Allianz Trade

19 December 2024

Allianz Research

Global Economic Outlook 2025-26

Defying gravity?

Our outlook playlist, inspired by Wicked, the musical.
Happy holidays!

Executive Summary

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The wicked witch of the west is (almost) dead! We're talking about inflation, of course. But will 2025 be the year we can finally stop paying attention to the men and women behind the curtain? After a super electoral year, 2025 will be all about effective policy making. As markets reached a new high this year, one question is on everyone's mind: will risky assets continue to be "popular" (you're gonna be popular)? In keeping with our tradition, we couldn't resist taking some musical inspiration for our last economic outlook of the year. We hope you find it Wicked!

- **Global economic growth: Not quite "dancing through life".** Global real GDP growth is expected to remain moderate but steady at +2.8% in 2025-26. We expect developed economies to experience a slight slowdown, with growth tapering from +1.8% in 2025 to +1.7% in 2026. In contrast, emerging economies are likely to sustain robust growth at +4.1% across both years. The US economy is forecasted to grow at +2.3% in 2025, slowing to +1.8% in 2026. The Eurozone is projected to grow by +1.2% in 2025 and +1.5% in 2026, with countries like Spain and Ireland leading with higher growth rates. Germany, however, is set to record modest growth after two years of recession. China's growth is projected to moderate from +4.6% in 2025 to +4.2% in 2026 as the country continues to transition towards a more consumption-driven economy while managing external trade pressures.
- **Is "something bad" on the way? After the super electoral year, "the Wizards (and not us)" of policy design will be very influential for both the economy and capital markets.** Political changes, such as the US elections, could reshape economic landscapes and introduce uncertainties. Geopolitical risks, including tensions between major powers, continue to be a significant concern for global stability. A potential trade war by Q2 2025, with US tariffs rising to 60% for China and 10% for others, could increase US inflation and weaken global growth. Significant US immigration cuts might strain labor markets in key sectors and add to inflationary pressures. Challenges to the Federal Reserve's independence, including possible currency interventions, could dramatically increase financial risks. Fiscal policy changes, such as major spending cuts or extensive tax cuts, could impact market confidence. In the Middle East, a tougher US stance on Iran could slow growth and raise oil prices. Similarly, reduced US support for Taiwan might lead to tariffs and negatively impact semiconductor equities. The climate and energy transition faces challenges, with the potential repeal of the Inflation Reduction Act, which could maintain neutral growth and reduce inflation while boosting fossil equities.

- **"No one mourns the wicked": Inflation should finally retreat to 2% in 2025, allowing for monetary policy easing to continue until end-2025. "Thank goodness" central bank policy will shift from taming inflation to supporting growth (but do not hold your breath).** Upside risks remain from potential tariff implementation in the US and unfolding retaliation measures. Further supply-chain constraints, from the rise in protectionist measures and ongoing conflicts triggering higher transportation costs, could temporarily increase inflation. The Fed, the BoE and the ECB are expected to lower rates to 3.5%, 3.25% and 2% by end-2026, respectively. Emerging markets are also likely to see cautious monetary easing, except for countries like Brazil, which may face rate hikes due to economic overheating.
- **"No good deed" goes unpunished: Government bond yields are expected to remain broadly stable over the next two years, with markets already pricing in significant central bank easing.** The effects of large US fiscal deficits and accelerated quantitative tightening in Europe will offset the downward pressure from falling policy rates. French bond spreads are likely to remain wider than those of Spain, reflecting comparatively weaker fundamentals for France, while swap spreads in Europe should remain close to zero.
- **But the outlook is not entirely "wonderful" for risky assets.** Recovering earnings and strong fundamentals should support risky assets, with equities projected to deliver an average total return of 8-10% and credit spreads likely to remain steady through 2025 and 2026. However, high valuations, economic uncertainty and concentration risks could cap gains and leave risky assets exposed to unexpected political or economic shocks..
- **"What is this feeling?": Uncertainty continues for companies.** While policy shifts and geopolitical risks present challenges, sectors like AI and technology are expected to see growth. Investment in infrastructure and sustainable sectors is also projected to increase. Business insolvencies are expected to increase by +2% in 2025 and to stabilize at high levels in 2026.

Global economic outlook:
Four years in a row of below 3% economic growth

We expect global growth to remain steady but not stellar at +2.8% in 2025-26. We expect developed economies to experience a slight slowdown, with growth tapering from +1.8% in 2025 to +1.7% in 2026. The US economy is forecasted to grow at +2.3% in 2025, slowing to +1.8% in 2026. This reflects a gradual deceleration as the country will navigate various economic challenges, including potential fiscal policy shifts and trade dynamics. The UK is expected to see growth of +1.3% in 2025, slightly increasing to +1.5% in 2026. The Eurozone is projected to grow by +1.2% in 2025 and +1.5% in 2026, with countries like Spain and Ireland leading with higher growth rates. Germany, however, is set to record modest growth after two years of recession.

Emerging economies are likely to sustain robust growth at +4.1% across both years. China's growth is projected to moderate from +4.6% in 2025 to +4.2% in 2026 as the country continues to transition towards a more consumption-driven economy while managing external trade pressures. India is expected to maintain

Table 1: Global real GDP growth, %

Growth (yearly %)	2022	2023	2024f	2025f	2026f
Global	**3.3**	**2.8**	**2.8**	**2.8**	**2.8**
USA	**2.5**	**2.9**	**2.8**	**2.3**	**1.8**
Latin America	**3.9**	**1.9**	**2.0**	**2.6**	**3.2**
Brazil	3.1	2.9	3.1	2.5	2.3
UK	**4.8**	**0.3**	**0.8**	**1.3**	**1.5**
Eurozone	**3.6**	**0.5**	**0.8**	**1.2**	**1.5**
Germany	1.5	-0.1	-0.1	0.4	0.9
France	2.6	1.1	1.1	0.7	1.2
Italy	4.8	0.8	0.5	0.8	1.0
Spain	6.2	2.7	3.0	1.8	2.0
Central and Eastern Europe	**1.1**	**1.2**	**2.1**	**3.0**	**3.2**
Poland	5.9	0.1	2.6	3.4	3.4
Russia	-1.3	3.7	2.8	1.8	2.0
Türkiye	5.5	5.1	2.7	2.5	3.5
Asia-Pacific	**3.2**	**4.3**	**4.2**	**4.1**	**3.9**
China	3.0	5.3	4.9	4.6	4.2
Japan	1.1	1.7	-0.3	1.2	1.1
India	6.5	7.8	6.6	6.4	6.5
Middle East	**6.1**	**1.3**	**2.1**	**3.0**	**3.2**
Saudi Arabia	7.7	-0.8	1.4	4.3	4.1
Africa	**3.9**	**3.1**	**2.8**	**3.4**	**4.0**
South Africa	1.9	0.7	1.1	1.7	1.6

