhile, we expect real wage growth to decelerate amid loosening labor markets. In the US, we expect flat real wages in 2026 on the back of high, tariff-related inflation. In all, we expect US consumption to soften but European consumption to accelerate in core countries such as Germany and France. However, political uncertainty, especially in France, is a key downside risk to consumption in 2026.

The US economy is expected to tread water in 2026, caught between mounting headwinds from tariffs and tight immigration policy versus growing strength of AI-related investment. We expect US GDP to grow +1.8% this year, +1.6% in 2026 and +1.8% in 2027. Policy uncertainty and tariff hikes have so far dampened non-AI related business investment. However, AI-related investment (data centers, software, hardware) has been surging,

cushioning the headwinds on the economy. Meanwhile, consumer spending has been resilient this year despite weak consumer confidence, albeit driven by high-income households, which have benefitted from strong wealth increases. As we head into 2026, we expect sequential US GDP growth to soften. Tight immigration policy is increasingly limiting labor supply, while elevated tariffs will start to be increasingly passed on to consumer prices, weighing on households' consumption. Persistently high mortgage rates and elevated tariff-related input costs will continue to pressure the construction sector. Nevertheless, our we expect the US economy to avoid a recession. Macro policy support – through lower Fed policy rates and the unleashing of fiscal stimulus via the One Big Beautiful Bill – will provide important cushions to domestic demand. Meanwhile, AI-related investment should remain dynamic.

UK growth surprised to the upside in 2025, but macro policy should turn increasingly restrictive in 2026, weighing on growth. We now expect growth at a solid pace of +1.4% this year (+0.5pp from our previous economic outlook). Business private investment has been running at a hot pace. Meanwhile, residential investment is strengthening a bit, though the recovery has remained soft so far. Good growth momentum is partially driven by the government and the central bank. Elevated real wage growth – partly supported by government initiatives (national living wage and public servants' wage hikes) – has been supported consumer spending. Meanwhile, public investment is showing signs of strengthening as government funds are being pulled. Finally, declining short-term real interest rates have supported a sharp acceleration in corporate lending, thanks to the BoE's dovishness. In 2026, with the BoE expected to turn more hawkish, real short-term rates should rise. Furthermore, fiscal policy will turn increasingly tight. We expect growth to slow to +0.9%.

Eurozone growth to reaccelerate in 2026, but risks remain tilted to the downside. Eurozone GDP rose by just +0.1% in Q2, in line with our expectations, as the boost from Q1 export frontloading to the US ahead of tariffs has fully unwound. Net exports were a drag in Q2 and are likely to remain a headwind in Q3, with tariffs still substantial despite the trade deal, and the euro strong against both the dollar and the yuan. Looking ahead, we expect growth to reaccelerate in 2026, supported by a gradual pick-up in domestic demand – especially in

Germany, where fiscal stimulus should finally begin to take effect. However, risks to the outlook remain skewed to the downside. Leading indicators show subdued growth for the next two quarters, prolonging the period of a negative output gap in the region.

Germany faces its third consecutive year of economic stagnation, with GDP growth forecast at just +0.1% in 2025 and only modest recoveries of +1.0% in 2026 and +1.4% in 2027. As a resource-scarce, export-driven economy, Germany remains vulnerable to global fragmentation and rising international competition, particularly from China. Structural challenges such as demographic pressures, labor market inefficiencies and pension sustainability continue to weigh on long-term growth. Inflation currently hovers around target but is expected to rise from end-2026 as fiscal stimulus measures, like the EUR500bn infrastructure fund and defense spending increases, gradually take effect. Despite the announcement of an Autumn of Reforms, many initiatives lack urgency, scale or clarity, and red tape continues to delay key measures. Most recently, business confidence has again deteriorated, with declining orders and weakening employment data. While investment incentives and tax reforms show some promise, Germany still lacks the bold, coordinated strategy needed to restore competitiveness and avoid being trapped in a prolonged phase of underperformance.

France's economy is expected to accelerate slightly in 2026, thanks a recovery of the credit cycle, but political instability represents a key downside risk. The ECB's past monetary easing will increasingly support domestic demand heading into 2026, with the recovery in the financial cycle increasingly visible. Fading trade uncertainties and a pick-up in German growth will also help to bolster the recovery. Residential investment will accelerate, though the recovery for new construction is expected to be soft amid the phasing out of flagship public subsidies. Consumer spending, which has been very weak in 2025, is expected to strengthen. Against this backdrop, persistent political uncertainty and a limited decline in long-term interest rates should cap the growth rebound, from +0.7% expected in 2025 to +1.0% in 2026 and +1.1% in 2027.

In Italy, we expect GDP to expand by +0.5% in 2025, followed by a timid rebound to +0.7% in 2026 and +0.9% in 2027. The reversal of tariff frontloading caused the economy to contract by -0.1% q/q in Q2 2025, as weak net trade offset modest domestic resilience. Consumption remained subdued despite gradually easing financial conditions, though household purchasing power and lower interest rates should provide support ahead. Investment rose by +1.0% and is expected to strengthen further as Next Generation EU (NGEU) funds are deployed, although spending delays continue to limit their impact, with less than one year left to meet requirements and submit payment requests. The better fiscal outturn in 2024 does not eliminate the public finance challenges ahead. While higher revenues provide some support to the outlook, normalizing employment (and thus direct tax revenues) and fading one-off measures, together with additional spending targets (i.e. defense) will further strain the budget. We expect the deficit to drop below the 3% target only by 2027, with debt remaining near 135% of GDP and interest costs to stay elevated around 3.7% despite declining policy rates.

Spain's economy continues to outperform the Eurozone, thanks to its services-oriented structure and limited exposure to US trade. Private consumption and investment, which lagged early in the post-pandemic rebound, have regained momentum. Household spending is expected to remain supported by real income gains, while investment should benefit from lower interest rates and the rollout of NGEU funds. Reflecting this stronger-than-expected performance, we have revised our 2025 growth forecast to +2.6% (up from +2.2% in July). Looking ahead, growth is expected to slow gradually due to global trade tensions, domestic structural challenges and cautious consumer and business sentiment, with activity projected to expand by +1.9% in 2026 and +1.8% in 2027. However, Spain's exports remain heavily reliant on tourism, which has performed strongly in recent years, with revenues reaching a record EUR120bn last year. Immigration has also become a key driver of job creation as the inflow of foreign workers helps offset demographic challenges. However, slower net immigration and an ageing population are expected to weigh on labor force growth, potentially constraining long-term economic expansion.

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 already be starting to show. After likely rising by around +2.5% through 2025, real exports of goods and services are expected to contract in 2026, leading to a negative contribution to overall growth from net exports, while investment is also expected to soften.

Table 1: Real GDP growth forecasts, %

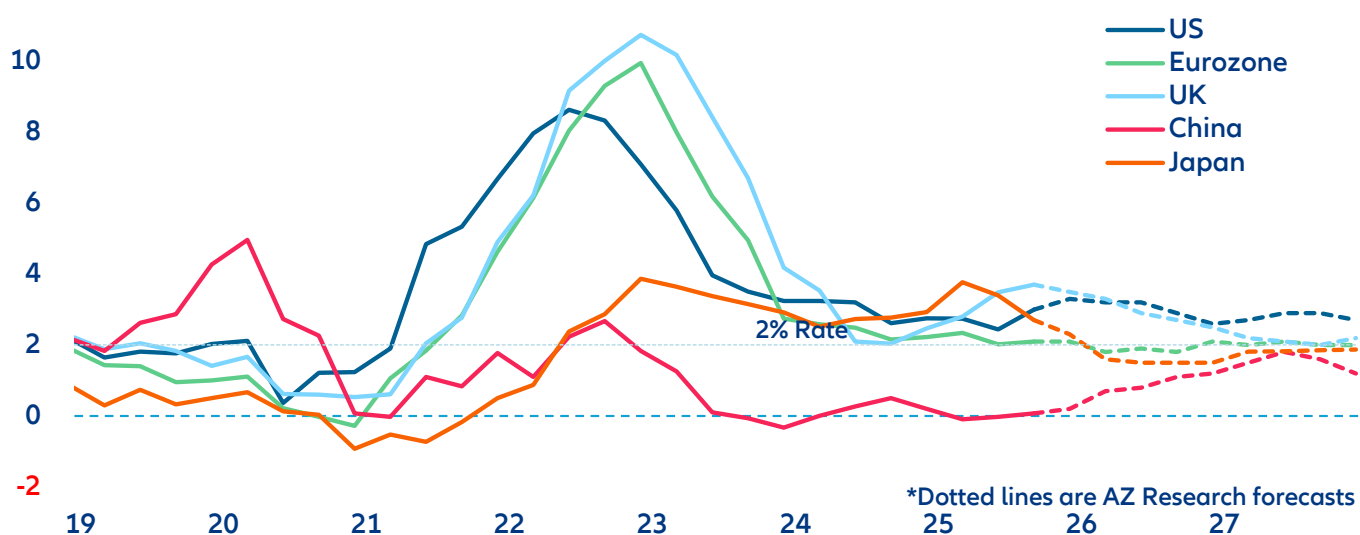
Growth (yearly %)	2023	2024	2025f	2026f	2027f
Global	2.9	2.9	2.7	2.5	2.8
USA	2.9	2.8	1.8	1.6	1.8
Latin America	2.1	1.8	2.2	2.3	2.6
Brazil	3.2	3.0	2.3	2.2	2.2
UK	0.4	1.1	1.4	0.9	1.2
Eurozone	0.5	0.8	1.2	0.9	1.4
Germany	-0.7	-0.5	0.1	1.0	1.4
France	1.6	1.1	0.7	1.0	1.1
Italy	0.8	0.7	0.5	0.7	0.9
Spain	2.7	3.2	2.6	1.9	1.8
Central and Eastern Europe	1.4	2.2	2.4	2.7	2.9
Poland	0.1	2.9	3.3	3.4	2.9
Russia	4.1	4.3	1.5	2.0	2.0
Türkiye	5.1	3.3	2.6	3.0	4.0
Asia-Pacific	4.5	4.1	4.2	3.7	3.9
China	5.4	5.0	4.8	4.2	4.3
Japan	1.2	0.1	1.3	0.6	0.8
India	8.8	6.7	6.6	6.2	6.2
Middle East	1.8	1.9	2.1	3.0	3.3
Saudi Arabia	0.5	2.0	3.1	3.7	4.4
Africa	2.7	3.4	3.6	3.6	3.8
South Africa	0.8	0.5	1.5	1.8	1.5

