

What to watch: AI bubble o'clock, Japan's spendy stimulus and EM central banks hit a fork in the road

In summary

Ludovic Subran
Chief Investment Officer and Chief Economist
ludovic.subran@allianz.com

Lluís Dalmau Taules
Economist for Africa & Middle East
lluis.dalmau@allianz-trade.com

Guillaume Dejean
Senior Sector Advisor
guillaume.dejean@allianz-trade.com

Thomas Hartl
Senior Investment Strategist
thomas.hartl@allianz.com

Michael Heilmann
Senior Investment Strategist
michael.heilmann@allianz.com

Patrick Hoffmann
Economist, ESG & AI
patrick.hoffmann@allianz.com

Françoise Huang
Senior Economist for Asia Pacific
francoise.huang@allianz-trade.com

Patrick Krizan
Senior Investment Strategist
patrick.krizan@allianz.com

Yao Lu
Investment Strategist
yao.lu@allianz.com

Luca Moneta
Senior Economist for Emerging Markets
luca.moneta@allianz-trade.com

Giovanni Scarpato
Economist for Central & Eastern Europe
giovanni.scarpato@allianz.com

Garance Tallon
Economist
garance.tallon@allianz-trade.com

Katharina Utermöhl
Head of Thematic & Policy Research
katharina.uterhoehl@allianz.com

Davide Corna
Research Assistant
davide.corna@allianz.com

Is it AI bubble o'clock yet? The financial market frenzy over AI shows classic signs of an asset bubble: widespread consensus, unproven valuations and returns at times detached from earnings. While economics cannot time a bursting bubble, the “Minsky Clock” suggests we are in a late-cycle phase. Our AI Bubble Risk Monitor, which looks at 30+ indicators across market signals, earnings expectations, financial risks and fundamental risks, suggests rising but still manageable bubble pressures. Market signals are mixed, though narrowing equity-market breadth and compressed technology credit spreads stand out, reflecting heavy debt-funded expansion by hyperscalers. But exuberant expectations show the strongest overheating, with persistent earnings upgrades and high forecast dispersion. Financial risks are elevated as corporate debt issuance climbs to fund large-scale AI capex, while fundamental indicators point to shorter GPU product cycles and tightening energy constraints as key indicators to monitor. Ultimately, while the long-term adoption of AI should outlast market corrections, the real risk is the markets may have priced in decades of growth overnight, leaving valuations vulnerable if adoption proves slower than expected.

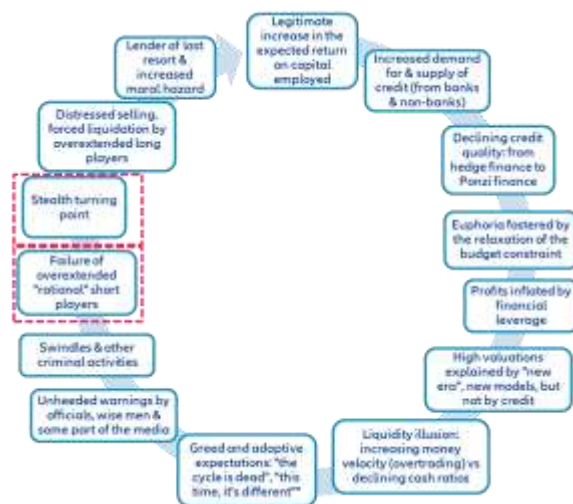
Japan: A spendy stimulus could test the Bank of Japan. The FY2025 supplementary budget, for which the Cabinet finalized the funding plan today, amounts to JPY21.3trn (3.3% of GDP), with a large rise in direct spending. This should worsen the fiscal deficit but will not prevent public debt-to-GDP from declining. We revise on the upside our GDP growth forecasts to +1.4% in 2026 (+1pp) and +1% in 2027 (+0.2pp) – less ambitious than the government – to account for uncertainties and potential tightening of financial conditions. Headline inflation is likely to fall below the BoJ's 2% target by early 2026 but core inflation should remain high. As a result, we keep our outlook for the next BoJ hike in January, with the policy rate ending 2026 at 1.0% and 2027 at 1.5%. We do not think the immediate market reaction was a “Truss moment”, but rather a repricing of Japan's policy mix (fiscal expansion and monetary tightening). Of the 1.8% 10-year JGB yield, 1.3% is now explained by the term premium, of which 0.7% is related to fiscal risks and 0.6% to inflation risks. We see a risk that markets may start testing the BoJ's commitment to monetary tightening, potentially forcing more aggressive interventions such as FX operations (with a likely trigger near 165 USD/JPY), an aggressive hawkish shift or resuming bond purchases to cap yields. Ultimately, the longstanding paradigm of the JPY as a low-yielding, stable funding currency is eroding and the role of the JGB market as a provider of global liquidity will diminish, leaving global financial markets more fragile.

EM central banks: caught between a soft dollar and hard (domestic) constraints. The global emerging market easing cycle that began in mid-2023 is starting to slow: After broad-based rate cuts from early 2024 to mid-2025, only four central banks delivered cuts in November, while 11 have been on hold for six months or longer. External tailwinds from a 10% USD depreciation this year and Fed easing allowed a third of EM central banks to ease more than expected – mostly in South and Southeast Asia, as well as Mexico – while nearly half eased monetary policies less than expected – mostly in Central and Eastern Europe and Latin America, and the rest delivered as projected. For most CEE and Latin American banks, domestic factors (sticky inflation, fiscal constraints and political uncertainty) explain the cautious stance: Hungary has held rates for 14 months despite 650bps of cuts, and Brazil reversed course with 450bps of hikes. As rate differentials narrow and a USD rebound potentially looms, EM debt returns are increasingly carry-driven, calling for selective and tactical positioning. The risk of sharp reversals is rising for currencies, especially BRL, MXN, and ZAR, as valuations are stretched and geopolitical risks loom.