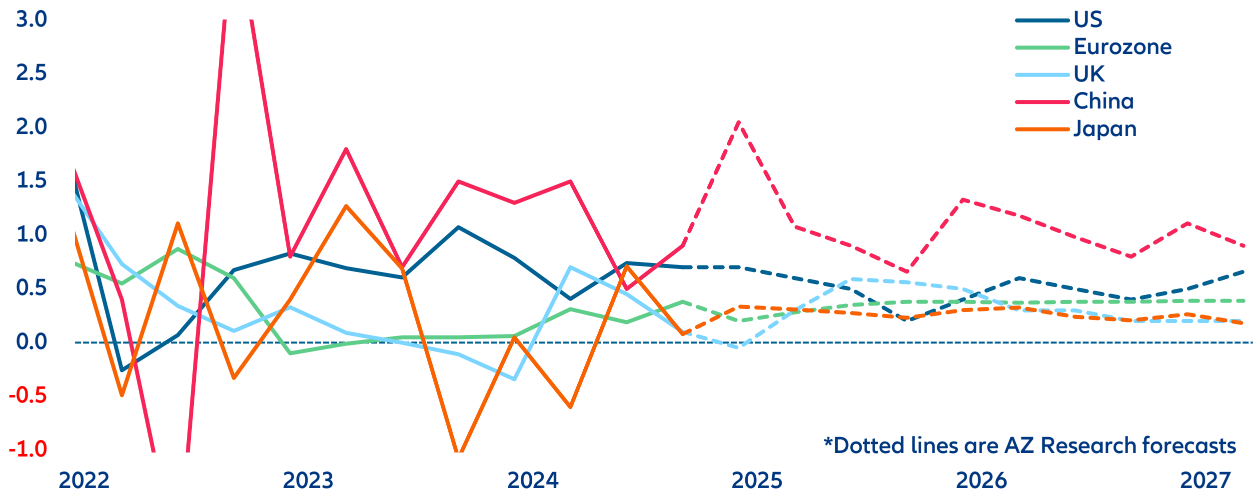
Sources: National sources, Allianz Research strong growth at +6.4% in both 2025 and 2026, driven by domestic consumption and investment. The Brazilian economy is forecasted to grow at +2.5% in 2025, slowing slightly to +2.3% in 2026 as it navigates inflationary challenges. Russia's growth is anticipated to be modest, with +1.8% in 2025 and +2.0% in 2026, reflecting geopolitical and economic adjustments to the overheating of the economy, pushing the central bank to take a hawkish stance. Central and Eastern Europe is projected to accelerate from +3.0% in 2025 to +3.2% in 2026, with Poland and Romania leading the growth. In Latin America, growth is forecasted to rise from +2.6% in 2025 to +3.2% in 2026, with countries like Argentina and Colombia showing notable improvements. The African continent is expected to see growth accelerate from +3.4% in 2025 to +4.0% in 2026, with countries like Nigeria and Kenya contributing significantly. In the Middle East, growth is projected to increase from +3.0% in 2025 to +3.2% in 2026, supported by recovery in countries like Saudi Arabia. Finally, in Asia, we expect strong growth, with slight moderation from +4.2% in 2025 to +4.0% in 2026, driven by major economies like India and Vietnam, exposed to fiscal consolidation and to a slower growth in global trade, even if Asean countries will continue to remain more attractive than China in the context of the US-China trade war.

Table 2: Potential surprises to our scenario

Factor	Market Theme	Description	Probability	Macro impact	Market impact
Trade	Full blown trade war	Rising tariffs will raise inflation in the US and depress global economic confidence and growth	45%	Growth - - Inflation + +	DM interest rates: - DM equities: -
Immigration	US cuts immigration drastically	Strong drop in net immigration or even massive deportation (above 1mn people per year)	20%	Growth - - Inflation neutral	US interest rates: - US equities: -
Monetary policy	Fed independence seriously challenged	Fed's mandate tweaked to allow for lower interest rates and its independence reduced	35%	Growth - Inflation + +	US interest rates: + US equities: -
	USD currency intervention	Fed intervenes on the FX market to weaken the USD	20%	Growth - Inflation +	EZ interest rates: -
US Fiscal policy	Fiscal spending cuts	DOGE drastically cuts spending (more than USD300bn per year), including federal agencies and social spending	30%	Growth - Inflation -	US interest rates: - US equities: -
	Tax cuts	All tax cuts promised are delivered (>2.5% of GDP in total)	45%	Growth + Inflation +	US interest rates: + US equities: +
Geopolitics	Ukraine-Russia end of war	Ukraine-Russia ceasefire, peace talks, US lifts sanctions on Russia, but Europe keeps them	45%	Growth + Inflation neutral	EZ industrials: +
	Europe under pressure on NATO	US threatens to defund NATO, pressuring Europe to increase defense spending to above 2% of GDP per year	40%	Growth + Inflation +	EZ defense stocks: +
	Middle East: Tougher stance and sanctions on Iran	US escalates pressure on Iran, including threats of US military intervention	30%	Growth – Inflation +	Oil price: +
	China-Taiwan: US reduces support to Taiwan	US threatens to impose tariffs on Taiwanese imports and to withdraw support against China if Taiwan does not increase military spending	30%	Growth – Inflation +	Semiconductor equities: -
Climate transition	Climate & energy transition	Repealing of the IRA, defunding of environmental agencies	55%	Growth neutral Inflation –	Fossil equities: + Oil price: -
EZ Fiscal policy	Germany lifts the debt brake completely	A two-third majority in the newly elected German parliament changes the constitution to remove the debt brake	20%	Growth + Inflation +	DE interest rates: + EZ equities: +

Sources: National sources, Allianz Research

Figure 1: Quarterly real GDP growth rates, q/q, %



Sources: National, Allianz Research

Risks to our scenario remain tilted on the downside. A full-blown trade war as soon as Q2 2025 (45% probability) with US tariffs rising to 60% for China and 10% for the rest of the world should push up US inflation and undermine global confidence and growth. Drastic US immigration cuts (more than 1mn people per year) could strain the labor market (20% probability), notably in sectors such as construction, farming, food preparation, healthcare and transportation, and exacerbate the inflationary pressures. Challenges to the Federal Reserve's independence, with a 35% chance of its mandate being altered to support lower interest rates, including potential USD currency interventions to lower the value of the USD, could push the US economy into a financial crisis. Fiscal policy shifts, such as substantial spending cuts (more than USD300bn per year) – 30% probability – or broad tax cuts (more than 2% of GDP in total) – 45% probability – could alter market confidence. In the Middle East, we see a 30% probability of the US taking a tougher stance on Iran, escalating sanctions and military threats, which could slow growth and increase oil prices. Similarly, a 30% chance exists of the US reducing support to Taiwan, potentially imposing tariffs and affecting semiconductor equities negatively. The climate and energy transition may face challenges, with a 55% probability of repealing the Inflation Reduction Act (IRA) and defunding environmental agencies. This scenario could maintain neutral growth, reduce inflation, and boost fossil equities while lowering oil prices.

In times of global uncertainty, the path to peace can be as challenging as the conflict itself. Since 2022, international markets have experienced disruptions due to changes in supply chains, particularly linked to the sanctions on Russia, notably on energy. Recent developments indicate that the newly elected US administration may continue to support Ukraine, albeit with a focus on stabilizing economic conditions. The evolving situation in Syria and Russia's reliance on assistance from other nations highlight the potential for diplomatic negotiations. This scenario underscores the importance of maintaining strong international relationships and economic resilience. Global markets, including those in the Caucasus and Central Asia, need to navigate these complexities carefully. Russia may seek to strengthen its economic ties and regain market share, which could influence global competition dynamics, especially between the US and China. The US could further push Europe to increase its military spending as part of the NATO commitments. The European Commission President has suggested the EU could increase its average annual military spending to 1.9% of GDP from the current 1.3% of GDP, which could mean an additional USD275bn spending, i.e. double what the US spends annually.

In this interconnected world, businesses and nations alike must remain adaptable, ensuring that they are prepared for shifts in the geopolitical landscape and their potential impact on global economic stability. All eyes are on fiscal moves following the super electoral year. In Europe, many economies anticipate moderate growth in 2025, bolstered by lower interest rates, a resilient labor market and NGEU inflows. But the fiscal adjustments required to comply with the reinstated and revised EU fiscal rules, as outlined in the first edition of the Medium-term Structural Plans, can face additional challenges if growth is hampered by further trade restrictions. The starting fiscal positions vary significantly among countries. Some economies, like the Netherlands and Greece, are cautiously loosening their fiscal stance, while others, such as Italy, are making minimal efforts to return to fiscal discipline. Meanwhile, countries like France and Belgium, which face national political challenges, face a more complicated path ahead to meet fiscal targets. Across the Atlantic, the incoming US Treasury Secretary has pledged to reduce the government deficit to 3%, a goal that will be hard to achieve, given the pledge to cut taxes. We would expect relatively limited spending cuts concentrated on federal agencies and the removal of some procurement contracts. Given large fiscal imbalances and the stated goal to reduce the deficit, we do not expect all of the tax cut promises from the campaign trail to be delivered[1].