Sources: national, Allianz Research

Table 2: Inflation forecasts, yearly, %

Inflation (yearly %)	2023	2024	2025f	2026f	2027f
Global	6.1	4.5	3.9	3.5	3.1
USA	4.1	3.0	2.9	3.0	2.8
Latin America	14.8	16.6	8.2	6.3	5.5
Brazil	4.6	4.4	5.3	4.3	3.0
UK	7.3	2.5	3.4	2.9	2.1
Eurozone	5.4	2.4	2.1	1.9	2.0
Germany	6.0	2.3	2.1	1.9	2.2
France	4.9	2.0	1.0	1.5	1.7
Italy	5.6	1.0	1.7	1.8	2.0
Spain	3.5	2.8	2.5	1.9	2.1
Central and Eastern Europe	11.0	3.9	5.0	3.9	3.2
Poland	11.4	3.8	4.0	3.1	3.2
Russia	5.9	8.4	9.5	8.0	6.5
Türkiye	53.9	58.5	32.4	18.8	14.3
Asia-Pacific	3.0	2.1	1.3	1.9	2.2
China	0.2	0.2	0.0	1.0	1.5
Japan	3.3	2.7	3.0	1.5	1.8
India	5.7	5.0	2.7	4.2	4.4
Middle East	16.4	10.6	17.2	12.7	9.2
Saudi Arabia	2.3	1.7	2.2	2.6	2.2
Africa	17.0	15.1	11.6	9.4	7.6
South Africa	5.9	4.4	3.1	4.0	4.1

Sources: national, Allianz Research

Figure 2: Inflation forecasts, quarterly yoy %

Sources: CPB, Allianz Research



3 Can central banks untangle their complex dilemmas?

Central banks on both sides of the Atlantic are navigating a complex labor market that shows signs of both easing and sustained pressures. Employment growth has plateaued in recent months, indicating that the post-pandemic surge in hiring is stabilizing. This softening may gradually reduce labor market tightness, potentially easing some upward pressure on wages and inflation. Yet nominal wage growth remains elevated, posing a challenging policy dilemma. In the US, the labor market is softening due to both weaker demand for workers and constraints on labor supply as immigration slows sharply amid intensified enforcement of border controls. Vacancy and layoff rates remain relatively stable, while the unemployment rate ticked up only slightly, reflecting modest slack in the labor market. In the Eurozone, unemployment remained near record lows at 6.2% in July 2025, though employment growth slowed to +0.1% q/q in Q2 2025. Slower economic growth and prolonged uncertainty have made firms more cautious in hiring. Employment expectations have stabilized, but national trends vary: Germany and France show signs of a labor recovery, while Spain and Italy indicate a normalization of employment gains. Overall, easing labor market pressures are expected to help services inflation moderate in the coming months as forward-looking indicators and business

surveys suggest wage inflation is gradually slowing.

The Federal Reserve (Fed) is expected to deliver an additional 75bps of interest rate cuts by June 2026 as it navigates a softening economy and persistently above target inflation. The Fed has recently placed more emphasis on weak payroll numbers, justifying the 25 September rate cut despite inflation slowly picking up. In the short term, we think labor market concerns will remain at the top of the list for the Fed, consistent with our view that payroll gains will remain subdued. We expect another 25bps cut in October. However, we also expect inflation to firm up further as tariffs are increasingly passed through while the unemployment rate should not increase by much amid increasing pressure on labor supply as the administration continues to tighten the screw on immigration inflows. In this environment, the Fed will have to move more cautiously from the winter as inflation concerns re-surface. Overall, though, we expect the Fed to continue cutting rates to cushion the labor market slowdown in H1 2026, by 50bps. Therefore, we continue to look at a terminal Fed funds rate at 3.5% (upper bound) by June 2026, unchanged from our long-standing view. This is higher than the market view. However, since we have pushed up our 2026 inflation forecast, real US policy rates

will be lower, though still positive. With more upside than downside risks to GDP growth in 2026 in our view, the Fed could also be forced to backtrack or even stop its cutting cycle prematurely.

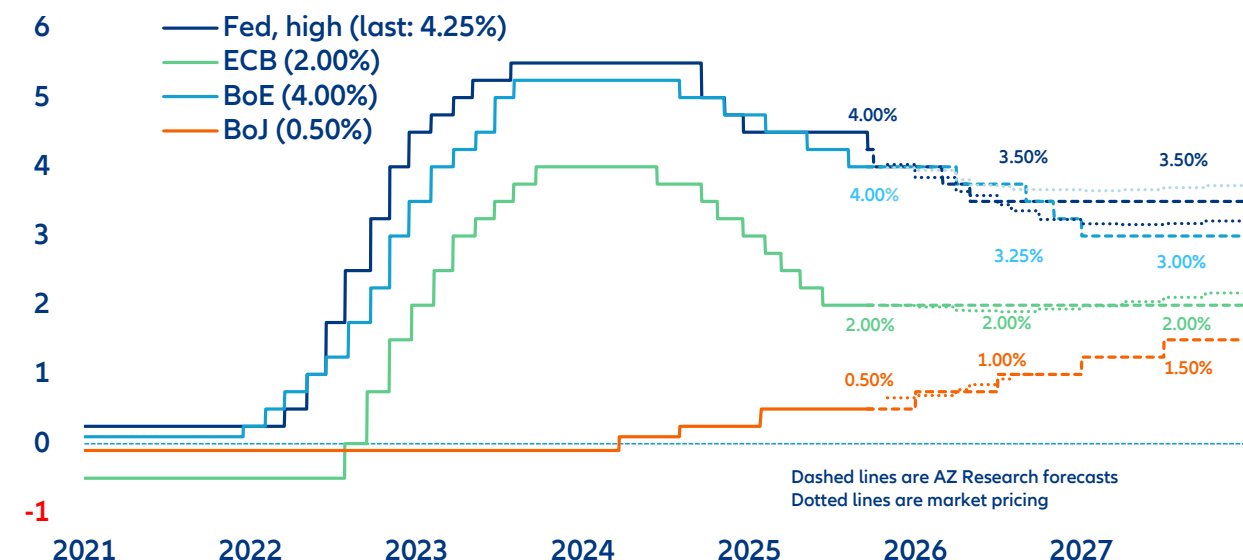
The ECB is expected to keep policy rates unchanged for the entire forecast horizon, maintaining the deposit rate at 2.0%, with risks tilted to the downside. Inflation is now at target, trade war uncertainty has eased and growth is set to rebound in 2026, supported by fiscal stimulus from Germany. We still see economic justification for modest additional easing as the output gap remains negative amid sluggish near-term growth and inflation will slightly undershoot in the next quarters. However, the ECB's tone has turned markedly more hawkish this year. The clear message: absent a major shock (which is not our baseline forecast), policy rates will remain unchanged. Yet, downside risks persist. Financing costs are rising amid elevated fiscal deficits, and political and economic fragility – particularly in core countries like France – is high. If long-end bond yields rise further, the ECB may need to reconsider the current pace of quantitative tightening, which is running at EUR48bn per month – equivalent to an additional annual government bond supply of 3.2% of GDP. At the same time, the ECB appears committed to further reducing its bond holdings, with EUR3.9trn still on the books under the APP and PEPP program, roughly 25% of Eurozone GDP, compared to just 11% at the Fed.

With inflation showing no sign of cooling down, we expect the Bank of England (BoE) to go into a prolonged pause. We think that persistently high inflation, combined with growth surprising on the upside, 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 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. On the balance sheet policy, we expect the BoE to stick to its recently scaled back pace of quantitative tightening, running at GBP70bn per year (GBP5.8bn per month), before announcing a further reduction to around GBP30bn in September 2026.

The Bank of Japan (BoJ) is likely to stay put until the end of 2025, with the next move likely in January 2026, as the central bank cautiously continues its rate-hiking cycle. Inflation indicators remain above the 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 BoJ'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 has been rising through 2025 (exceeding 3% as of latest data) and should remain around 2% on average in 2026. The BoJ should thus carry on with its rate-hiking cycle, albeit cautiously. We expect the 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) and with the dust having somewhat settled on the political front. All in all, we expect the BoJ 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 3: Monetary policy key rates, %



Sources: national, Allianz Research



4 Is the USD's dominance facing a new era of uncertainty?

The USD's dominance is facing a new era of uncertainty as cyclical dynamics increasingly intertwine with politics. Still, this year's dollar weakness has been largely driven by near-term interest rate differentials. Softer-than-expected US inflation and cracks in the labor market led markets to price in more Fed cuts than anticipated at the start of the year, while the ECB turned more hawkish, widening the transatlantic policy gap. We estimate that roughly two-thirds of the year-to-date depreciation stems from these cyclical drivers. The remaining third can be attributed to de-dollarization pressures. These have so far materialized primarily through increased FX hedging rather than outright capital outflows, with foreign investor inflows into US capital markets remaining steady. Foreign holdings of US equities remain particularly elevated in the technology and semiconductor sectors, underscoring the dollar's continued structural support. Yet, politics adds a new layer of vulnerability. Concerns over the Fed's independence have grown, with dissent among new FOMC members weighing on sentiment, even if long-term inflation expectations remain well anchored, which would be the first warning sign if investor trust were truly eroding.

We expect the dollar to remain broadly stable around 1.18. While we acknowledge an ongoing de-dollarization trend, we view it as mild. Looking ahead, some of that hedging may translate into slight reductions in actual dollar exposure by foreign investors but given the lack of attractive alternatives, both in terms of returns and market depth, we expect only a gradual shift. Our stable dollar view is also driven by our Fed call, which includes fewer rate cuts than markets currently price in. This results in a more favorable interest rate differential for the dollar, helping cushion the impact of de-dollarization.

Uncertainty remains high, and much will depend on future US policy developments. Overall, the outlook for the USD remains fragile. A more accommodative Fed in the event of a downturn, persistent uncertainty around institutional independence and – under a severe downside scenario – a revival of “Mar-a-Lago Accord”-style measures such as implicit expropriation or a “revenge tax” on foreign capital gains could all undermine global confidence in the greenback.