Is it AI bubble o'clock yet?

The financial market frenzy over artificial intelligence bears the classic hallmarks of an asset bubble, with signs mounting that we have entered a late stage of the equity cycle, equivalent to nine on the Minsky clock. Key criteria for an AI asset bubble are currently all present: 1) investors are pursuing a new asset class with no established valuation, with the market seemingly rewarding anything branded with "AI" at staggering multiples; 2) there is a broad consensus on its potential and 3) investment returns have become disconnected from earnings, already pricing in a series of optimistic future outcomes (e.g. Palantir trading at prices equivalent to 229x 2025 earnings and still 81x earnings projected for 2028). However, although economics can identify bubbles, it offers no deterministic way to predict when they will burst. In this context, the classic Fisher–Minsky–Kindleberger framework (see Figure 1) provides a useful lens for assessing where we are in the AI bubble cycle. Indeed, signs are mounting that we have entered a late stage of the equity cycle. Warnings from officials – from the IMF to major central banks – along with commentary from seasoned investors and frequent media comparisons to the dot-com era have largely gone unheeded. Anecdotal reports of short-selling funds capitulating and returning capital further reinforce the sense that it is roughly 9 o'clock on the Minsky clock. In addition there are early signs of a "stealth turning point," with markets gradually shifting into risk-off mode in recent weeks. For instance the Cboe Volatility Index (VIX), Wall Street's "fear gauge," last week rose to its highest level since April, when US tariff announcements triggered a sharp sell-off. Technology stocks – particularly those sporting lofty AI-driven valuations – have come under significant pressure, thanks in part also due to mounting uncertainty over US monetary policy. So is the financial market correction therefore imminent? Not quite. It is important to note that while the Minsky clock can help identify a bubble phase, it cannot predict the timing of the next shift: After all, bubbles are not linear processes. The transition from 8 to 9 o'clock may have unfolded within weeks, yet other stages may persist for many months – or even years.

Figure 1: The Fisher-Minsky-Kindleberger model



Sources: Adapted from Charles Kindleberger's *Manias, Panics and Crashes a history of financial crises*, 1978.

Our AI Bubble Risk Monitor flags rising bubble pressures, **especially under "exuberant expectations"**. To monitor AI bubble risks and keep track of likely catalysts, we look at more than 30 indicators under the following four dimensions: 1) market signals (indicating broader market sentiment and positioning), 2) exuberant expectations (to monitor earnings momentum and in turn the risk of a set-back), 3) financial risks (credit and liquidity) and 4) fundamental risks (to monitor AI demand and supply dynamics to determine whether the technology can ultimately deliver). Our results suggest that while overall risks are on the rise, especially with respect to "exuberant expectations", some warning signals are flashing.

Figure 2: AI Bubble Risk Monitor

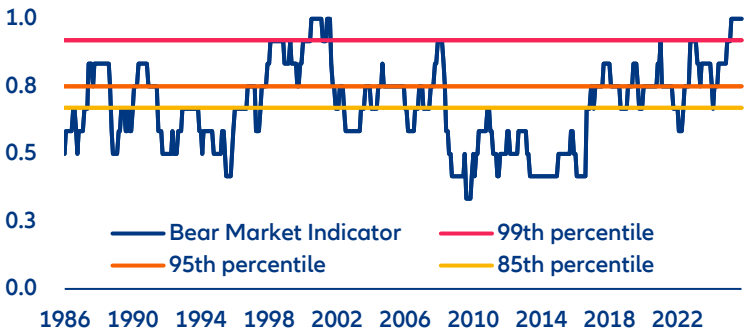
Dimension	Q1 2025	Q2 2025	Q3 2025	Last value
Market Signals	0	0	0	0
Exuberant Expectations	1	1	1	2
Financial Risks	0	1	1	1
Fundamentals Risks	1	1	1	1

Legend	Normal	Elevated	Overheated	Bubble-like
--------	--------	----------	------------	-------------

Source: Allianz Research. Note: In addition to general market indicators, where applicable we also monitor AI sub-segments via equity baskets. The monitor assigns scores to each signal – 0 = normal, 1 = elevated, 2 = overheated and 3 = bubble-like – to help aggregate and compare diverse developments within and across dimensions. Thresholds for scores are derived statistically where long-time data series are available but also via expert judgement.

When it comes to market signals, overall developments remain broadly muted, but narrowing equity breadth and tightening investment-grade tech credit need watching. Overall price momentum is merely strong rather than excessive following the April equity correction. However, two market-pricing developments stand out as meaningful warnings. First, equity gains are increasingly concentrated: Fewer than half of S&P 500 constituents have delivered a positive 12-month return. Such narrow market breadth is reminiscent of the dynamics seen during the Dot-Com bubble. Second, investment-grade credit spreads for tech companies are converging toward broad-market levels, diminishing their traditional safe-haven status. This reflects a surge in debt issuance by major hyperscalers – whose aggressive data-center build-outs are no longer fully financed through internal cash flow – while at the same time maintaining the shareholder distributions and buybacks investors have come to expect.