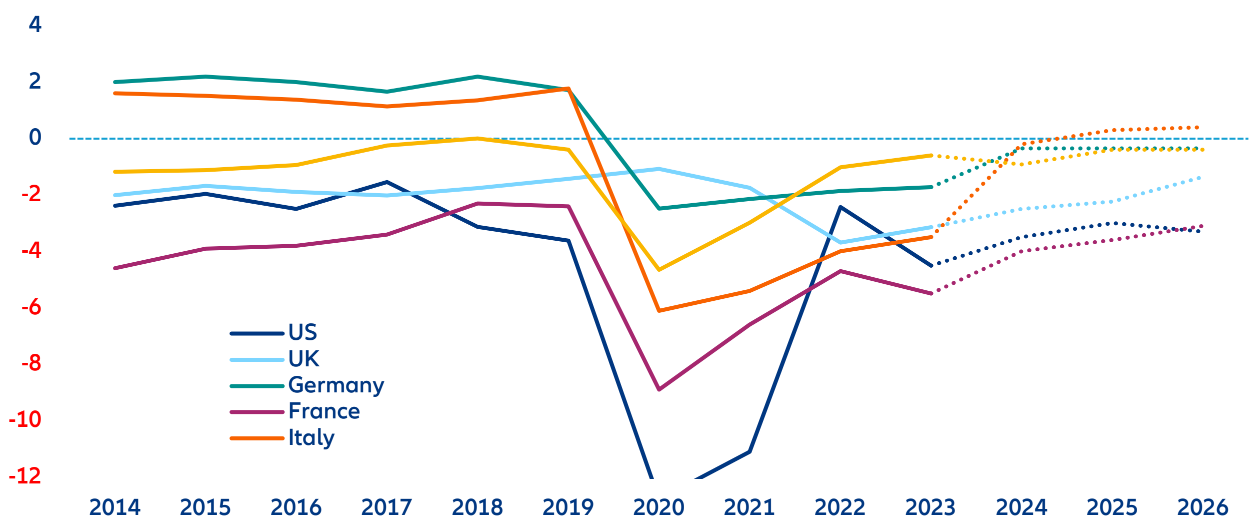
With the return of President Trump and a trade war looming, we now expect slower trade growth in 2025-2026. After a recession in value terms in 2023, global trade will see a moderate rebound in 2024, likely growing by +3.6% in volume terms (roughly matching the average pace over 2011-2019, Figure 3), helped by companies restocking and households renewing purchases of durable goods while reducing spending on services. The end of the year will also likely be supported by companies rushing to ship goods in anticipation of the higher tariffs likely to be imposed by the next US administration, and other potential disruptions in the coming quarters. This frontloading will likely remain a tailwind for global trade in the first half of 2025, before the effects of a renewed but contained trade war[2] are felt from the second half of 2025 and in full in 2026. As a result, we now expect global trade in volume to grow by +2.8% in 2025 (-0.2pp from our previous forecast) and +2.3% in 2026

1 In all, we expect around USD100bn of spending cuts per year, USD160bn of tax cuts delivered in 2026 (vs. USD285bn pledged), and the renewal of the 2017 TCJA.

2 In our baseline scenario, a contained trade war consists of US measures targeted at China (with tariffs increasing to 25% on goods without critical dependencies) and modest tariff hikes on the rest of the world (to 5%), excluding Canada and Mexico.

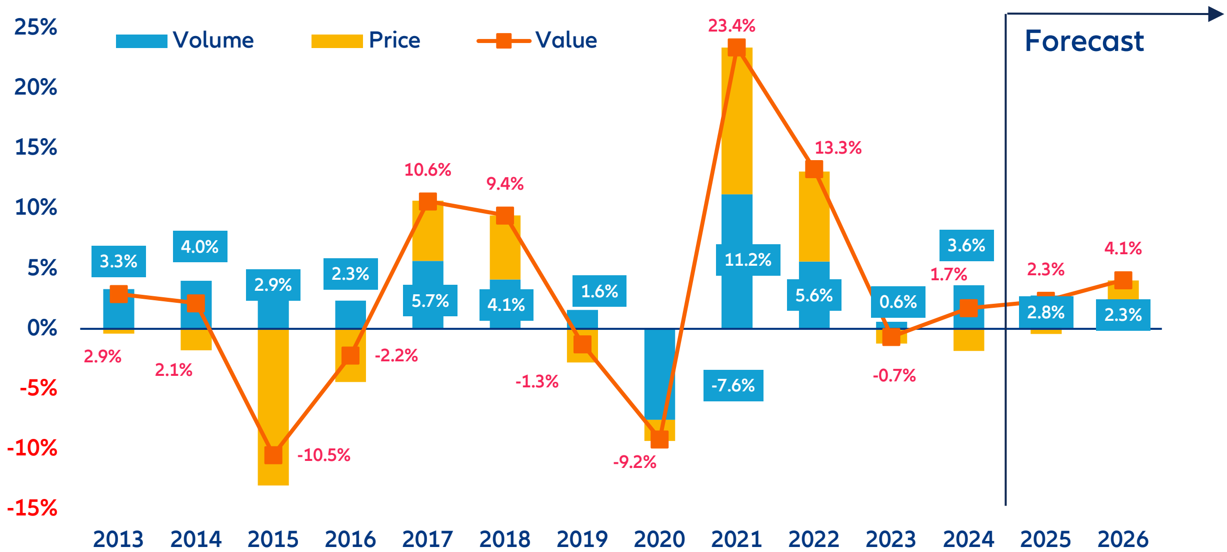
(-0.5pp from our previous forecast). In terms of export prices in USD terms, the deflationary environment observed since 2023 will likely continue into 2025 as exporters partly take on the impact of higher tariffs to maintain their market shares. As a result, in USD value terms, the downside revisions to our forecasts are even larger, with growth reaching +2.3% in 2025 (-1.7pp) and +4.1% in 2026 (-0.8pp).