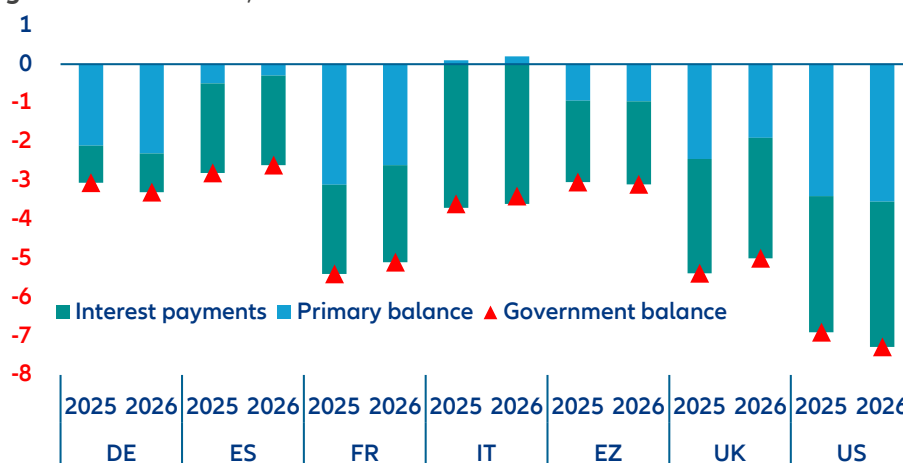
5 How far can fiscal dominance propel long-term interest rates?

Fiscal policy shows little to no signs of consolidation and the combination of slow growth and additional spending pressures is further complicating the fiscal outlook. In the US, the One Big Beautiful Bill expected in 2026 will deliver a fiscal boost, complementing a more accommodative monetary stance and providing short-term support to growth. The government deficit is projected to widen in 2026. The primary balance is expected to remain close to 2025 levels at 3.4% of GDP (down from 3.9% in 2024) as tariff revenues help offset the revenue loss from the new tax cuts. However, rising interest costs – expected to reach 3.7% of GDP – will continue to increase fiscal pressures. In the Eurozone, higher defense spending targets will weigh particularly on highly indebted countries, which have historically devoted a smaller share of GDP to military expenditures. Trade disruptions are also complicating the picture, constraining growth prospects and shrinking fiscal space. In response, many governments have already announced targeted support for the most affected firms and sectors. France, Italy and Belgium are still seeking to exit the Excessive Deficit Procedure and return their deficits to below 3% of GDP, but consolidation efforts remain limited and politically difficult. On the flip

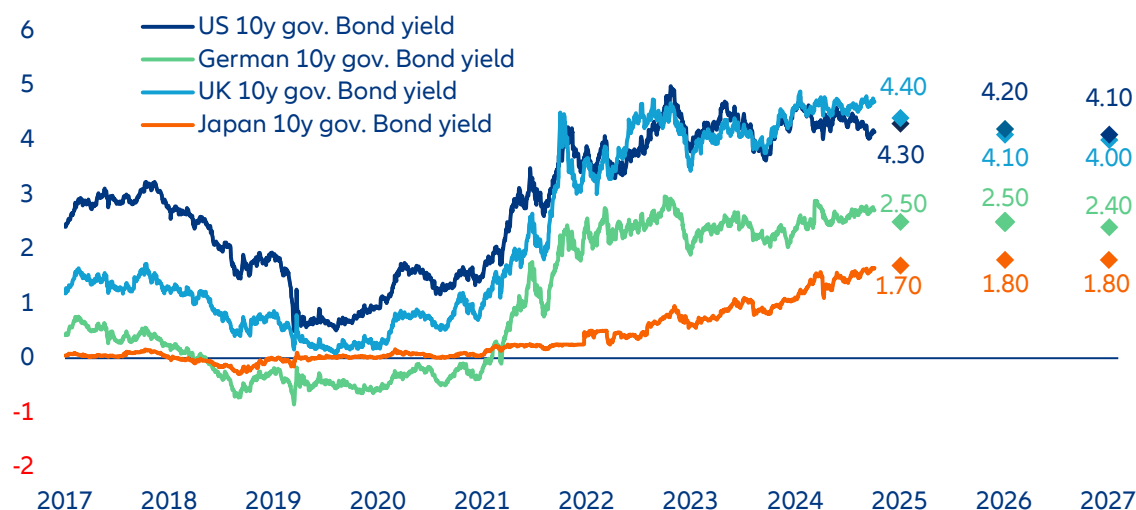
side, Germany's large fiscal package is expected to start supporting economic activity from mid-2026, with potential spillover effects across the wider Eurozone. Meanwhile, Southern and Eastern European countries will continue to benefit from the final year of NGEU funds, which are providing temporary support to both fiscal positions and growth prospects. However, once the program expires in 2027, underlying fiscal challenges are likely to resurface, just as several major economies, including France, Italy and Spain, head into election-heavy political cycles

Government bond yields remain under pressure across major economies. Although the specific drivers vary, fiscal dominance is omnipresent. In the US, softer growth and cracks in the labor market have pushed markets to price in more Fed rate cuts than anticipated at the start of the year, but large fiscal deficits and corresponding heavy issuance keep long-end yields elevated. Debt-servicing costs are rising rapidly as a share of government revenues, reinforcing fears of fiscal dominance. In the UK, 30-year gilts recently touched their highest levels since 1998 (5.7%) as large deficits, a hawkish Bank of England and lingering memories of the "Truss moment" compound

Figure 4: Fiscal deficits,%



Source: Allianz Research

Figure 5: Government bond yields and forecasts, %

Sources: LSEG Datastream, Allianz Research

supply pressures. In Germany, Bund yields have risen as the ECB has sped up quantitative tightening this year, with monthly reductions of around EUR40bn, while limited fiscal consolidation keeps supply from both policy sides elevated. Japan is the main outlier, with the Bank of Japan hiking against the global easing trend and reducing its JGB holdings by about JPY2.7trn per month. This has pushed 30-year yields to their highest level since records began in 1999 (3.2%). Overall, yields are set to stay high, with remaining monetary policy moves largely priced in and supply pressures persisting.

Yield curves have steepened in unusual ways, with the ultra-long end in focus. At the front end, the US and Eurozone curves have shifted higher as markets normalize expectations for policy rates rather than pricing deep recessionary cuts. This front-end steepening contrasts with previous downturns, when curve dynamics were driven by aggressive easing cycles. More concerning is the movement at the long end. Rising term premia, driven by persistent fiscal deficits and large-scale quantitative tightening, have lifted long-maturity yields in the US, UK and Eurozone, resulting in steepening of the 10y30y segment. The UK stands out with particularly strong upward pressure. In the US, although the Fed slowed its Treasury runoff to USD5bn per month, fiscal supply remains overwhelming. Germany faces similar pressures as Bund supply collides with ECB runoff. Japan diverges in the sense that in addition to accelerating balance sheet reduction markets are digesting ongoing policy hikes. Overall, the current steepening is not signaling an imminent recession but rather the dominance of fiscal and supply-driven factors, leaving yield curves more vulnerable to shocks and sentiment swings than in previous cycles.

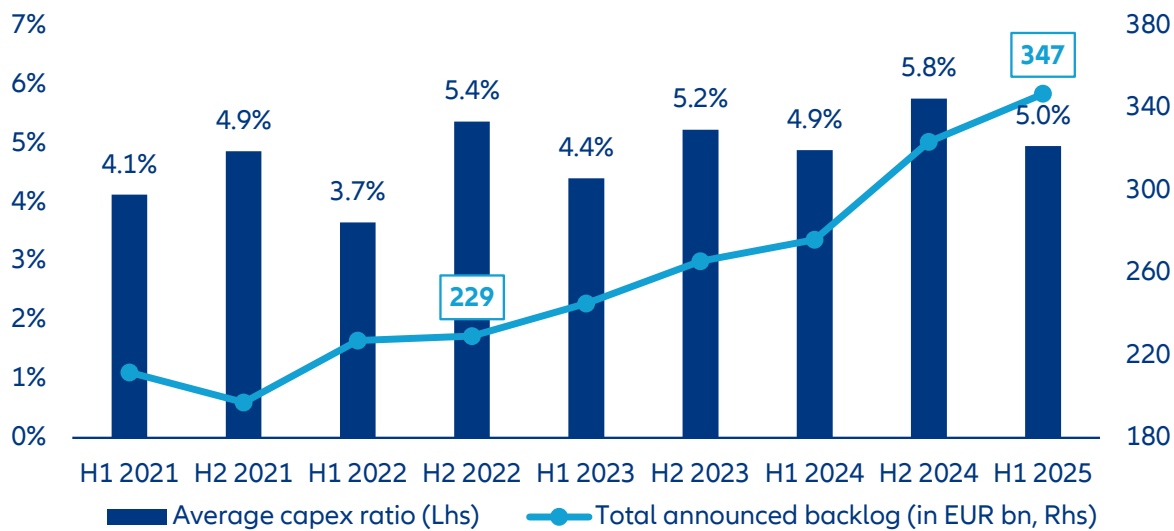
Eurozone spreads are increasingly driven by divergent debt trajectories and domestic political risks. Italy has so far benefitted from NGEU loan inflows but also more stable politics, which eased fiscal financing pressures and supported convergence. With the end of NGEU in 2026, though, this effect is expected to partially fade in 2027. In general, Eurozone spreads reflect country-specific debt paths, with high-debt sovereigns facing greater risk premia. Spain stands out on the positive side of the spectrum while France is the big swing factor: political uncertainty on current budget talks as well as a hung parliament will likely increase ahead of the 2027 presidential election. This is coupled with a persistently large fiscal deficit near 5–6% of GDP, which should keep OAT-Bund spreads volatile and elevated. The ECB's Transmission Protection Instrument (TPI) acts as a backstop, but intervention would likely require spreads to move well beyond 120–150bps and lead to some sort of contagion beyond France. A more likely first step would be a halt or slowdown the current QT pace. Our main scenario for France sees moderate widening amid political uncertainty in 2026 and a re-tightening in 2027 under our baseline assumption of a centrist president and a more constructive set-up in parliament. But multiple alternative scenarios are possible, up to a low-probability tail risk of OAT-Bund spreads above 150bps in a euro-crisis-style scenario if deficits balloon and market confidence erodes as the ECB would not step in. Overall, we remain constructive in the longer term. Most high-debt countries from the Eurocrisis era have made significant progress on fiscal consolidation, while core countries are now moving in the opposite direction. This shift should support a gradual convergence in Eurozone spreads. In addition, persistent geopolitical uncertainty continues to bolster demand from overseas investors, providing a solid anchor for European government bonds.