Figure 3: Bear market indicator



Sources: LSEG Datastream, Allianz Research

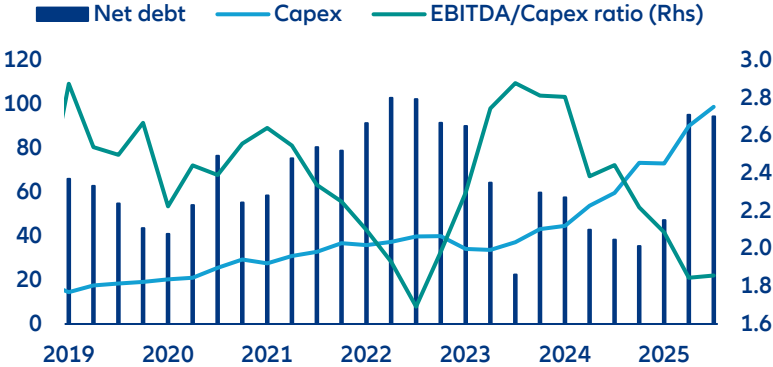
At the same time, surging AI earnings expectations are setting up the risk of disappointment. In this dimension, two indicators are already in bubble-like territory. First, the Bear Market Indicator (Figure 3) – which tracks 12 signals across price momentum, valuation, sentiment, credit and interest rates – has been flashing red¹ since the start of the year and shows no sign of easing. The average of the signals defines the Bear market Indicator, which sees all indicators triggered as of today. In addition, earnings revisions for AI-related stocks remain exceptionally strong, with at least 50% net positive three-month rolling revisions across the AI baskets that we monitor

¹ The individual signals are binary, i.e. either 1 or 0, and we check whether they were triggered over the past twelve months.

(hyperscalers, data centers, semiconductors, software and power), compared with just 12% for the S&P 500 and a long-term average near zero. This translates into global technology earnings expectations for 2026 being revised up by c. 12% year-to-date while broad market earnings expectations remained largely stable. This level of optimism sets a high bar for future earnings beats and increases the risk of disappointment, which could eventually weigh on investor sentiment. Adding to this, a widening dispersion in analyst forecasts for the tech sector is emerging as an early warning signal and recently switched to an **“elevated”** score.

With regard to financial risks, there are rising concerns as hyperscalers increasingly rely on debt to fund the AI capex cycle. The capital-intensive race to build ever-greater computing capacity leaves little room for restraint, with firms assuming that only the largest platforms will capture future AI gains. Massive capex is justified by hopes of exponential demand and high eventual returns, and major US tech firms still show net-income-to-capex ratios above 1. But given the scale of AI spending and elevated expectations, past benchmarks may no longer hold. This investment surge has driven a sharp rise in net debt, pushing even cash-rich giants into debt markets and raising pressure to deliver strong returns. As a result, tech companies are among the biggest issuers of US corporate debt in 2025. As AI narratives spread through credit markets, concerns grow about fallout if expectations deflate. Higher leverage is costly in **today’s** high rate environment, with inflation and tariffs adding pressure. The circular nature of AI investments also increases the risk of cascading damage if a major player falters. Investors have yet to fully **question the sustainability of “tit-for-tat” customer financing arrangements**, but this could quickly become a concern if profit growth weakens or adoption rate curves slow down.

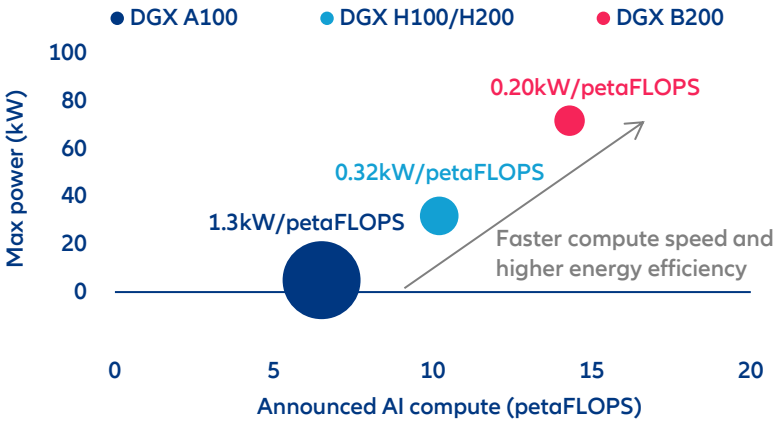
Figure 4: US AI-related hyperscalers fundamentals (debt & capex, in USD bn)



Sources: LSEG Datastream, Allianz Research

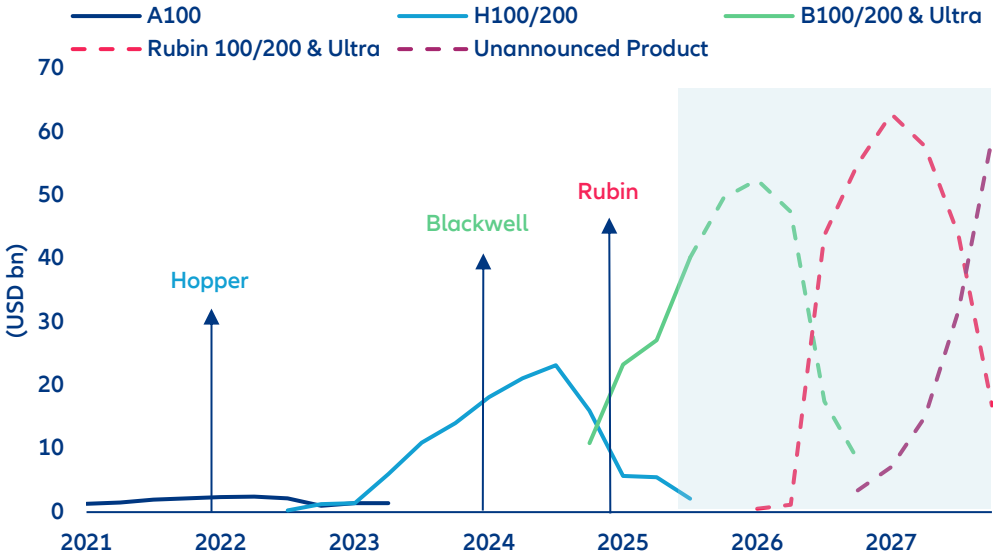
In terms of fundamental risks, GPU product-cycle dynamics and energy-supply bottlenecks need watching. We assign an **“elevated”** score to GPU product-cycle trends as each new generation brings major performance and efficiency gains, increasing hardware-obsolescence risk. **NVIDIA’s announced** computing performance has jumped roughly 14-fold from the A100 to the B200, while power consumption has only doubled (Figure 5), improving energy efficiency from about 1.3 kW/PFLOP to 0.20 kW/PFLOP. At the same time, product update cycles are shortening: NVIDIA has moved from a two-year architecture cadence to annual releases, and sales-mix data show commercial life cycles compressing from roughly 15 quarters for the A100 to estimated 8–9 quarters for Blackwell and Rubin (Figure 6). Peak-sales windows have similarly tightened from 11 quarters to estimated 5–6. This rapid rollout is already pressuring legacy GPUs. Since Blackwell shipments began in late 2024, rental rates for older models have dropped sharply – A100 down over 30% and H100 over 20% – as customers shift to more efficient chips. While older GPUs remain operable for years, their economic competitiveness erodes quickly, raising residual value and capex recovery risks for data center operators and investors.