Figure 2: Fiscal policy – government primary fiscal balance % of GDP



Sources: LSEG Datastream, Allianz Research

Figure 3: Global trade of goods and services, annual growth

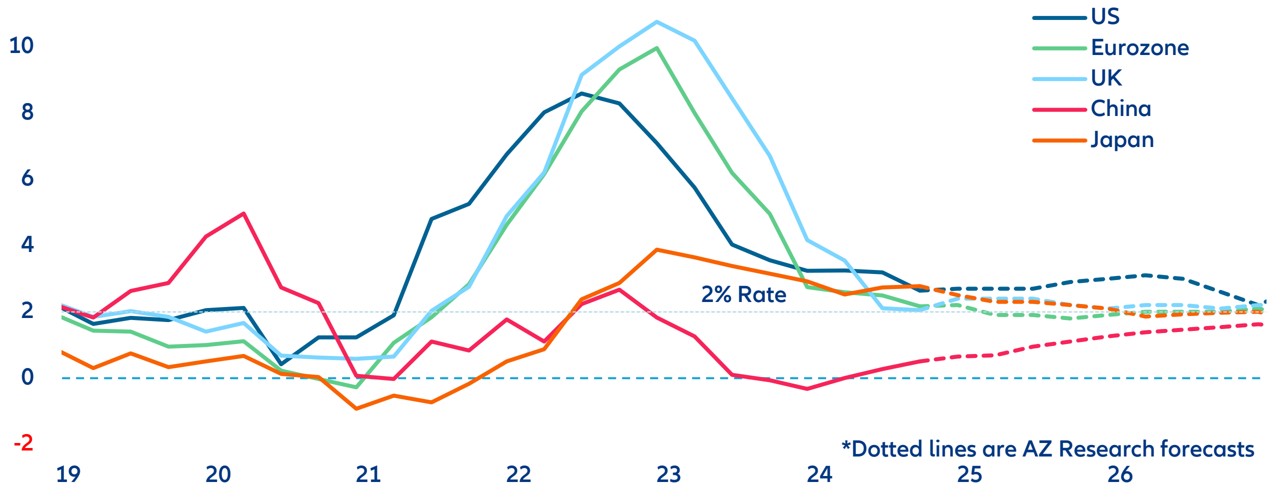


Sources: LSEG Refinitiv, Allianz Research

Inflation should finally retreat to 2% allowing monetary easing to continue

The trajectory of inflation is expected to differ between the US and other developed markets in 2025. In the US, underlying measures of inflation have remained sticky over the past six months or so. For instance, core CPI inflation trimmed mean inflation has steadied at around +3.2% y/y. We expect US inflation to continue to overshoot the Fed's 2% target over the next 18 months or so as the policies likely to be implemented by the Trump administration will push up prices. In an economy with little, if any, spare capacity, the combination of tariff hikes, very tight immigration policy, loose financial conditions and tax cuts (coming in 2026) should maintain inflationary pressures. We expect the US ''reflation'' policies will start to lose traction towards the second half of 2026 as prolonged tight monetary policy would push economic growth below potential. On the other hand, in developed European countries, we expect inflation to hover at or around the central banks' targets during 2025 as the combination of prolonged weak demand and the fading of past supply shocks takes an increasing toll on underling wage and price growth. Services inflation will remains elevated, but this would mostly reflect a catch up with past wage and cost pressures; we expect services inflation to moderate through 2025, but remain above the pre-Covid average. In all, we expect inflation to average +1.9% in 2025 in the Eurozone vs +2.8% in the US. In the UK, we expect inflation to remain a bit above the Bank of England (BoE)'s target (at +2.3%), supported by stronger public investment and still elevated, albeit easing, wage pressures.

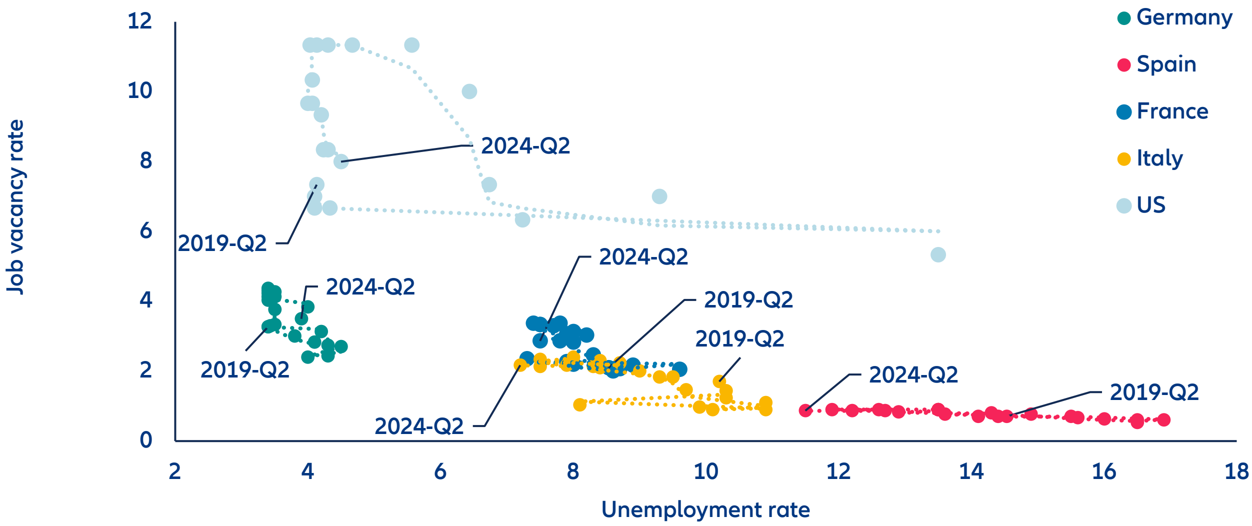
Figure 4: Quarterly inflation rates, y/y **%**



Sources: LSEG Datastream, Allianz Research

Global labor markets appear to be still in good shape – at least at first glance. In the Eurozone, unemployment reached historic lows, stabilizing around 6.3% in October 2024, while employment continued to grow, rising to 4.7% above end-2019 levels, and across countries and age groups. This resilience is partly due to the furlough scheme implemented during the pandemic crisis and then because of companies hoarding labor in anticipation of a favorable economic environment and a subsequent increase in demand, as well as benefiting from higher profits bolstered by inflation. However, this situation has also led to a decline in productivity. Now, there are early signs of cooling in the bloc's labor markets. Vacancy rates have begun to decline from the record highs achieved during the post-pandemic job-rich recovery, although they remain above end-2019 levels. Simultaneously, hiring intentions are softening, and labor is now viewed less as a limiting factor to production, after being reported as a major constraint for months. We expect unemployment to rise slightly to 6.5% in Europe in 2025 as the normalization of corporate profits, coupled with sustained wage growth, prompts firms to reconsider their cost efficiency.

Figure 5: Beveridge curves by country, %



Sources: LSEG Datastream, Allianz Research

Conversely, in the US, the unemployment rate has risen steadily since April 2023. Moreover, surveys suggest that it will continue to rise in the coming months. However, the pick-up of the unemployment rate is primarily driven by strong labor force growth rather than weakening job growth. Measures of labor market tightness as well as a low private layoff rate also indicate that the Fed should not be concerned by an increasing unemployment rate. Rather, persistent inflation and wage pressures suggest that the natural rate of unemployment (i.e. the rate that brings wage growth and inflation to their steady state) may be a bit higher than the Fed's estimate of 4.2%. In this context, we think the Fed will eventually have to accept a higher unemployment rate to tame inflation.

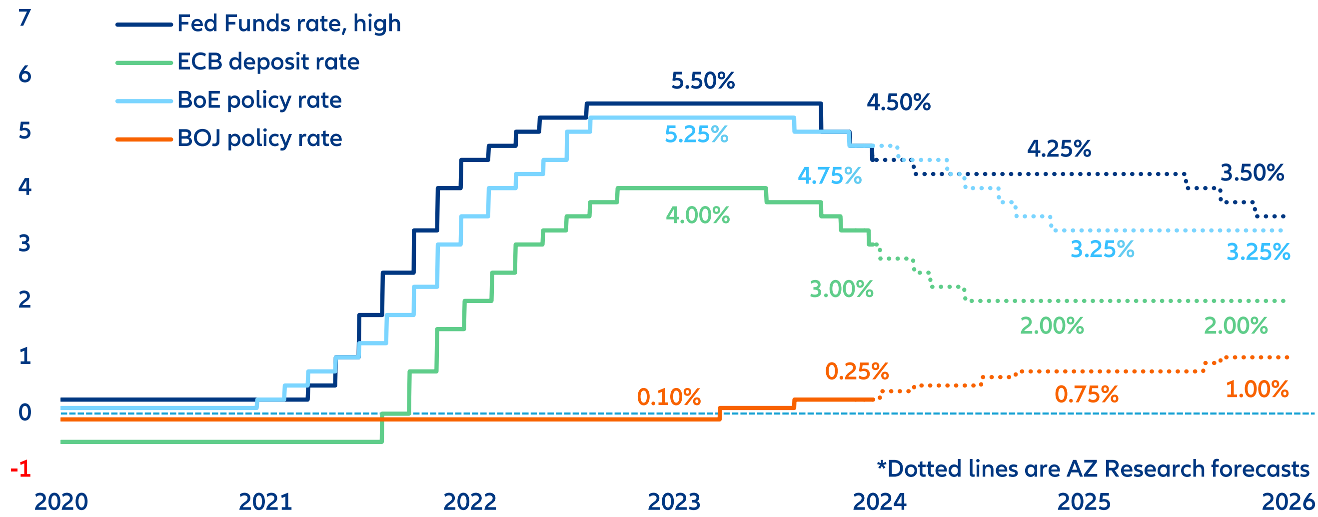
Sticky US inflation will prompt the Fed to become increasingly hawkish. Stalling progress on disinflation and the strength of the economy have already made some FOMC cool their heels on easing policy, with Chair Powel stating that the FOMC ''can afford to be a little more cautious'' on moving policy toward a neutral setting. While we expect the US economy to slow down through 2025, we still expect it to expand at a comfortable clip of +2.3% on average. Meanwhile, we expect inflation to remain above the Fed's target. We do see a further easing of the labor market in coming months, but with only a moderate increase in the unemployment rate. Indeed, slowing labor supply, induced by tight immigration policy, should put floor on unemployment. In this context, we see little scope for further easing of monetary policy in the next 18 months. We expect the Fed to pause in January 2025, to deliver a 25bps rate cut in March and to stop from there with still-tight monetary settings as inflation remains stubbornly above its target and the economy keeps growing at a healthy clip. Accordingly, the Fed funds rate would settle at 4.25% (upper bound) over the next 18 months or so. We see the Fed normalizing policy in the second half of 2026 by cutting interest rates down to our estimate of the neutral rate (3.5%) amid lower growth and cooling inflation.