6 Will the EU finally ramp up defense spending in 2026-27?

A late wake-up call and a strong political push on defense. The EU faces a pivotal moment in defense, driven by the ongoing war in Ukraine and risks of the US reducing NATO support. These factors have revealed Europe's heavy reliance on external military backing, prompting EU leaders to accelerate efforts toward strategic autonomy. To support this ambition, the EU has deployed key financial tools, including the Rearm Europe initiative, the SAFE/STEP platform and loosened fiscal rules on military spending. Between 2026 and 2030, up to EUR800bn may be invested to modernize and rearm Europe's forces, aiming for military independence by 2030. National defense budgets are rising accordingly. From an average of 1.9% of GDP in 2024, EU member states are expected to surpass 2.0% in 2025 and approach 2.3–2.5% by 2026–2027, with many targeting 3% by 2030. However, this increase is uneven. Countries like Poland and the Baltics already exceed NATO's 2% benchmark, while Spain plans to limit spending to around 1%, reflecting fragmented commitment across the bloc.

Discrepancy between political commitment and industrial capacities to hammer ambitions. Despite growing political will and funding, Europe's defense industry faces bottlenecks. Order backlogs are at record highs and production capacities are stretched thin. Expanding output requires new infrastructure investments as productivity gains alone are insufficient. Yet, European champions remain cautious about making large capital expenditures due to previous delays in EU funding programs and unresolved disputes – such as the Franco-German disagreement over a new European fighter jet – that hinder common projects. Consequently, capital investment hovers around 5–6% of revenues. This gap between intent and capability raises risks. Although Europe aims to rely more on domestic or affiliated suppliers, production constraints could prolong dependence on imports. The US remains the EU's largest arms supplier, providing almost 45% of imports in 2021–2022, with unmatched rapid delivery of advanced equipment. Transatlantic economic ties further complicate

Figure 6: Backlog and capital investment ratio of top EU defense companies*

*Due to the absence of public data from Airbus Defense segment and Safran on backlog, both companies have not been included in that analysis.
Sources: LSEG Datastream, Corporate filings, Allianz Research

matters. In exchange for eased US tariffs on European goods, the EU is expected to invest roughly USD600bn – mostly private capital – into the US economy. While there is no official commitment on arms and military equipment, this dynamic may divert funds from Europe's own defense infrastructure, especially if military tensions in Europe increases.

A moderate boost expected, with speed bumps on the scale-up road. Overall, Europe's military spending will likely increase gradually, constrained less by funding than by fragmented strategies, bureaucratic hurdles, industrial limits and US economic interests. In our view, defense budgets should increase moderately by +10-20% by 2026/2027, inching up defense budgets to 2.3-2.5% of GDP and boosting EU growth by about +0.2% annually during this period. However, without stronger cohesion and industrial coordination, Europe risks falling short of its goal for true defense autonomy by 2030.

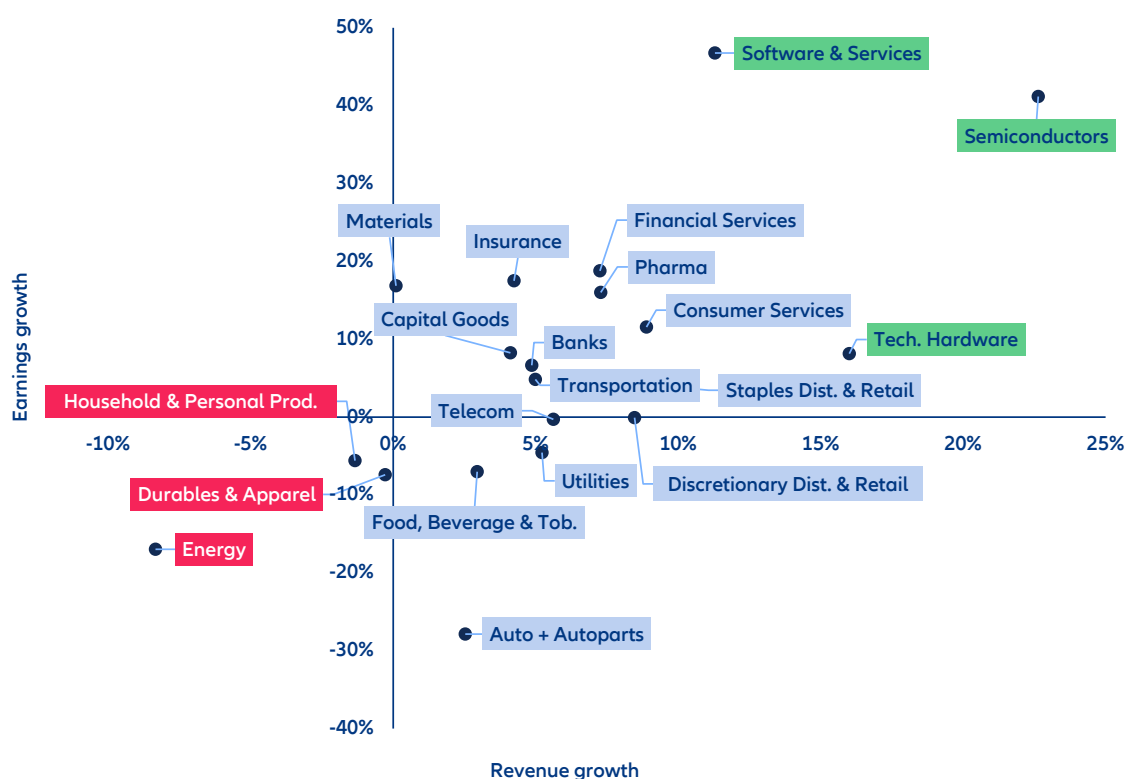


7 How are firms navigating the challenge of persistently high financing costs?

High borrowing costs are squeezing firms on both sides of the Atlantic, but many companies are weathering the storm with (surprising) resilience. Q2 2025 earnings underscored how most sectors managed to meet or beat expectations on both sales and profits despite the drag from interest expenses (see Figure 7). In the US, software and hardware firms exceeded revenue forecasts, as did a majority of capital goods, transport, energy and auto companies – indicating that demand has held up better than feared. Only a few pockets like basic materials and household products saw more than half of firms miss their top-line targets, hurt by sluggish demand and watered-down pricing power. Profits have been broadly robust. IT service providers and consumer retailers also beat earnings estimates, thanks to cost discipline. Banks have also benefited from the current context through wider interest margins. By contrast, some high-tech manufacturers disappointed: unrealistic investor expectations meant many semiconductor and electronics firms fell short in Q2 earnings season. Overall, the picture is far from a profit collapse – tech sectors delivered double-digit revenue and earnings growth, and defensive industries like pharmaceuticals and financials posted solid gains – but the pressure of expensive capital

is evident in more rate-sensitive corners. Auto and energy companies saw sharply lower earnings despite decent revenue, reflecting rising financing and input costs, while consumer durables and household goods even slid into negative earnings growth on flat sales, a sign of eroding pricing power. Overall, corporate results in 2025 have been resilient but mixed, with cost control emerging as one of the critical differentiators between winners and laggards.

Behind this resilience lies adaptation, but not all companies are equal in this high-rate environment. Over the past two years, firms have streamlined operations and supply chains to offset higher financing and input costs. Supply-chain disruptions – a major driver of inflation in 2021–22 – have largely abated, relieving some cost pressure. Many businesses built up inventories and liquidity buffers during the cheap-money era; now they are drawing down stockpiles and cash reserves to avoid expensive new borrowing. Meanwhile, cost efficiency drives are in full swing. From Silicon Valley to European factories, companies have cut expenses – exemplified by big tech's layoffs and industrial firms squeezing procurement costs – aiming to protect profit margins as interest expense are still high. Crucially, US firms have also

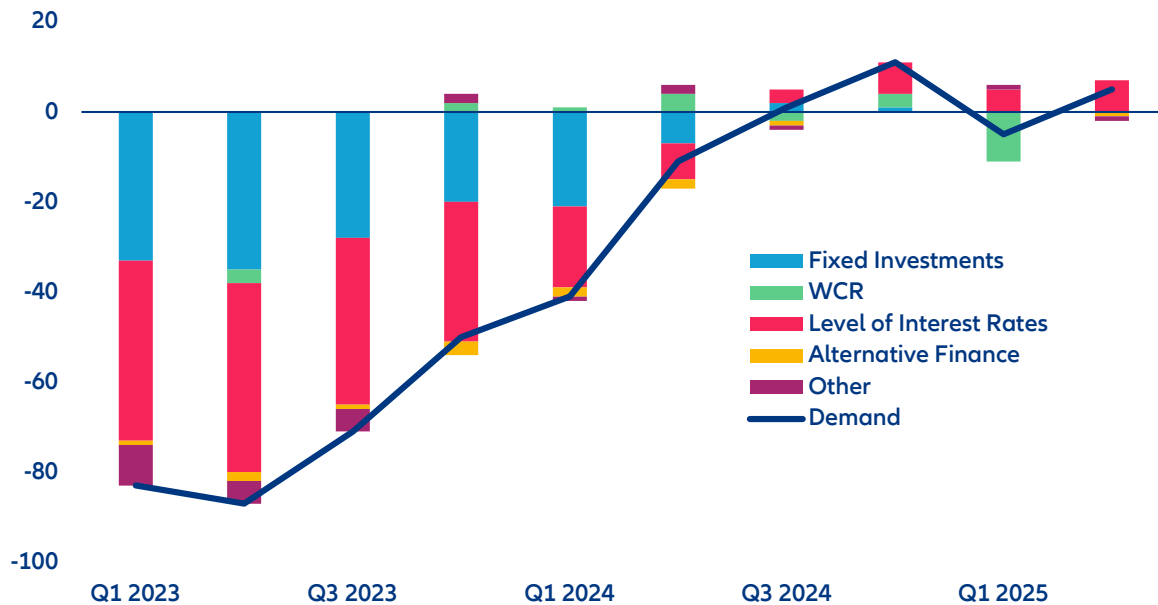
Figure 7: Q2 2025 earnings and revenue growth for global sectors (y/y%)

Sources: LSEG Workspace, Allianz Research

leveraged pricing power where possible in the context of tariffs, many passed on higher costs to customers, or benefited from price moderation of trading partners. As of mid-2025, aggregate corporate margins have held near record highs, helping many companies cover their debt-servicing needs despite interest rates at decade highs. However, a clear split is emerging between large, well-capitalized firms and smaller, heavily indebted ones. Bigger US and European corporations took advantage of 2020–21's rock-bottom rates to term out their debt; many locked in fixed-rate bonds maturing years down the road. They now enjoy a "grace period" of sorts – interest costs on existing bonds remain low, even though yields in secondary markets have doubled for new issues. By contrast, small and mid-sized enterprises (SMEs), which rely on bank loans and shorter-term credit, are feeling the crunch immediately. In Europe especially, most business lending uses floating rates. With borrowing costs having spiked for countless SMEs, demand for loans has slumped. Banks in the Eurozone and US alike report that businesses have pulled back on credit appetite and are more cautious

in capital spending. In Q2 2025, a significant net share of US banks noted weaker demand for commercial loans, though volumes of loans rebounded recently, most likely driven by large companies. The credit squeeze is still evident in Europe although ECB rates have eased (see Figure 8). Larger European companies have tapped bond markets instead – debt market issuance picked up almost 60% in mid-2025 – but smaller players often lack that option. The result is a financing gap: many weaker firms are effectively paying down debt or going without, while cash-rich corporates sit on the sidelines or tap financial markets.