Figure 5: Each new GPU generation brings greatly improved performance and energy efficiency



Sources: NVIDIA, Allianz Research

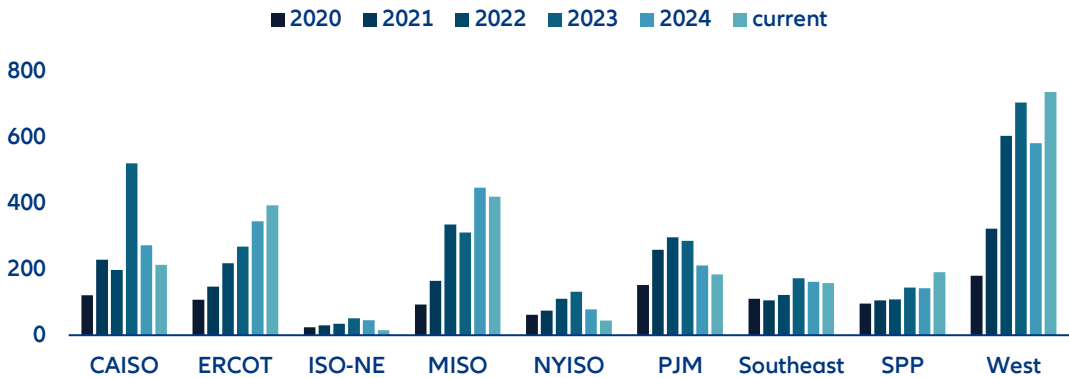
Figure 6: Accelerating upgrade cycles are driving rapid sales dominance of new GPU generations and shortening the product cycle for each



Note: arrows point to the announcement dates of models; dotted lines in blue-shaded area represent estimated future sales
 Sources: Morgan Stanley, Allianz Research

Another area to watch in the fundamentals dimension is the emergence of energy-market bottlenecks. AI-driven electricity demand is soaking up much of the new supply, resulting in an “overheated” score, while growing interconnection queues warrant an “elevated” rating. US data-center power demand is expected to rise +19.5% in 2026 (about 52 GWh), and while planned additions could add roughly 130 GWh, the margin is thin and further pressure from electric vehicles and electrification could lift prices. The bigger problem is that many new power sources cannot connect to the grid fast enough. Despite a +40% increase in the number of projects processed over the past decade, interconnection queues continue to expand, heightening the likelihood of delays for new data centers (Figure 7). Conditions are especially tight in Texas, where ERCOT’s swelling queues pose a near-term bottleneck for the AI build-out.

Figure 7: Interconnection queues in US power markets (in GW)



Source: LBNL, [interconnection.fyi](https://www.lbnl.gov/interconnection.fyi)

Important disclaimer: Calling an AI asset bubble does not mean dismissing the technology itself. While the AI Bubble Risk Monitor underlines growing risks that the asset bubble will burst, we expect its long-term adoption to outlast current market corrections. After all AI is already having a profound impact on sectors such as healthcare, finance, as well as productivity. The real risk is that markets may have priced in decades of growth overnight, leaving valuations vulnerable if adoption proves slower than expected. Put simply: AI may well change the world but markets don't always move in a straight line.

Japan: A spendy stimulus could test the Bank of Japan

The FY2025 supplementary budget, for which the Cabinet finalized the funding plan today, amounts to JPY21.3trn (3.3% of GDP), with a large increase in direct spending. While worsening the fiscal deficit, the package is unlikely to prevent the public debt-to-GDP ratio from declining in the coming years. The supplementary budget includes JPY17.7trn (2.8%) of direct spending, i.e. JPY4trn (0.6%) more than last year. Much uncertainty remains around the details of the package, but as usual three pillars of measures have been proposed. The first pillar, addressing the rising cost of living, amounts to more than half of the package (see Figure 8). Measures include direct subsidies to households (e.g. for electricity and gas, child support, food vouchers), wage hikes for healthcare workers and additional cuts on gasoline and income taxes. The second pillar focuses on long-term investments to strengthen economic security in fields such as shipbuilding, critical minerals, semiconductors and AI, and supply-chain security (notably to reduce import dependency in the food industry). The third pillar focuses on defense and brings forward the 2% of GDP spending deadline from FY2027 to FY2025. The supplementary budget is expected to worsen the fiscal deficit by roughly 1pp of GDP in FY2025 and FY2026, which we estimate could add up to +3pps to Japan's debt-to-GDP ratio by 2027. This would imply a slower decline in the ratio, though it would still be manageable from a debt-sustainability perspective.