Table 3: Inflation forecasts, yearly, %

Inflation (yearly %)	2022	2023	2024f	2025f	2026f
Global	**8.2**	**6.1**	**5.6**	**3.9**	**3.2**
USA	**8.0**	**4.1**	**2.9**	**2.8**	**2.7**
Latin America	**14.0**	**14.4**	**16.7**	**10.7**	**6.5**
Brazil	9.3	4.6	4.3	4.0	3.5
UK	**9.1**	**7.3**	**2.5**	**2.3**	**2.2**
Eurozone	**8.4**	**5.4**	**2.4**	**1.9**	**2.0**
Germany	6.9	5.9	2.2	2.1	2.0
France	5.2	4.9	2.0	1.6	1.8
Italy	8.2	5.6	1.0	1.7	2.0
Spain	8.4	3.5	2.7	2.1	1.9
Central and Eastern Europe	**9.1**	**11.0**	**3.9**	**4.4**	**3.4**
Poland	14.4	11.4	3.8	4.4	3.6
Russia	13.8	5.9	10.0	12.0	8.0
Türkiye	72.3	53.9	59.3	34.5	18.5
Asia-Pacific	**4.0**	**3.0**	**1.9**	**2.0**	**2.2**
China	2.0	0.2	0.4	1.0	1.5
Japan	2.5	3.3	2.5	2.2	1.9
India	6.7	5.7	4.9	4.3	4.4
Middle East	**13.9**	**10.7**	**12.5**	**11.4**	**7.2**
Saudi Arabia	2.5	2.3	1.7	2.3	2.1
Africa	**14.2**	**18.2**	**18.1**	**12.1**	**8.9**
South Africa	6.9	5.9	4.6	4.4	4.9

Sources: National, Allianz Research

Figure 6: Monetary policy key rates, %



Sources: LSEG Datastream, Allianz Research

The ECB has delivered four rate cuts this year and is expected to deliver another batch of four in 2025. After bringing the deposit rate down from the all-time high of 4% to 3% this year, we expect an ongoing meeting-by-meeting cutting cycle, with a terminal rate of 2% to be reached by June 2025. Given the economic headwinds and a faster-than-expected disinflation process, we share the view of ECB chief economist Philip Lane who indicated that the ECB should start looking at "upcoming risks" rather than past data. Indeed, the amount of risks has increased, including a looming trade war, the break-up of the German government and political woes in France. Risks for our forecast are therefore tilted to the downside. A full-fledged trade war derailing the global economy could foster more rate cuts. Moreover, the 2% terminal rate implies a real neutral rate around 0% – a historically high level for the Eurozone. Despite lower policy rates, we do not expect any change to the ongoing quantitative tightening (QT) process, which will accelerate in January 2025 to around EUR40bn per month as the entire PEPP portfolio holdings will passively run off the balance sheet. Despite widening government bond spreads in France, government bond yields have fallen recently, suggesting no urgency to support the long end of European yield curves anymore at this stage.

The Bank of England (BoE) is expected to maintain a hawkish bias until Q1 2025, before accelerating the pace of rate cuts. Despite a weak economy, the BoE has started to normalize its monetary settings at a cautious pace, uncomfortable with stubbornly sticky services inflation. With unfavorable energy price base effects coming into play in end 2024-early 2025, headline inflation is set to pick up again, which should keep the BoE hawkish. We expect a 25bps rate cut in February, but a pause in March. However, from Q2 2025, easing inflation and a still sluggish economy should prompt the BoE to deliver back-to-back rate cuts in each meeting from May, pushing the bank rate down to 3.25%. Admittedly, we see inflation remaining a bit above the BoE's target because of supply constraints in the face of increased public investment. Nevertheless, our view that GDP growth and inflation will undershoot expectations in 2025 means that we expect the BoE to increase its support to the economy.

The Bank of Japan (BoJ) will continue going against the curve but retain a cautious approach to normalizing its monetary policy. After ending negative interest rates in March this year and another hike in August that took global markets by surprise, the BoJ will likely take a more cautious approach going forward to prevent negative spillover effects. The policy rate is likely to stay put at 0.25% until the end of the year, before rising to 0.75% by the end of 2025, 1% by the end of 2026 and stabilizing thereafter. The pace and precise timing of rate hikes will be data-dependent, with a particular focus on the results of the annual spring wage negotiations (shunto) domestically, and foreign policies that may affect the weakness of the yen (e.g. Fed and US trade policy). In parallel, the BoJ will also steadily scale back its asset purchase programs. Overall, policy normalization will be gradual, with the BoJ probably favoring an accommodative stance, and Japanese interest rates remaining lower than in other major economies in the coming years.

Developed markets to slow down lead by the US economy

The US economy is expected to slow down but retain solid momentum. After two years of buoyant growth, the US economy is expected to slow down to +2.3% in 2025. The pick-up in household confidence in the wake of the elections and loose financial conditions should support a strong start of the year. Meanwhile, the economy will continue to benefit from the pro-investment policies rolled out during the Biden administration (CHIPS Act, IRA, IIJA); although the construction spending boom has plateaued, follow-up equipment investment for these factories is likely to accelerate. Other tailwinds for capex growth include growing investment in data centers and hardware equipment. Nevertheless, tight immigration policy and upcoming tariff hikes on imports – with foreign countries expected to retaliate on US exports – will provide some headwinds to US growth. Trade uncertainty will likely hurt corporate sentiment while higher tariffs will be passed on to some degree to consumer prices and corporates importing input costs. Tight immigration policy could increase labor shortages in some industries heavily reliant on foreign labor, such as farming, construction, food preparation and healthcare, and weigh on aggregate demand. In 2026, we expect the Trump administration to deliver new tax cuts, but the net fiscal boost to the economy should be modest as federal spending will be restrained. We forecast GDP to grow below potential in 2026 at +1.8%.

The Eurozone is expected to continue growing slightly above potential despite economic headwinds. The Eurozone economy grew by a solid +0.4% q/q in Q3 2024, up from +0.2% q/q in Q2. Domestic demand drove growth, with consumption and investment rising, while net exports declined after two strong quarters. Encouragingly, this marks the third consecutive quarter of clear growth following stagnation in 2023. Looking ahead, slightly above-potential growth is expected to persist, gradually closing the negative output gap. Growth will likely be supported by consumption, driven by rising real wages, and by long-overdue investment gains. Net exports should provide further momentum, though government consumption will remain a drag due to fiscal tightening. While higher US tariffs pose challenges, the downside risks should be offset by lower oil prices, stronger trade with non-US partners, and additional ECB rate cuts. A weaker euro will also help cushion the impact of tariffs on exports.