Persistently high financing costs could translate into further insolvencies: We expect a +6% increase in 2025 and +4% in 2026. Our Global Insolvency Index, which accounts for the economic weight of each country, indicates a +5% y/y increase in the first half of 2025, following a +10% and +7% for the full years 2024 and 2023, respectively. This global trend remains driven by an upside dynamic in most countries, with more cases than

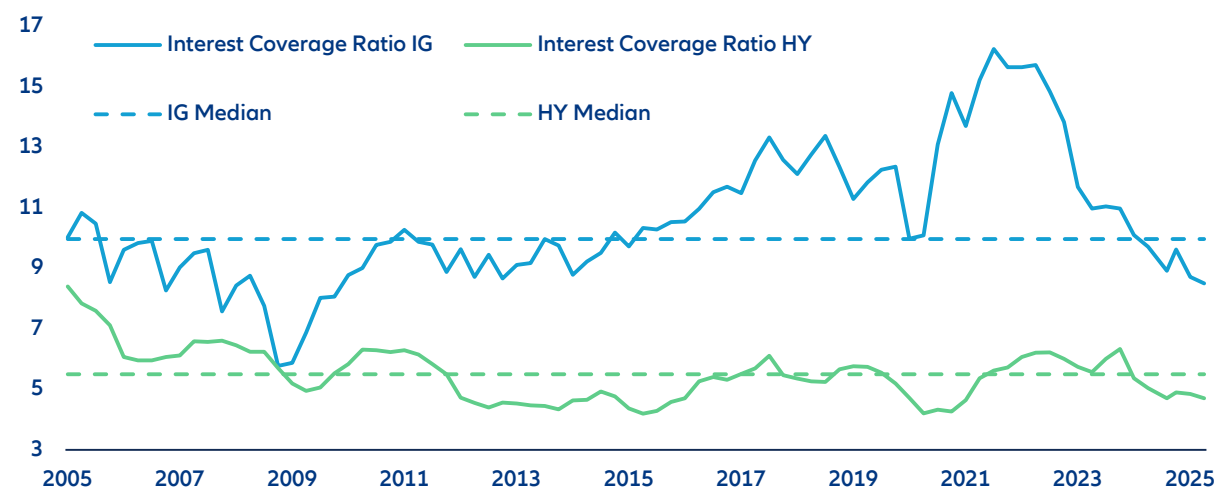
Figure 8: Balance of banks (net %) saying loan demand has increased in the Eurozone & contributing factors

Sources: ECB, Allianz Research

previously anticipated, notably in Asia and in Europe, both Western and Central and Eastern. Yet all regions show mixed trends. Western Europe sees a larger upside trend in Italy, Switzerland and Germany, while the number of insolvencies softened in the Netherlands, Portugal and to a lesser extent the UK. The US is also contributing with more insolvencies of large firms. Globally, many SMEs are struggling to adapt to the succession of shocks and disruptions, while the fiscal context is less open to direct and indirect state support. Overall, we expect full-year insolvencies to rise in three out of five countries, which will record more cases than averaged over the 2016-2019 period. This upward trend is likely to continue into 2026 globally, though at a slower pace (+4%). However, projections are more severe for the US (+9% and +8% in 2025 and 2026, respectively) and APAC (+6% and +6%) despite a mixed picture. Western Europe will face a slightly lower increase than previously anticipated for 2025 (+6%) before a moderate but broad-based decrease across countries in 2026 (-2%).

Both investment-grade and high-yield credit markets generally had a firm quarter, with spreads remaining at or near historical lows. In Europe, IG credit spreads tightened to 76bps, while in the US and the UK spreads tightened to 75bps and 81bps, respectively. The rally is supported by strong technical factors, higher-than-expected growth and central banks easing. In the short term, these factors will continue to prop up valuations until the end of the year, extending the trading range of the recent months and providing carry. However, corporate credit metrics are at the weakest levels post-pandemic. Interest coverage ratios have left behind post-pandemic highs and stay below – but close to – the long-term median level. The deleveraging trend also seems to have come to an end, while leverage remains at a healthy level. With the normalization of fundamentals, the strong rating upgrade momentum that has lasted for three years also eased, especially in speculative-grade companies. Meanwhile, default rates, while still tracking below historic means, are set to rise in high yield.

Figure 9: Euro credit issuers’ interest coverage ratios (ICR) now off peak



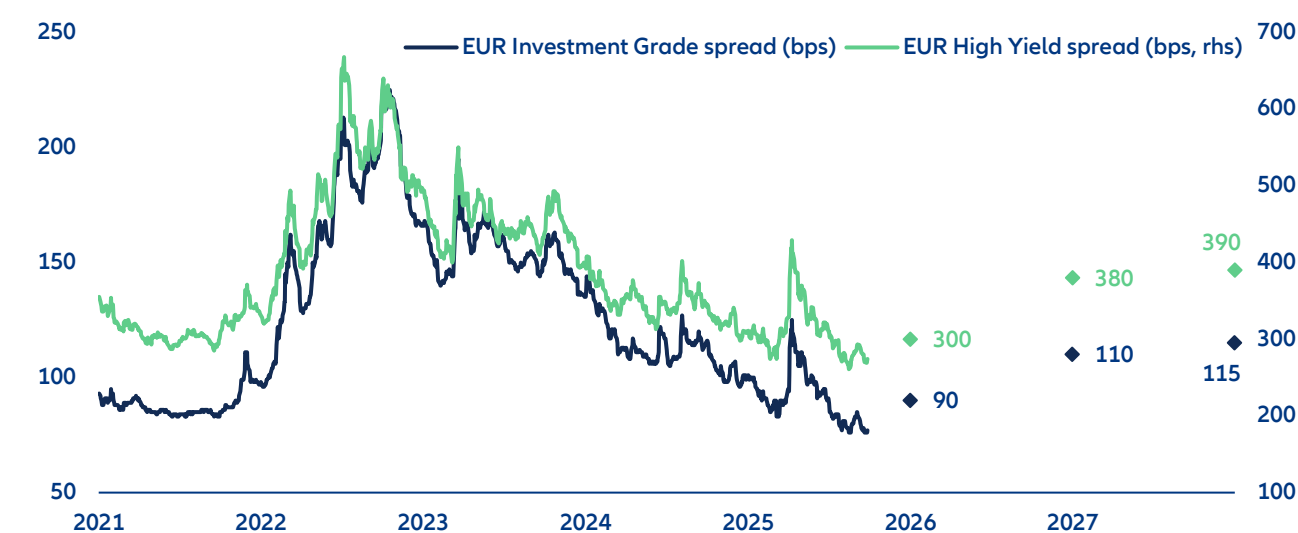
Sources: LSEG Datastream, Allianz Research

Technical drivers, strong fund inflows and modest net issuance during the summer have kept spreads grounded. But the supportive technical factors may prove temporary as the policy backdrop shifts. Yields have dropped from 3.2% at the beginning of the year to 3%, making credit less attractive to yield buyers, who have been the primary source of demand. In this context, current stretched valuations leave little cushion against either mild spread widening (to median level) or any adverse market events. As such, we maintain a neutral view on investment grade as carry remains solid but the excess return is curbed by the risk of spread widening. However, we are cautious on high yield, given lower-rated issuers have less robust fundamentals and higher cyclical

sensitivity, especially when yield-seeking tactical investors leave the asset class amid rising risks.

Looking ahead, we maintain our view of a mild upwards pressure in both EUR and US credit spreads from the current low levels. Spreads are projected to be range bound through 2025, then move 20/25bps wider for Euro/US IG and 80/90bps wider for Euro/US high yield by the end of 2026. At the same time, modest yet steady economic growth is expected to prevent spreads from rising above the long-term median. So, for investors, the core message is clear: fundamental normalization and tightest spreads mean that careful quality, sector and issuer selection will be critical.

Figure 10: European credit spreads, bps



Sources: LSEG Datastream, Allianz Research

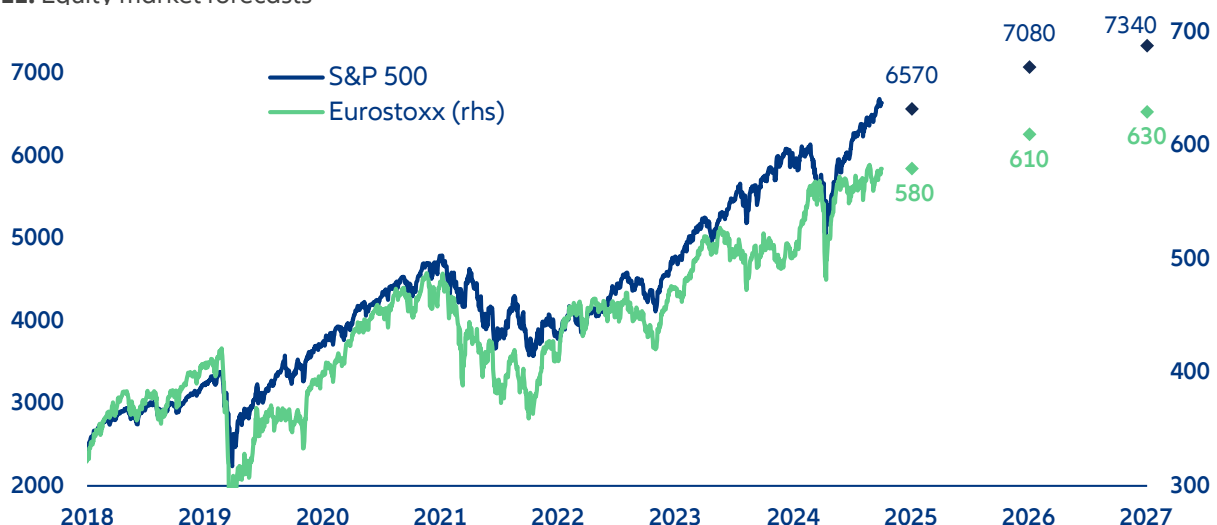
8 Is a capital market bubble on the horizon?