Figure 8: Japan's 2025 supplementary budget

	JPY trn	% of GDP
Pillar I - Measures to address high prices and enhance living environment	11.7	1.8%
Electricity and Gas bills assistance	0.5	0.1%
Child-rearing support	0.4	0.1%
Priority Support Local Allocation Grant expansion	2.0	0.3%
Household support program	0.6	0.1%
Food program	0.4	0.1%
Healthcare support	1.4	0.2%
SMEs wage growth support measures	1	0.2%
Tax cuts	2.7	0.4%
Gasoline tax rate abolition	1.5	0.2%
Increase of the income tax annual income threshold	1.2	0.2%
Pillar II - Crisis management and growth investments	7.2	1.1%
Pillar III - Measures to strengthen defense capabilities and diplomatic effectiveness	1.7	0.3%
Defense budget	1.1	0.2%
Reserve Fund	0.7	0.1%
Total	21.3	3.3%

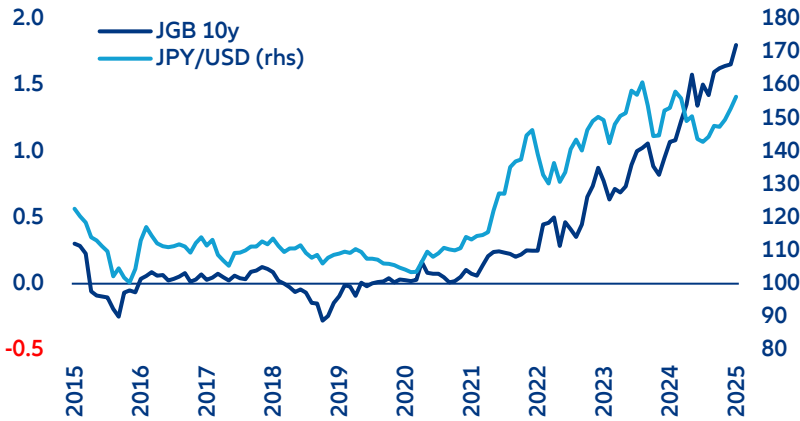
Sources: Japan Cabinet Office, Allianz Research

The measures are expected to raise 2026 GDP growth by +0.7pp, and reduce headline inflation by -0.4pp on average – although core inflation should remain elevated. The government is expecting the supplementary budget to increase GDP by JPY24trn by FY2027, implying a boost of +1.4pp to GDP growth on average per year, though this seems ambitious. Taking into account standard fiscal multipliers uncertainties regarding the precise timing of implementation of certain measures and potential tightening of financial conditions, we are revising on the upside our GDP growth forecasts more mildly, to +1.4% in 2025 (+0.1pp), +1.4% in 2026 (+1pp) and +1% in 2027 (+0.2pp). The government expects the elimination of the gasoline tax to reduce inflation by -0.3pp on average in 2026, while electricity and gas subsidies are expected to further reduce it by -0.4pp around Q1 2026. This should push headline inflation below the Bank of Japan's 2% target by early 2026, while core inflation (excluding fresh food and energy) should remain elevated.

With underlying inflation still elevated and likely exacerbated by the supplementary budget, we maintain our expectations for the BoJ, with the next hike in January and policy rate ending 2026 at 1.00% and 2027 at 1.50%. We expect the supplementary budget's relief on headline inflation to be short-lived as the stimulus measures will boost household demand. Furthermore, *RENGO*, the Japanese Trade Union Confederation, has started the yearly wage negotiations (*shunto*, due to be concluded in spring) by asking for a hike of at least +5% for 2026, the same initial ask as last year's, when they ultimately obtained +5.52%. The BoJ mentioned last week it was closely monitoring the wage negotiations and discussing potential interest rate hikes during upcoming meetings. In this context, we maintain our policy rate outlook: The next hike should occur at the BoJ's January 2026 meeting (to 0.75%), followed by additional ones in July 2026 (to 1.00%), January 2027 (1.25%) and July 2027 (1.50%). Meanwhile, a weak JPY is creating additional inflationary pressures through higher prices of imported food and energy, prompting the finance minister to confirm last Friday that FX intervention could be considered if needed.

Market reaction: **not a "Truss moment"**. Following the budget announcement, yields on 10-year Japanese Government Bonds (JGBs) surged to a 17-year peak, exceeding 1.8%, while the yen depreciated to its lowest level against the US dollar in 10 months, reaching 158 JPY/USD (Figure 9). Rather than indicating a loss of market confidence akin to a Japanese "Truss moment," we see this market reaction as a repricing of Japan's policy mix combining fiscal expansion with ongoing monetary tightening.

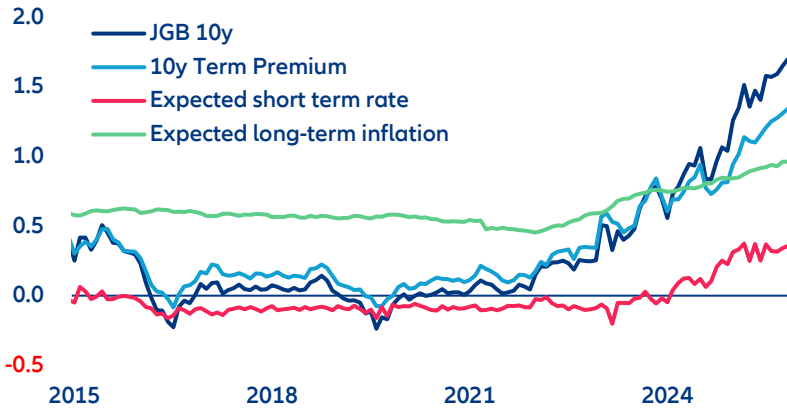
Figure 9: Markets are repricing Japan's fiscal and monetary policy mix