Following the collapse of the German coalition, snap elections are set for February 2025. After a period of high political fragmentation and uncertainty, Germany urgently needs greater stability and reduced uncertainty to restore its economic footing. However, the upcoming elections and the threat of a trade war with an increasingly protectionist US could halve the projected GDP growth in 2025 to just +0.4%. The German economy requires reorientation and while a CDU-led grand coalition is expected by mid-2025, it will face similar challenges as its predecessors (i.e., increased global fragmentation, protectionism that threatens its export driven model and competition – especially from China – along with increased energy costs and pressure on the manufacturing sector). The next German government must implement substantial structural reforms to improve economic prospects and tackle low productivity, employing a combined strategy of increased spending alongside competitiveness-focused reforms, although significant fiscal loosening seems unlikely even after the elections. To address pressing budget gaps and invest in the green transformation, infrastructure, and innovation, Germany needs a comprehensive Agenda 2030 that unites political and industrial stakeholders. Additionally, demographic reforms and tax changes are essential for boosting competitiveness. In an increasingly fragmented world, Germany needs to transform its export-oriented economic model, embracing more European solutions.

The French economy is expected to slow down in 2025 as political uncertainty takes its toll. On top of external headwinds such as weak German growth and the upcoming trade war, the French economy will have to contend with the lagged negative effect of political deadlock in 2025. Business and consumer surveys indicate that political uncertainty is already weighing on spending and investment decisions, especially for SMEs. On the positive side, looser monetary policy should provide some offsetting support to credit growth and somewhat ease interest expenses for corporates. But we do not expect to see a meaningful acceleration in private spending before H2-2025 at the earliest. Meanwhile, while fiscal policy will not be tightened as much as planned in the aftermath of the fall of the Barnier government, though it will nonetheless restrain aggregate demand. In all, we expect the French economy to slow down to +0.7% in 2025, before picking up pace to a moderate +1.2% in 2026.

Italy's growth takes a break, but in 2025 can be a bit better. Activity stagnated in Q3 2024, and Italy's recent economic resilience began to fade. Despite a surge in household consumption (+1.2% q/q), investment activity disappointed, declining by -1.2%, and net trade further dragged down growth. Along with the recent national accounts' revision, this has led to a downward revision of 2024 GDP growth, now expected to reach +0.5% before slightly accelerating to +0.8% in 2025. The fiscal efforts required to return fiscal "anchors" to target, requiring adjustments of 0.5% of GDP per year, are weighing by around 0.25pp on the economy. Given the significant goods export exposure to the US and Germany, at 11.9% and 10.7%, respectively, we expect only marginal improvement in net trade, and downside risks from further trade tariffs.

In Spain, growth momentum is expected to soften but will still, for the fifth consecutive year, outpace the Eurozone average. Spain's economic performance has been surprisingly strong. In Q3, GDP posted solid growth of +0.8% q/q. Tourism activity has rebounded following the Covid-19 pandemic, boosting economic activity, with tourist expenditure set to reach EUR120bn this year. On the other hand, investment and consumption have not performed as robustly, but lower interest rates and NGEU spending should improve the outlook for 2025-2026. The floods in the Valencia region are estimated to have a 0.2% negative impact on Q4 growth, although this is expected to be offset by government support. Overall, we anticipate activity to expand by +3.0% this year before slowing to +1.6% in 2025.

The UK economy is expected to pick up pace in 2025 after two years of dismal growth but risks are on the downside. The loosening of financial conditions has started to support a pick-up in credit (especially to corporates) and the early revival of the housing market. With the BoE continuing with rate cuts through 2025, private spending should be increasingly supported. Furthermore, public spending is set to increase sharply, notably on infrastructure and public services. Against this backdrop, planned tax hikes have hurt sentiment. The planned increase in National Insurance contributions will likely lead to a mix of lower corporate margins, lower wage growth and lower employment growth. Meanwhile, the external sector will continue to struggle as the US will likely impose tariff hikes. In this context, we forecast UK GDP to grow by a modest +1.3% in 2025 and +1.5% in 2026.

Japan: recovery ahead thanks to improving real wage growth and supportive fiscal policy. We expect Japan's GDP to contract by -0.3% in 2024 (after +1.7% in 2023), due to the high cost of living weighing on private consumption. But as wages are now rising faster than prices, as expectations of deflation fade and supported by recent stimulus measures, household spending will improve in 2025-2026 and underpin a broader economic recovery. Additionally, investment will be supported by the government's industrial policies to drive digitalization and clean-energy technology. The ruling coalition's low approval rating will limit the room for fiscal consolidation. Overall, we expect the Japanese economy to grow by +1.2% in 2025 and +1.1% in 2026.

Emerging markets: Resilient despite headwinds from a contained trade war

China: policy support will likely come through but will not prevent an economic slowdown in the coming years. China's policy stance clearly shifted since late-September: The PBOC delivered a super package of monetary easing, followed by fiscal measures that both provide short-term support and attempt to tackle the long-term sustainability of public finances. While markets were disappointed by the lack of direct measures in favor of consumers, we estimate that the fiscal stimulus is sufficient to allow China to reach its official growth target of "around 5%" in 2024 and boost 2025 growth by +0.4pp. Further policy support will also likely be delivered in coming quarters. Top leaders discussed the priorities for the economy in 2025 in mid-December, with a special focus on domestic demand. Larger room for maneuver for fiscal spending by the central and local governments may translate into favorable measures for households – although the scale may ultimately depend on how large the shock from higher US tariffs is. On the monetary side, we expect at least two policy rate cuts of -10bps each in 2025, and two cuts of -25bps each in the reserve requirement ratio. Overall, we expect China's GDP growth to reach +4.9% in 2024 (after +5.2% in 2023), +4.6% in 2025 and +4.2% in 2026.

Emerging markets (EMs): resilient growth in the context of spillovers from Donald Trump's re-election and the newly instated European Commission. Emerging markets as a whole will grow by +4.1% in 2025-2026 – and even slightly accelerate when excluding China. Many EM sovereigns are now better placed to cope with external pressures through strengthened balance sheets, solid capital inflows and resilient consumption, despite sticky inflation and prolonged regional and intra-state conflicts. Risks to the economic outlook relate to external trade (e.g. a full-fledged trade war for Mexico and Vietnam, political uncertainties in Germany for Central and Eastern Europe), commodity prices, geopolitical tensions and climate-related events. Funding fiscal deficits will remain an issue to monitor for EMs at large, while some countries will be dealing with reduced credit and corporate margins due to restrictive monetary policies (Brazil, Nigeria and Türkiye).