Global equity markets are at record highs, with US stocks driving the surge. The forward price-to-earnings (P/E) ratio for the US stands at 23, which is well above its 20-year average and raises concerns about stretched valuations. Nevertheless, analysts are projecting annual S&P 500 earnings growth of around 15% over the next years, compared to 10% in Europe. Taking this into account, the US price-to-earnings-to-growth (PEG) ratio is approximately 1.4x, which is a historically sustainable level. Therefore, although P/Es appear high, robust EPS forecasts, particularly in technology, partly justify them. Much of the US rally is concentrated in a few large technology firms, such as NVIDIA, Microsoft, Amazon and Alphabet, which has driven optimism around AI. These 'Magnificent Seven' companies have sharply increased capital expenditure (capex), averaging USD36bn each over the past year, compared to just USD2bn for a typical S&P 500 firm. Investments in AI infrastructure have fuelled gains in semiconductors, hardware and utilities tied to power demand. Nevertheless, risks remain. While infrastructure companies demonstrate clear earnings visibility, sectors integrating AI into products are lagging behind, reflecting investor caution. Multiples for leading tech stocks remain below the peaks seen during the dot-

com boom, but this momentum depends on continued capital expenditure growth. Any slowdown could put valuations under pressure, leaving markets vulnerable given their dependence on AI-led optimism.

We are shifting our outlook on equities from negative to neutral, supported by profit growth led by AI and big tech. Q2 results confirm the dominance of the technology sector, with strong earnings momentum likely to continue alongside the expected reduction in interest rates. Global conditions should continue to support European earnings growth in 2026. Although valuations in the US remain elevated, they are sustained by exceptional tech profitability, suggesting no bubble risk. Meanwhile, the valuation gap with Europe is unlikely to narrow. In the near term, equity momentum may ease following the rally. However, positioning and sentiment remain balanced, which limits downside risks. Taking these projections into consideration, we anticipate that the EMU will conclude the year with year-on-year growth of +18%, followed by a solid +8% growth in 2026. For the US, we expect a robust finish at +14% this year, maintaining momentum into 2026 with an anticipated +10% return.

Figure 11: Equity market forecasts



Sources: LSEG Datastream, Allianz Research

Table 3: Capital market forecasts

EMU	Last*	Unit	2023	2024	2025f	2026f	2027f
Government Debt							
ECB deposit rate	2.00	%	4.00	3.00	2.00	2.00	2.00
10y yield (Bunds)	2.71	%	2.03	2.36	2.50	2.50	2.40
10y EUR swap rate	2.64	%	2.48	2.39	2.40	2.30	2.20
20y EUR swap rate	2.88	%	2.51	2.39	2.60	2.50	2.40
Italy 10y sovereign spread	85	bps	168	117	80	90	90
France 10y sovereign spread	82	bps	53	83	80	90	70
Spain 10y sovereign spread	55	bps	97	70	60	60	50
Corporate Debt							
Investment grade credit spreads	78	bps	135	101	90	110	115
High-yield credit spreads	272	bps	395	311	300	380	390
Equity							
Eurostoxx (total return p.a.)	19 ytd	%	19	10	18	8	6

US	Last*	Unit	2023	2024	2025f	2026f	2027f
Government Debt							
Fed Funds rate (high)	4.25	%	5.50	4.50	4.00	3.50	3.50
10y yield (Treasury)	4.15	%	3.87	4.57	4.30	4.20	4.10
Corporate Debt							
Investment grade credit spreads	76	bps	104	82	90	115	120
High-yield credit spreads	280	bps	334	292	300	390	410
Equity							
S&P 500 (total return p.a.)	15 ytd	%	26	25	14	10	6

UK	Last*	Unit	2023	2024	2025f	2026f	2027f
Government Debt							
BoE rate	4.00	%	5.25	4.75	4.00	3.25	3.00
10y yield sovereign (Gilt)	4.70	%	3.54	4.57	4.40	4.10	4.00
Corporate Debt							
Investment grade credit spreads	81	bps	134	91	100	125	135
High-yield credit spreads	404	bps	515	364	420	450	460
Equity							
FTSE 100 (total return p.a.)	18 ytd	%	8	10	16	5	5

Emerging Markets	Last*	Unit	2023	2024	2025f	2026f	2027f
Government Debt							
Hard currency spread (vs USD)	167	bps	215	202	210	200	200
Local currency yield	6.34	%	6.19	6.39	6.00	5.80	5.70
Equity							
MSCI EM (total return p.a. in USD)	28 ytd	%	10	8	28	11	6

FX & Commodities	Last*		2023	2024	2025f	2026f	2027f
EUR USD	1.18	\$ per €	1.10	1.04	1.18	1.18	1.18
Oil (Brent)	69	\$ per bl	78	75	65	63	70
Natural gas (Dutch TTF)	32	€ per MWh	32	49	36	35	32

Sources: LSEG Datastream, Allianz Research

Notes: Year-end figures, *As of 30. Sep 2025

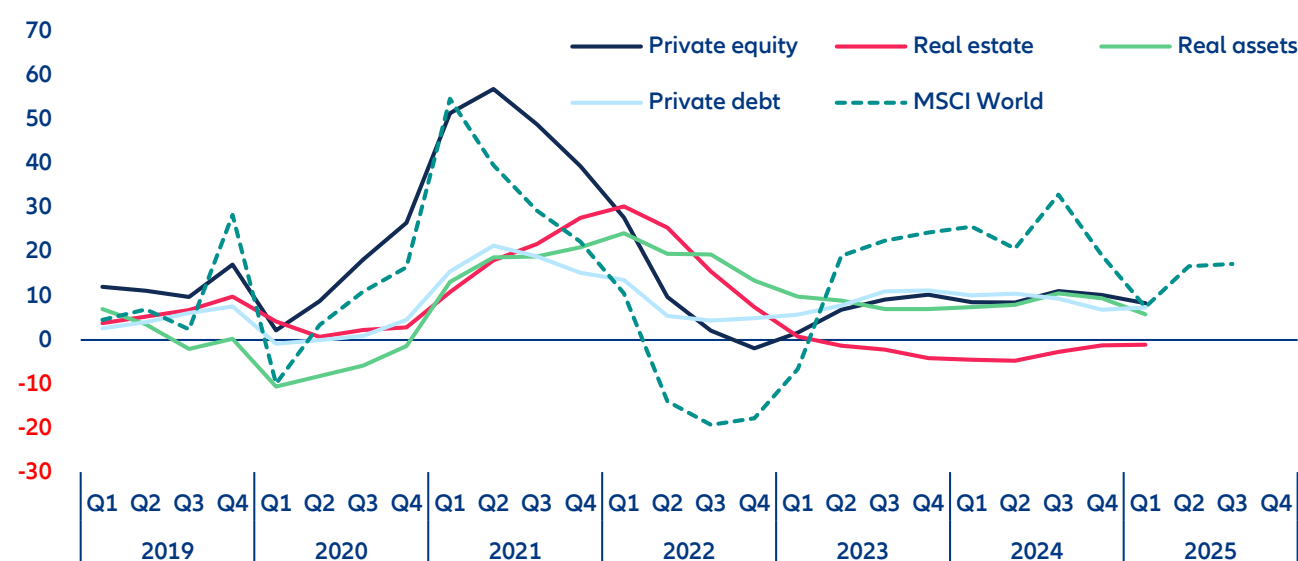
Global private markets concluded the summer of 2025 with an overall feeling of cautious optimism.

The momentum that had built up during 2024, when steady rate cuts and an orderly public equity rally created a favourable backdrop for deal-making, had carried over into 2025. Early 2025 saw the continuation of this positive trend until the unexpected “Liberation Day” tariff shock led to a resurgence of inflation concerns and a shift in expectations for further easing. During this period, fundraising activity experienced a notable slowdown, with global commitments through June decreasing by almost -19 y/y%. Additionally, dry powder declined for the first time since 2010 as capital calls exceeded new inflows. However, overall assets under management have continued to rise as net asset values showed steady growth. Distributions have decreased to the lower end of recent standards, which has led to a tightening of liquidity. This has occurred at the same time as public equities have shown signs of recovery, which has increased the opportunity cost of remaining private. Nevertheless, the performance has proved resilient: The latest benchmarks indicate that private capital has increased by +0.5% in Q1 2025, +7.5% over one year and +12.8% on an annualised basis over five years. The fundamentals have softened slightly but remain stable. Earnings growth has cooled slightly, credit spreads remain contained and secondary markets are steadily clearing backlogs. All of this points to a more balanced second half if trade tensions ease (Figure 12).

Private equity mirrors the delicate balance that shapes broader private markets.