Sources: LSEG Datastream, Allianz Research

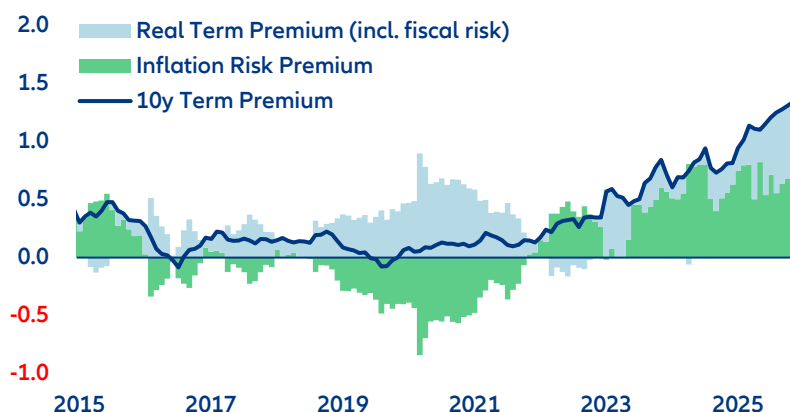
In this regard, the dynamics in Japan somewhat mirror the situation in the US, where risks associated with a nominal growth stimulus (fiscal credibility) and central bank independence are driving the bond and currency markets. For now, JGB markets have not priced in a lasting effect on nominal growth from the stimulus package. Long-term inflation expectations remain anchored, the inflation risk premium is stable and short-term rate expectations remain flat. The recent rise in long-term yields is therefore solely due to the real term premium, reflecting in particular changes in sovereign bond supply-demand dynamics (i.e. fiscal risk) (Figure 10). The Cabinet's funding plan for the FY2025 supplementary budget consists in the issuance of government bonds amounting to JPY11.7trn, which would bring total issuance in FY2025 to JPY40.3trn (compared to JPY42.1trn in FY2024). Of the 1.8% total nominal yield for 10-year JGB, 1.3% is now explained by the term premium, of which 0.7% is related to fiscal risks and 0.6% to inflation risks. That is very different from the situation from early 2024 when inflation risks explained almost the entire term premium (Figure 11).

Figure 10: Yields of 10y JGB are mostly driven by term premium*



*based on Abrahams et al. (2015)
Sources: LSEG Datastream, Allianz Research

Figure 11: Fiscal risks have been priced in the 10y JGB term premium*



*based on Abrahams et al. (2015)

Sources: LSEG Datastream, Allianz Research

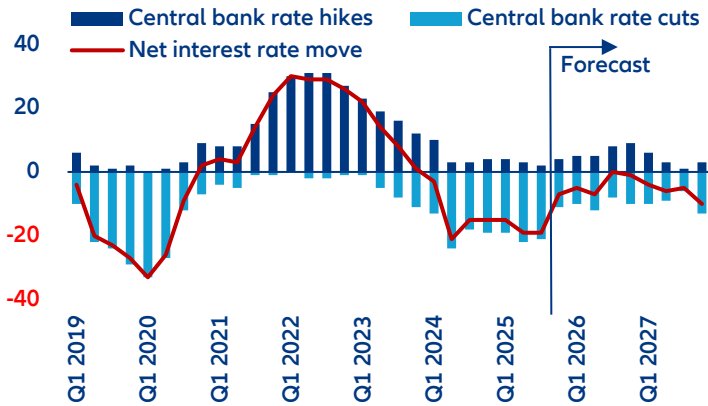
The BoJ's strategy tested by markets. We maintain our view that the BoJ has at least tolerated the increase in long-term JGB yields so far, counting on capital repatriation as a stealth support for the JPY. However, this strategy has not paid off yet mainly because real yields remain too low in Japan relative to other G10 economies. In the near term, the expected BoJ policy rate hikes are likely to put a floor under the JPY and cap further bond routs. But with domestic investors still largely on the sidelines, foreign investors are currently setting marginal prices at the long end of the JGB curve, often with thin liquidity. We see a risk that they will start testing the BoJ's passive stance and its commitment to its policy rate path and/or quantitative tightening, potentially forcing more aggressive interventions such as FX operations (with a likely trigger near 165 USD/JPY), an aggressive hawkish shift or resuming bond purchases to cap yields. We even see a possibility that the BoJ ends up re-flattening the JGB curve by lifting the short end with a more hawkish rate path, while dampening the long end by ending QT.

Global financial markets risk becoming more fragile. The market reaction to the new fiscal stimulus package is another signal that the longstanding paradigm of the JPY as a low-yielding, stable funding currency is eroding and the role of the JGB market (second largest sovereign bond market in size after the US) as a provider of global liquidity, leverage and volatility suppression will diminish. This leaves global financial markets more fragile and prone to funding shocks as the era of easy carry trade is ending.

EM central banks: caught between a soft dollar and hard (domestic) constraints

The global emerging market (EM) easing cycle that began in mid-2023 has entered a mature and increasingly differentiated phase. After a broad wave of rate cuts spanning from early 2024 through mid-2025, momentum has slowed markedly in Q4 2025: Only four central banks delivered cuts in November, while 11 have now been on hold for six months or longer. Out of the 27 major EM central banks we track, 25 technically remain in cutting cycles but a clear divide has emerged between those that are still actively easing – such as Mexico, Poland, South Africa, the Philippines and Egypt – and those that have largely front-loaded their adjustments or exhausted policy space amid persistent inflation and domestic constraints. Hungary, for instance, has kept rates unchanged for 14 months despite 650bps of cumulative cuts, reflecting fiscal concerns and currency fragility. Domestic factors are now taking precedence, with sticky inflation and fiscal imbalances limiting room for additional moves even as the Fed continues to ease. Brazil, meanwhile, has embarked on a divergent trajectory by reversing its earlier cuts, with 450bps of hikes since September 2024 mostly due to fiscal concerns and domestic inflation. Domestic events also forced the Turkish central bank to resume a hawkish monetary policy following March events, and the pace of easing slowed thereafter, with a year-end inflation target of 32% – a revision of about 8pps from the initial target. Looking ahead, the overall pace of EM easing is expected to moderate further through 2026 as more countries reach or approach their terminal rates (Figure 12).