Table 4: Key drivers and challenges for emerging market economies

Emerging Asia, excluding China	· We expect the Asia-Pacific region to grow by +4.1% in 2024 (after +4.3% in 2023), followed by +4.1% in 2025 and +3.9% in 2026. South and Southeast Asia will continue to outperform, with India growing by +6.5% on average in 2025-2026 and ASEAN by +4.6%. Tailwinds include gains in global export market shares and cautiously easing domestic monetary conditions, but fiscal policy will not be supportive in some economies. · Inflation fell back to or below central bank targets in most of the region and is likely to remain moderate. We forecast inflation for Emerging Asia (excluding China) overall at 4.0% in 2024 (after 5.5% in 2023), 3.6% in 2025 and 3.5% in 2026. · Domestic conditions provide grounds for monetary easing in most of Emerging Asia, but central banks will have to be wary about the Fed policy and contain depreciation pressures on local currencies. The rate-cutting cycle has already started for some (e.g. the Philippines, Indonesia and Thailand) and will likely start soon for others (e.g. India), while a few exceptions are likely to stay on hold in the coming quarters (e.g. Malaysia and Vietnam). · The main geopolitical risks in the region are around the Taiwan Strait and the South China Sea. Economies also need to affirm themselves amidst the US-China rivalry.
Emerging Europe	· Regional growth is forecasted at just +2.1% in 2024 and around +3.0% in both 2025 and 2026. Economic activity is gradually recovering in CEE, driven mainly by domestic demand and fiscal stimulus. · Inflation is forecast to remain above central bank targets in most economies until end-2025, due to fiscal stimulus and strong wage growth. This will keep the regional average at around 3.9% in 2024, 4.4% in 2025 and 3.4% in 2026. · This combination of labor market tightness, rising wages and accelerating inflation limits the central bank's scope to ease monetary policy. The interplay between these factors poses significant risks to economic stability and growth prospects. Policy rates are thus expected to remain above pre-pandemic levels. Fiscal policy is forecast to remain loose, putting public finances at risk in the medium term. · Growth in Russia is set to slow amid spiraling inflation and further credit limitations. In Türkiye, inflation will remain well into double digits until 2026 highlighting the challenges posed by real salary growth on corporate margins at a time when the inflow of migrants, particularly from Syria, may stop or even reverse.
Latin America	· Latin America continues to surprise with slight upward revisions to economic growth, starting with Brazil, which will also hover around +3% in 2024, with consumption and investment on the rise. · However, some of this growth will fall on the shoulders of governments, which are struggling to reduce public spending or increase revenues, especially in Central America. The Caribbean and Mexico will be affected by the new US administration, both in terms of return migration and manufacturing exports. · The impact of increased trade tensions will be felt most in these areas, while it should be relatively muted for the extractive sectors, which tend to be more diversified and ready to serve a variety of markets, including China (already an important trading partner for several countries, including Peru) and the EU, with the Mercosur accession process seemingly on a promising trajectory.
Africa and the Middle East	· In 2025, growth is forecasted at +3.4% in Africa and +3.0% in the Middle East, higher than the respective +2.8% and +2.1% in 2024. Greater access to financing and lower oil prices are supporting higher growth for non-oil exporters. Meanwhile, growth for oil exporters in Africa and the Middle East has been revised down given the lower oil prices forecasted with Trump in the White House. · Inflation has remained elevated in Africa during 2024 at 18.1%, yet it is expected to fall to 12.1% in 2025, even though price pressures will continue in some sizable economies such as Angola, Ethiopia and Nigeria. In the Middle East, inflation will continue to stabilize at 1.9% in 2025, a slight decline from 2.1% in 2024. · Central banks in the region are aligning with major global economies in terms of monetary easing. Gulf economies have followed the Fed's lead, reducing rates. Selected African and non-GCC economies have also begun easing, although many remain cautious, especially those worst hit by the price inflation. · Ongoing conflicts in the Levant and the horn of Africa continue to pose significant threat to stability. A wider regional conflict in the Middle East has so far been avoided, but tension points in Gaza, Lebanon, Yemen and most recently in Syria remain and could eventually escalate.

Source: Allianz Research

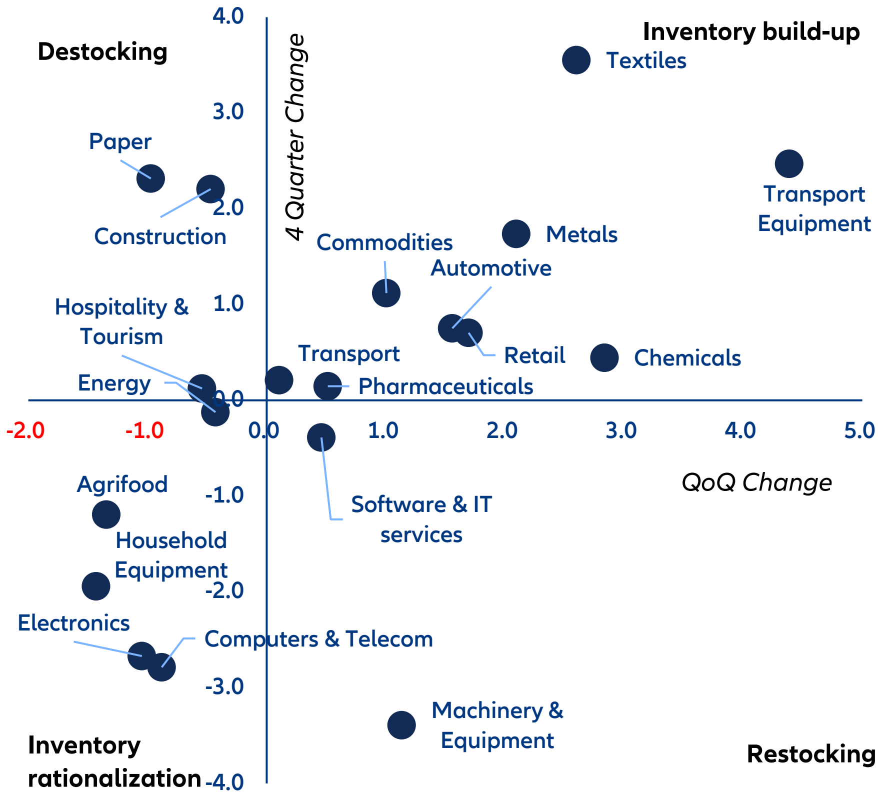
Corporates are navigating uncertainty and continue to rebalance inventories

Corporate earnings remained solid, but Europe is still the ugly duckling. Throughout 2024, corporate earnings have been largely resilient despite the multiple economic and political challenges. In the last 12 months, global earnings per share have increased by +4.6%, albeit unevenly across different regions. North America has been the strongest region (+6.1%), boosted by the technology, financial and healthcare sectors. APAC also registered solid growth of +6.0%, particularly boosted by Japanese corporations, which have seen strong earnings in sectors like electronics and machinery. Companies in Western Europe (+2.4%) continue to lag as consumer demand stays sluggish, and raw material and energy prices are still high, while supply-chain issues and regulatory changes, and higher employee bargaining power over wages, remain a challenge for labor-intensive sectors. In 2025, we expect earnings to flourish more, with growth being driven by technology (AI, cloud computing and semiconductors), healthcare, and renewables, while sectors like consumer discretionary, industrials and oil & gas may continue to face challenges due to inflation, regulatory pressures and global economic headwinds. The regional divide will remain pronounced, with North America and APAC likely outperforming Europe, where earnings growth should range between +2%-3%.

Restocking and front-loading of tariffs to fuel inventories rebalancing. Following Covid-19 and the war in Ukraine, many corporates went on a shopping spree and piled up large inventories. This was both a hedge against supply-chain disruptions and rising prices and also a way to make sure to be well positioned to benefit from strong demand. However, with demand fading amid a purchasing power crisis, many companies deployed destocking strategies for most of 2024, especially consumer goods sectors such as computers, appliances, or electronics (see Figure 7). Over Q3 2024, we observed that at the global level days inventories remained stable, but nine out of 21 sectors were still reducing inventories. On the other end of the spectrum, sectors like textiles, metals and auto are experiencing inventory build-up amid sluggish demand. Going forward, we still expect demand to recover for some sectors, especially for durables, which will fuel restocking. Furthermore, geopolitical risks will continue to have an effect, and we expect corporates in industries such as computers, semiconductors, metals and pharma to increase inventories ahead of incoming US tariffs that are likely to disrupt global trade flows. Also, inventory levels may still be somewhat elevated in 2025, especially in sectors like automotive and machinery, amid high uncertainty weighing on both consumer and corporate spending.