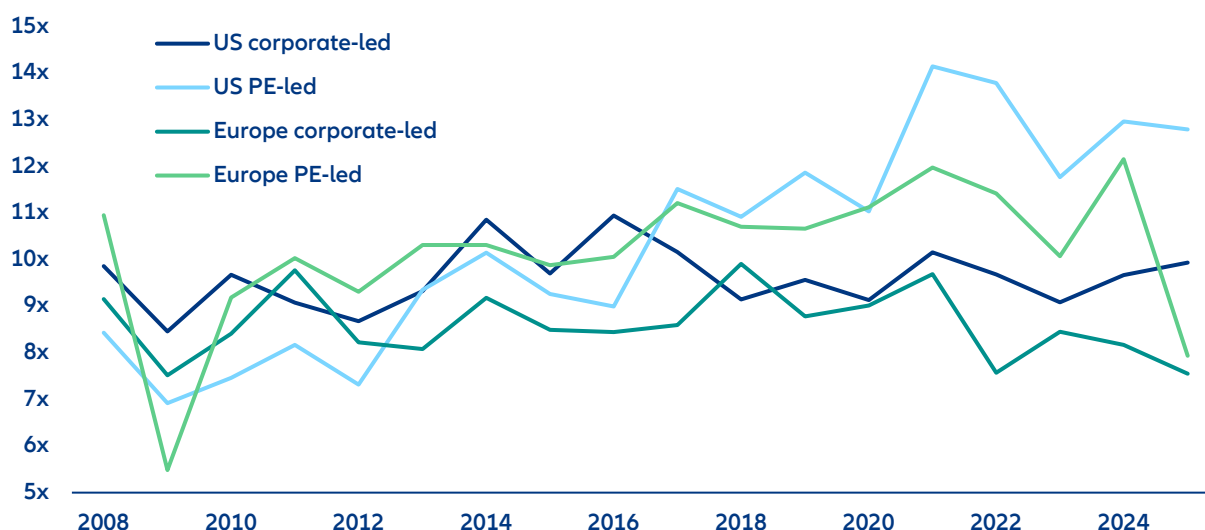
Managers have a budget of almost a trillion dollars to invest, but exits remain elusive and the gap between buyer and seller expectations is impacting cash flows. Distributions to limited partners (LPs) have slowed to the lower end of recent norms, reinforcing the sense of pent-up capital waiting to be released. Valuations have softened to the point that they are attracting interest without triggering distress, while mid-market pricing has returned to pre-pandemic levels. Public equities have surged, with the MSCI World advancing +19% in 2024, which has raised the bar for private allocations. However, the long-term record still argues for patience, with preliminary Q1 2025 returns coming in at 0.3%, with a 9.4% one-year IRR and 15.9% over five years. Even in the current environment, macro and market conditions are conducive for M&A transactions. In this context, should tariff pressures ease and central banks resume rate cuts, the combination of abundant capital, subdued distributions and tempered valuations could quickly unlock a wave of exits and recapitalizations, turning the present pause into the next phase of growth (Figure 13).

Figure 12: Global private markets performance, y/y in %



Sources: Pitchbook, Allianz Research

Note: Geography: Global; as of Q1 2025

Figure 13: Median M&A EV/EBITDA multiples

Sources: Pitchbook, Allianz Research

Private debt has emerged as a reliable source of income for the market, providing consistent returns even as other private strategies face challenges with slower exits and thinner distributions. The robust financial health of borrowers and the conscientious underwriting practices employed by lenders have contributed to maintaining low default rates (although we see some credit risk pockets showing up). Consequently, lenders have been able to capitalize on higher base rates, which have ensured the preservation of favorable spreads despite intense competition in the market. Fundraising continues to demonstrate resilience, maintaining its position as one of the few strategies that have achieved positive year-on-year growth. This contributes to offsetting the industry-wide decline in fresh commitments. Valuations remain stable (although spreads continue to decline), and direct lenders continue to secure premium terms in sectors such as infrastructure and asset-based finance. Preliminary Q1 2025 returns reached 2.4%, with a 8% one-year IRR. Despite heightened competition driving spreads closer together and decelerating distributions, the amalgamation of floating-rate protection, senior security and resilient mid-single-digit returns continue to position private credit as a compelling alternative to public bonds and a cornerstone of diversified private market portfolios.

Private commercial real estate sits at an inflection point, shifting from price discovery to price formation as bid-ask spreads narrow and financing conditions slowly thaw. Valuations have largely stabilized, with cap rates plateauing and selective inward drift where leasing momentum and lease structures support pricing. Fundamentals are mixed but broadly stable: logistics demand is resilient in both the US and the Eurozone, though rent growth is normalizing; multifamily rent gains have cooled amid affordability constraints and higher operating costs; retail footprints are leaner and more defensive; office remains bifurcated, with prime, amenitized space holding up while older stock faces structural obsolescence. Transaction volumes are stabilizing from a low base as appraisals catch up and underwriting turns more conservative. But the 2025–26 refinancing wall is catalyzing deleveraging, asset sales and a rise in structured solutions. Performance is increasingly income-led, with modest scope for capital appreciation as we expect rates resume a moderate downward path. Against that backdrop, disciplined asset selection, balance-sheet repair and the ability to execute business plans should be the primary drivers of returns, while refinancing stress and shadow vacancy remain the key tail risks.



9 Which emerging markets are grappling with rising imbalances?

China still has the means to meet its growth targets, but has to deal with continued imbalances: strong export competitiveness while domestic demand remains weak, robust manufacturing while construction remains sluggish, stimulus with supply-side bias while deflationary pressures remain, etc. We had already revised up our GDP growth forecast for China in 2025 to +4.8% (see here), on the back of stronger-than-expected economic performance in the first half of the year. The positive surprise mainly came from continued strong export competitiveness, which means net exports will likely contribute positively to growth in 2025. Meanwhile, domestic demand remains weak, and only segments supported by the consumer trade-in scheme are performing well, e.g. durable goods such as consumer electronics, personal household products and furniture. As the global trade cycle is likely to turn less supportive going into next year, we expect exports to contract in 2026 and overall GDP growth is likely to decline to +4.2%. Even if US-China trade relations do not worsen further, costs incurred by higher tariffs will eventually dent global demand. Domestically, the real estate downturn that has further to run keeps a lid on private sector confidence and consumption. Further policy support, more geared towards demand rather than supply, is necessary to accompany domestic demand back towards an eventually self-

sustained and reflationary recovery. We expect at most another policy rate cut by the end of the year, and further fiscal stimulus is unlikely to be announced before early 2026.

Emerging economies overall have been surprising positively – but potentially on borrowed time. Some markets are facing rising imbalances and would be vulnerable to risk-off shifts. Growth in emerging markets (EM) excluding China is forecast to reach +3.7% in 2025, +3.5% in 2026 and +3.7% in 2027. 2025 is thus turning out better than previously expected as EMs remain in an expansionary cycle, thanks to a milder effect from the trade war so far (especially for Asia, Latin America, Africa) as well as policy support. Asian exporters in particular have gained market shares in the US, with Taiwan, Vietnam, Thailand and Indonesia even retaining spare manufacturing capacity. In the meantime, domestic policies have mostly been supportive as an environment of contained inflation (except in Central and Eastern Europe) and a lower USD has allowed most EM central banks to frontload policy rate cuts (the easing cycle should slow down by mid-2026), preparing for an economic outlook that is likely to turn grimmer into next year. Our growth forecasts are indeed generally lower for 2026. More than half of EMs are also easing fiscal policies. Markets do not

seem concerned at this stage, but some economies require close monitoring (e.g. Argentina, Brazil, Egypt, Indonesia). Most of Latin America and Central and Eastern Europe (and some in Southeast Asia and Africa) would also be vulnerable to a risk-off shift, being net debtors with current account deficits.

EM sovereign debt continues to ride a wave of optimism, supported by improving credit quality and a favorable macro backdrop. Spreads have compressed to historical lows, reflecting robust fundamentals and a resurgence in investor risk appetite. The Fed's anticipated easing cycle and a softer dollar have added fuel to the rally, while EM central banks retain room to cut rates, reinforcing the growth differential versus developed markets. Inflation trends are benign, and fiscal dynamics are improving, with current accounts remaining manageable. These factors underpin the strong performance across EM sovereigns. Technical factors have turned supportive as well, with flows showing renewed momentum after a prolonged period of outflows. However, valuation is a growing concern. The spread pick-up over US corporates is now at the lower end of its historical range, leaving little cushion for further tightening. While the fundamental backdrop remains constructive, the risk-reward profile is less compelling at current levels. Lower yields and a weaker path of the USD support demand for EM LC debt. From a EUR investor's perspective, there is still upside for EM FX performance. EM debt continues to offer attractive carry, but the upside may be capped unless valuations reset or growth surprises to the upside.

The outlook for emerging market and Chinese equities remains optimistic, with expectations of a 11% total return in USD for 2026, following a robust performance of +28% expected in 2025 for emerging markets and +39% for China. This optimism is underpinned by a macro environment conducive to risk assets, characterized by a no-landing scenario in the US, with growth estimates close to potential and a slight acceleration anticipated in 2027. The Fed is expected to cut rates to 3.5% in 2026 which paves the way for EM central banks to continue loosening monetary policy as well. Low oil prices and a stable USD after recent depreciation further bolster this positive outlook for EMs. Trade uncertainty has notably diminished as more and more deals are agreed with the US. Developed markets, i.e. Europe and Japan, have

significantly more revenue exposure to the US than EMs on average. Tech exports from Taiwan and South Korea are the exception. But the US tech industry is heavily dependent on these tech imports, including from China, which puts EMs in a more favorable negotiation position compared to DMs. Valuation concerns persist, especially in US equities, but the AI and tech megacycle continues to drive earnings and capex as the latest earnings season confirmed. Therefore, we do not expect the tech valuation premium to come down sustainably soon.



10 What political events could steer us toward a downside scenario?

Between 2025 and 2027, risks may come from a particularly intense elections schedule across all regions of the world. In total, countries which represent 63.3% of global GDP will head to the polls in two years, with 2026 being the most critical year, as countries weighing a third of the world GDP will hold elections. In Europe, the rising influence of populist parties will continue heightening economic policy uncertainty, with elections in the Netherlands, Hungary, and France being held in October 2025, April 2026, and April 2027 respectively. In the United States, the midterms of November 2026 will be a decisive moment for Trump's second presidency, and Democrats could regain control of the House of Representatives. In Africa, the focus will be on ensuring safe political transitions, notably in Ivory Coast (October 2026). Meanwhile, South America faces a major electoral cycle at the end of 2025 and into 2026, with large economies such as Argentina, Chile, Brazil, and Colombia holding elections that could have significant macroeconomic repercussions.

We assign the highest probability (45%) to global trade entering a recessionary phase, if three scenarios materialize: President Trump's escalation of tariffs through Section 232 measures, the removal of product exclusions and the end of the China truce. Should these

developments occur, we expect a severe negative impact on global growth and a sharp rise in US inflation. Outside the US, reduced American demand would lead to excess supply and rising inventories, particularly in Asia, putting downward pressure on global prices. On the market side, we would expect interest rates to increase further. As rates rise, developed market equities are likely to face moderate downside pressure.