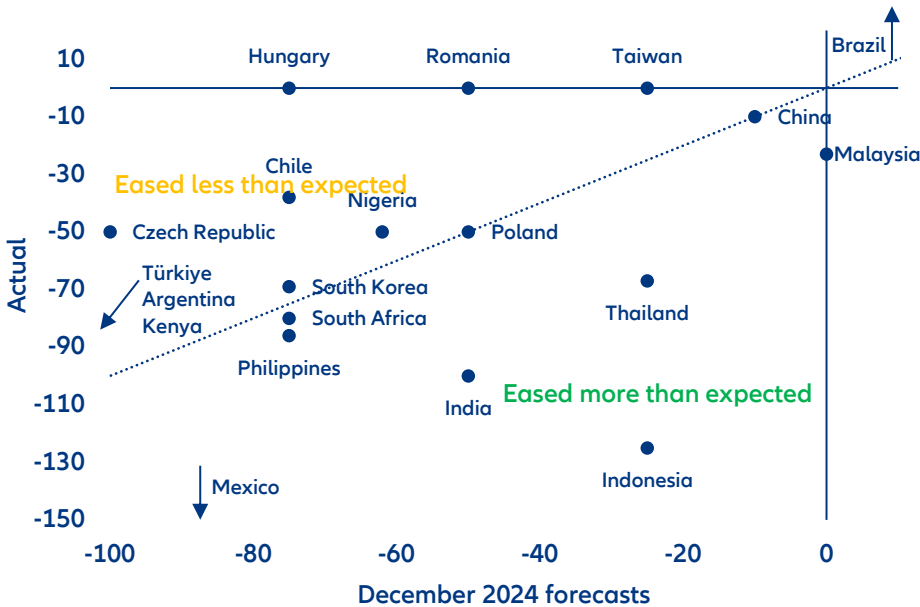
Figure 12: Net number of countries hiking/cutting policy rates across 40 EMs



Sources: LSEG Datastream, Allianz Research

In a year with a relatively weak USD and major shifts in expectations regarding the Fed policy, some EM central banks were given more room to frontload and ease their monetary policies. Between the end of 2024 and the end of Q3 2025, the US Dollar Index declined by nearly -10% (with most of that decline happening by the end of April 2025). Yet, looking at the cumulative change in policy rates between the end of 2024 and the end of Q3 2025 and our forecasts from December 2024, we find that nearly half of the major EM central banks we track actually eased monetary policies less than expected – mostly in Central and Eastern Europe and Latin America. Only a third eased more than expected – mostly in South and Southeast Asia, as well as Mexico – and the rest delivered as projected.

Figure 13: Cumulative change in policy rates between Q4 2024 and Q3 2025, our December 2024 forecasts vs. actual changes (bps)

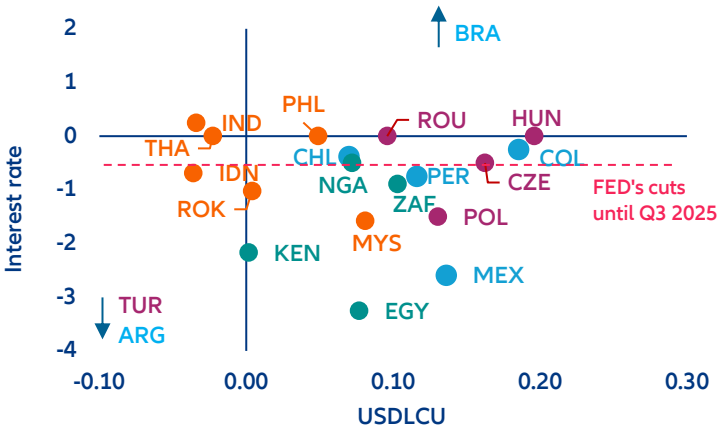


Sources: LSEG Datastream, Allianz Research

Some central banks in EM Asia and Mexico eased more than previously expected due to a combination of external factors, including more aggressive US trade policy towards the region, closer synchronization with the Fed’s cycle and USD dynamics. ASEAN nations together with India were among the most affected by US tariffs, with initially announced rates above 30%, later reduced to between 19% and 25% for Indonesia, Malaysia and Vietnam. Thailand and India are yet to reach a deal with the White House. Aggressive US trade policy weighed on the region’s growth outlook, providing an additional reason for central banks to ease monetary policies as inflation risks were subdued. The region remains correlated with the Fed’s moves, given historically higher sensitivity: As

shown on Figure 14, countries in Asia have almost all remained closer to the Fed’s -50 bps in the first three quarters of 2025. The milder economic outlook and more aggressive trade war caused many currencies in EM Asia to depreciate against the USD, attracting lower hard currency inflows – a phenomenon that could continue in countries where current account deficits are deteriorating, such as the Philippines and Indonesia. While still moving in sync with the Fed, Mexico also eased more than expected (-250bps), given lower economic activity and limited price pressures. Looking ahead, the potential turnaround of the USD could be a contributor to the maturing easing cycle of certain central banks. In recent weeks, USD appreciation has signaled a potential return to a stronger greenback, eroding the benefits for EMs’ external and fiscal positions, increasing both debt-servicing costs and the costs of imports. This risk is especially amplified for countries with large external financing needs – such as Ethiopia, Egypt and Argentina – and countries highly exposed to USD-issued debt, such as Colombia.