Considering the outlook for monetary policy, we assign a 35% probability that Federal Reserve actions could trigger a de-dollarization shock. A broad weakening of the USD would likely stem from changes to the Fed's mandate and reduced independence as the White House pushes for lower interest rates to stimulate the economy. Under this scenario, the Fed could begin cutting rates below 3% in 2026, potentially overheating the US economy. Across the Atlantic, the ECB is not expected to shift policy, preferring to remain hawkish in the medium term. Taken together, these dynamics would weigh on growth but exert an even stronger upward pressure on inflation. US interest rates would rise, equities would come under pressure and the dollar would weaken. We believe this could drive EUR/USD above 1.25.

A sovereign debt crisis is a 20% probability as fiscal policy will remain under pressure over the 2025-2027 horizon. Two key factors – elevated debt levels and persistently high long-term interest rates – will strain public finances. European economies under particular scrutiny include France, Italy and the UK, where rising defense and welfare costs are adding pressure. The US also warrants attention as widening deficits combined with expansionary fiscal programs (e.g. the “Big Beautiful Bill”) will limit fiscal space to support growth. A large-scale sovereign debt crisis would carry severe costs for global growth and inflation. Interest rates would likely move higher to reflect rising risk premia, potentially prompting a renewed quantitative easing response from central banks. Equities would also face significant downside pressure. also warrants attention as widening deficits combined with expansionary fiscal programs (e.g. the “Big Beautiful Bill”) will limit fiscal space to support growth. A large-scale sovereign debt crisis would carry severe costs for global growth and inflation. Interest rates would likely move higher to reflect rising risk premia, potentially prompting a renewed quantitative easing response from central banks. Equities would also face significant downside pressure.

The global environment is expected to remain highly volatile, with geopolitics continuing to impact markets. We consider four high-impact events. First, a large-scale NATO-Russia conflict from a protracted Ukraine-Russia war could spill over into Eastern European NATO members. Russia could engage in drone incursions, airspace violations and hybrid tactics from sabotage to political interference. We assign a 20% probability to this scenario, the same as its opposite (the resolution of the war). A NATO-Russia conflict would negatively impact growth, inflation and markets strongly, while the end of the war would provide moderate positive effects for the Eurozone. Third, escalation of violence in the Middle East (30% probability), including Israel pursuing strikes and territorial actions, or conflicts such as Iran-Israel tensions or Houthi attacks in the Red Sea. These events would moderately depress growth and inflation, while pushing up oil prices and supporting USD appreciation. Fourth, in Asia, we project a 30% probability that tensions in the Taiwan Strait escalate into an open conflict between China and Taiwan. This scenario could be triggered by either US disengagement in the region or increased US support for Taiwan, while China could also be tempted to redirect attention from domestic economic issues. Overall, given the economic significance of these stakeholders, global

growth would be negatively affected, inflation could rise from supply-chain disruptions, and financial markets would face pressure, including higher interest rates, falling US equities and a weaker USD.

AI presents both opportunities and risks. On the downside, we assign a 20% probability to an AI bubble burst, in which companies and investors reassess the profitability and valuations of AI technologies. This could lead to reduced investment flows and enterprise failures. Such a burst would likely slow global and (and even more US economic) growth, put downward pressure on interest rates, weigh on US equities and contribute to USD depreciation.

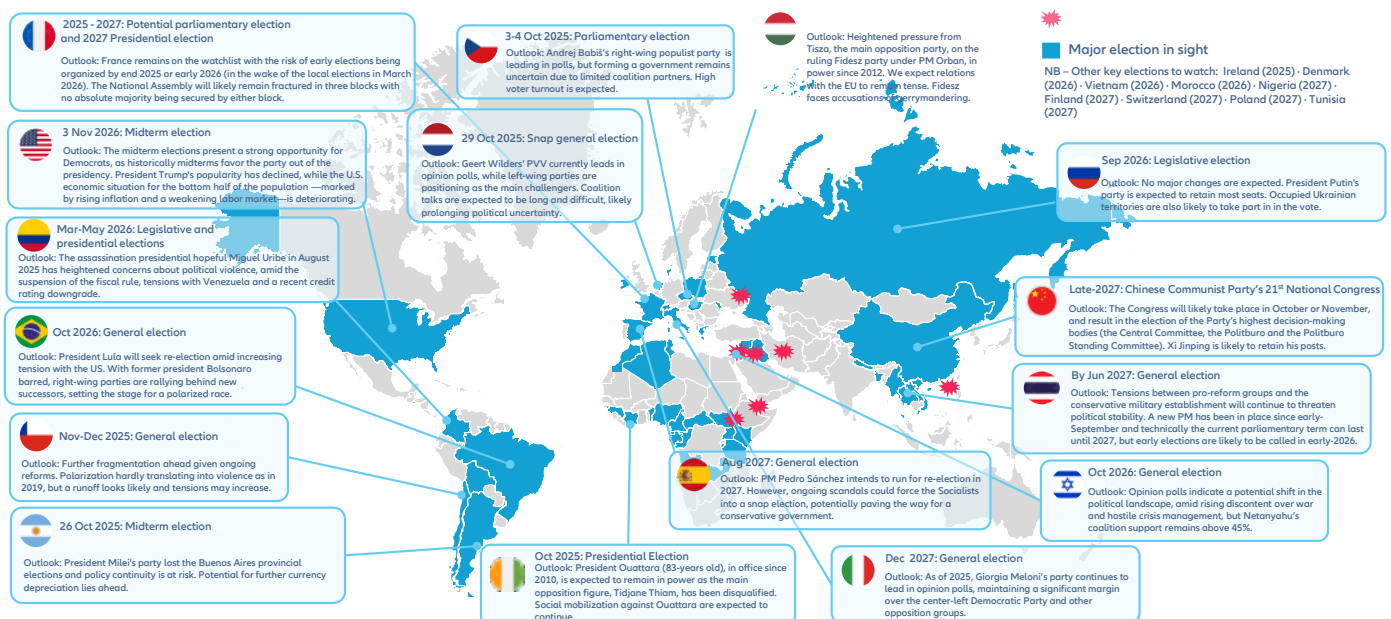
On the upside, we assign the same 20% probability that AI boosts US economic growth, reinforcing US exceptionalism and validating Trumponomics. Offshore companies will increase investment in the US, while deregulation could further support GDP and capital expenditures. This scenario would likely put upward pressure on inflation and be highly favorable for financial markets, leading to higher interest rates, USD appreciation and gains in developed-market equities.

Between 2025 and 2027, risks may also come from a particularly intense elections schedule across all regions of the world. In total, countries which represent 63.3% of global GDP will head to the polls in two years, with 2026 being the most critical year, as countries weighing a third of the world GDP (current prices, April 2025) will hold elections then. In Europe, the rising influence of populist parties will continue heightening economic policy uncertainty, with elections in the Netherlands, Hungary, and France being held in October 2025, April 2026, and April 2027 respectively. In the United States, the midterms of November 2026 will be a decisive moment for Trump’s second presidency, and democrats could regain control of the House of Representatives. In Africa, the focus will be on ensuring safe political transitions, notably in Ivory Coast (October 2026). Meanwhile, South America faces a major electoral cycle at the end of 2025 and into 2026, with large economies such as Argentina, Chile, Brazil, and Colombia holding elections that could have significant macroeconomic repercussions.

Table 4: What could go wrong ?

Factor	Market Theme	Description	Probability	Macro impact	Market impact
Trade	Heightened protectionism	Global trade enters recession due to further US tariff escalation through Sector 232 tariffs, removal of product exclusions and end of China truce.	45%	Growth -- Inflation ++ (US) Inflation - (ROW)	US interest rates: + DM equities: - USD: -
Monetary policy	De-dollarization policy shock	Fed's mandate tweaked to allow for lower interest rates and its independence reduced. The Fed could cut rates below 3% in 2026, increasing overheating risks for the US economy. At the same time, the ECB could remain hawkish for too long.	35%	Growth - Inflation ++	US interest rates: + (steeper) US equities: - USD: --
Fiscal policy	Sovereign debt crisis	High debt and high long-term interest rates put pressure on government. France, Italy, and the UK face constrained budgets and very fragmented Parliaments with the balance going more towards the right. In the US, rising deficits, coupled with expensive tax cuts, also limit fiscal space for growth support.	20%	Growth -- Inflation --	DM interest rates: ++ then - (QE) DM equities: --
Geopolitics	NATO-Russia conflict	No resolution in the Ukraine-Russia war in sight, with escalation risks beyond Ukraine as Russia tests European and NATO's resolve.	20%	Growth -- Inflation 0	DM interest rates: + DM equities: -- USD: +
	End of Ukraine-Russia war	Ukraine-Russia peace treaty, sanctions lifted on Russia progressively	20%	Growth + Inflation -	EZ equities: +
	Middle East escalation	Regional conflict escalates. Israel conflict with Middle-East and less support from the West.	30%	Growth - Inflation +	Oil price: + USD: +
	China-Taiwan open conflict	US disengagement or, on the contrary, increased support for Taiwan, as well as China's potential willingness to divert attention away from Companies and investors reassess the profitability of AI technologies, leading to reduced funding, valuation and consolidation of firms.	30%	Growth - Inflation +	Tech equities: - USD: +
Markets	AI bubble bursts	AI boost transmits to real economy via increased productivity, Trumponomics succeeds with companies moving production to the US and deregulation boosts GDP and investment.	20%	Growth - Inflation -	DM interest rates: - US equities: -- USD: -
Economics	US exceptionalism continues	AI boost transmits to real economy via increased productivity, Trumponomics succeeds with companies moving production to the US and deregulation boosts GDP and investment.	20%	Growth + Inflation +	DM interest rates: + DM equities: ++ USD: +

Sources: national, Allianz Research

Figure 14: (Geo)political risk: From ballots to battlefields

Sources: various, Allianz Research

A photograph showing a group of diverse hands stacked on a tree branch. The hands are of various skin tones and are positioned in a way that suggests teamwork and support. The background is a lush green forest with sunlight filtering through the leaves. The text "Our team" is overlaid on the image, with "Our" in white and "team" in yellow.

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