Figure 14: 2025 window of easing cycle and local currency appreciation in EMs



Sources: LSEG Datastream, Allianz Research

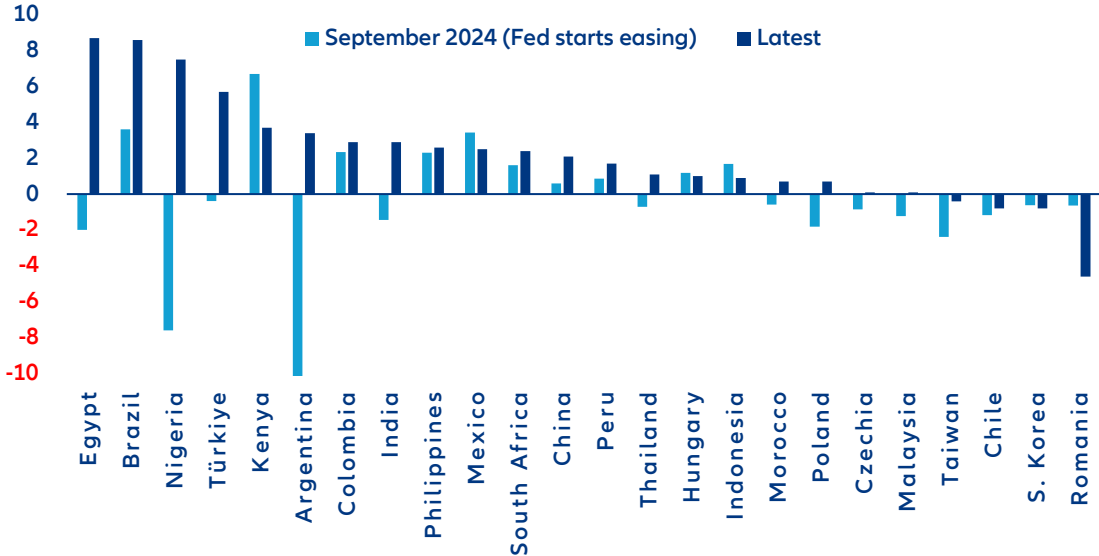
Meanwhile, domestic drivers forced central banks particularly in Central and Eastern Europe and Latin America (Brazil and Colombia) to turn more hawkish than expected. Local inflation pressures, especially sticky core and services inflation linked to strong wage growth, tight labor markets and imported inflation, remained elevated even as global disinflation continued. The most evident example for CEE is Romania, where an unexpected spike in inflation to close to double digits was driven by fiscal tightening and changes to energy policies, keeping underlying inflation sticky despite weaker external pressures. In Latin America, central banks maintained a cautious stance as food-price volatility, resilient domestic demand and fiscal uncertainties (including pre-electoral uncertainty, spending risks or debt concerns) kept inflation risks skewed upward. Looking ahead, meaningful policy easing hinges on a clear deceleration in core prices and wages alongside credible fiscal discipline, while renewed fiscal slippage, exchange-rate depreciation, food or supply shocks and stronger-than-expected domestic demand remain the key triggers that could prolong or even intensify the hawkish stance in countries like Brazil and Colombia.

The current easing cycle has had a constructive effect on debt markets. Local bonds delivered strong returns as yields retraced from multi-year highs, and hard currency spreads compressed to historical lows. Technical factors – renewed inflows and improving liquidity – amplified performance. Yet, valuations now appear stretched, leaving limited room for further spread tightening. Growth has stabilized, supported by lower borrowing costs and resilient domestic demand, but geopolitical risks and fiscal slippage remain headwinds. As the ongoing EM easing cycle matures, the initial tailwinds for EM debt begin to fade. At this stage, performance becomes more carry-driven rather than price-driven, and investors shift focus to relative value and credit selection. Additionally, the risk-reward profile deteriorates: while lower rates support growth and liquidity, they can also encourage fiscal complacency and increase vulnerability to external shocks. In short, late-cycle dynamics call for a more tactical approach, emphasizing selective exposure and active risk management.

Early in an easing cycle, EM FX tends to benefit from improved risk sentiment and capital inflows, especially when global liquidity conditions are supportive and the US dollar weakens. But these advantages diminish as the cycle matures. High real yields relative to developed markets attract carry trades, reinforcing currency strength.

The average spread between EMs and the US real interest rate (i.e. net of inflation) currently stands at 2pps, which helps attract capital flows, accumulate reserves and retain room for maneuver in case of currency volatility. When the Fed began its easing cycle, the differential was close to zero (see Figure 15). However, as the easing cycle matures, these advantages diminish. Rate differentials narrow, reducing carry appeal, and positioning becomes crowded, increasing vulnerability to profit-taking and volatility spikes. Moreover, if easing coincides with fiscal deterioration or political uncertainty, FX can underperform despite lower rates. In the current cycle, while BRL, MXN and ZAR remain favored for carry, the risk of sharp reversals is rising as valuations are stretched and global (geopolitical) risk factors are looming.

Figure 15: Real interest rate differential vs. the US (pps)



Sources: LSEG Datastream, Allianz Research

Overall, a major correction in global markets (extending beyond AI and the tech sector) would lead to further monetary easing. A potential market correction would especially affect chip and electronics manufacturing hubs, such as Taiwan, Malaysia or Vietnam, which could see demand drop, as well as by countries in the Middle East that are upstream in the supply chain, such as Israel, a leading hub for AI research and development. Gulf countries would also be exposed, given the large sums of money invested in the industry. The demand hit of AI-related commodities could also be felt especially in Chile, Indonesia or the Democratic Republic of Congo, major exporters of lithium, nickel and cobalt. All these factors would make many EM central banks return to an easing policy stance. Beyond AI, a major global correction could have implications reducing global liquidity levels that would further contribute to the easing cycle.

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

FORWARD-LOOKING STATEMENTS

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.

Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the EUR/USD exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

NO DUTY TO UPDATE

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.