Incoming fiscal consolidation is likely to pressure corporate revenues and profits. Reduced government spending can have significant direct and indirect implications for corporates. Government spending is critical for growth through infrastructure projects, subsidies, defense contracts, public services, welfare payments and other forms of expenditure. When such spending is curtailed, companies that rely on government contracts or benefit from related economic multipliers often experience immediate revenue declines, leading to lower profit margins. Directly, companies in industries such as defense, construction, healthcare and technology are particularly vulnerable. Indirectly, reduced government spending affects corporate profits through its impact on overall demand. A reduction in spending often leads to slower economic growth, diminishing consumer confidence and reducing household spending power (through higher taxes or lower redistribution). This decrease in consumer demand affects companies in consumer goods, retail, and services, forcing businesses to contend with lower sales volumes and pressured margins. Furthermore, the multiplier effect of government spending amplifies its impact on the private sector. Our analysis suggests that there is a 50% correlation between corporate profit growth and government spending growth in the previous year for the US and Italy. This correlation is lower for France and Germany while it seems that corporate earnings are uncorrelated to government spending in the UK.

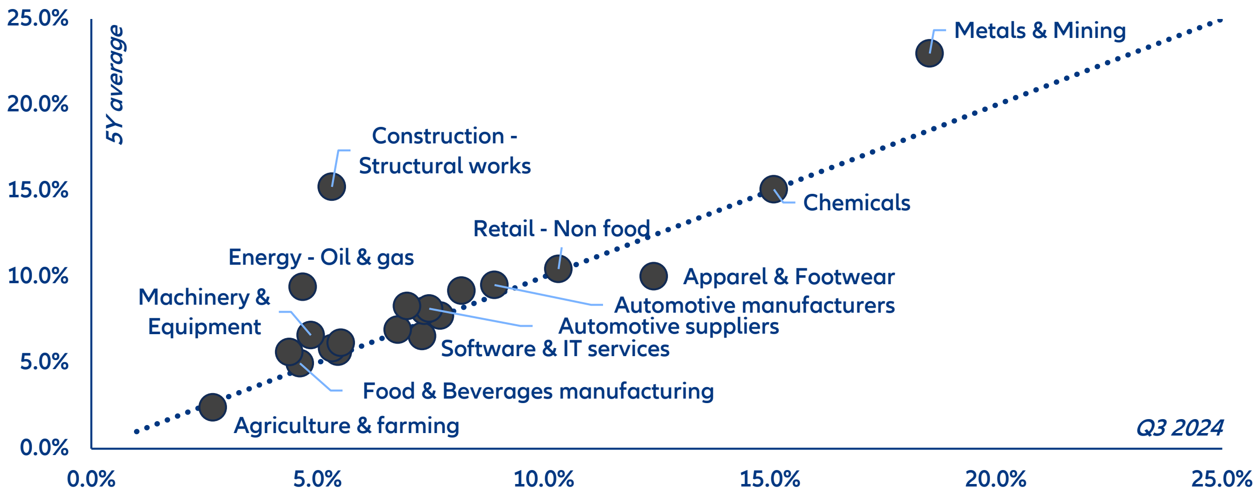
Figure 7: Days inventories for global sectors (latest quarter change vs four quarters cumulative change)



Sources:LSEG Workspace, Allianz Research

Reduction in short-term debt points to strong liquidity and debt rebalancing. As interest rates have started to decline, conventional wisdom might suggest that firms would capitalize on lower borrowing costs and increase their use of short-term debt. However, we notice that corporates in most sectors have reduced their reliance on short-term debt (see Figure 8). Firstly, declining interest rates are coinciding with broader economic challenges. In this context, deleveraging might suggest that firms may anticipate weaker demand or revenue declines in the near term, prompting them to focus on preserving liquidity and strengthening their balance sheets. Second, corporates can also reduce their reliance on short-term debt when their liquidity positions are strong – which is the case in many sectors. Lastly, firms can take the opportunity of declining rates to rebalance their debt. We highlighted in 2023 and earlier this year that corporates have been decreasing their long-term debt to increase short-term obligations. By doing so, they were able to keep interest expenses in check in a higher interest rate environment. Now that interest rates are declining, they are presented with an opportunity to shift their debt profiles back toward longer-term obligations. The shift from short-term to long-term debt enhances financial stability and aligns debt maturities with investment lifespans.

Figure 8: Short-term debt to assets (Q3 2024 vs 5Y average)



Sources:LSEG Datastream, Allianz Research

Business insolvencies are likely to reach a prolonged high level in most countries. The most recent dynamics mainly confirm the continuation of the upside trend in business insolvencies in 2024 in most countries. We expect another acceleration globally for the full year, with four out of five countries experiencing increases, in particular Australia, Singapore, Canada and Brazil. Business insolvencies are above their pre-pandemic number (compared to 2016-2019 average) in two out of three countries, up from half in 2023, notably in the most advanced economies of Western Europe, as well as America (Canada) and Asia (Japan, Australia, South Korea, Singapore). Interestingly, large firms have not been immune to rising business insolvencies. With more than one bankruptcy a day, 2024 is set to be a record-high year for insolvencies of companies with over EUR50mn in turnover. In 2025, we expect our Global Insolvency Index to reach a stable level after three consecutive years on the rise (+1%, +7% and +9% in 2022, 2023 and 2024, respectively). However, this stabilization would result from more uneven regional and national trends than in 2024: only three out of 10 countries should see business insolvencies increase, but this will include a mix of large and smaller economies, accounting for more than half of global GDP. European countries would see the largest decreases, but most often from a strong bounce-back over 2021-2024 and/or from a historic high. We have adjusted our central scenario to factor in the US elections and the weaker outlook amid the trade war and uncertainties in Europe, including the spillovers of German and French (political) uncertainties on other countries. In the US, we now expect business insolvencies to rise by +4 in 2025 before accelerating by +6% in 2026. In Germany, they will increase by +5% before falling by -4% in 2026. In France, they will slightly moderate from very high levels (-3% in 2025 and -7% in 2026) while in Italy they will continue to rise (+6% and +1% respectively). The UK should confirm the trend reversal started end of 2024 (-5% both in 2025 and 2026).

Capital markets outlook: Investing with optimism and vigilance

The tightrope ahead: investing with optimism and vigilance. At the close of 2024, valuations in risky assets are reflecting a year of strong performance, while sovereign government bond yields slightly increased over the course of the year as policy rates have been kept higher for longer after all, as neither hard-landing risks nor soft-landing risks have materialized. However, geopolitical risks, such as trade tensions and regional conflicts, will continue to keep investors cautious. In credit markets, strong corporate fundamentals and robust investor demand have continuously created a favorable environment, yet ultra-tight spreads continue to highlight the vulnerability to economic or policy shocks. At the same time, equity markets have soared on optimism fueled by AI advancements and resilient corporate earnings, though elevated valuations and sector concentration risk have continued to raise concerns about sustainability. These 2024 dynamics reveal a delicate balance between optimism for growth and the realities of geopolitical and economic risks.

Looking ahead to 2025 and 2026, sovereign, credit and equity markets will face a dynamic landscape defined by evolving macroeconomic trends and geopolitical challenges. Central bank policies will remain pivotal, with the potential for divergent approaches as inflationary pressures persist in some regions while others seek to stimulate growth. Trade tensions and shifting alliances, particularly in the wake of Trump administration policies, could create headwinds, affecting global capital flows and investor confidence. Geopolitical risks, including ongoing conflicts and their potential resolutions, will continue to be a critical factor influencing market stability. Tailwinds such as technological innovation, fiscal stimulus measures and the gradual recovery of global supply chains will continue to offer opportunities for growth. However, elevated valuations across asset classes pose a challenge, leaving limited room for missteps in policy or economic management. In this environment, investor focus is expected to shift toward quality, with increased scrutiny of macro indicators like inflation trends, monetary tightening and the resilience of key economies. The balance between optimism about growth and caution over geopolitical and economic shocks will define the strategies for navigating these markets, emphasizing the importance of adaptability and diversification in investment approaches (Table 5).

Government bond yields are set for a soft decline in 2025. Neither hard-landing nor soft-landing scenarios materialized this year, leaving markets recalibrating central bank expectations. At the start of 2024, markets anticipated 160bps of rate cuts each from the ECB and the Fed. Instead, they delivered just 100bps each, pushing 10-year yields higher than initially forecast. Today, market expectations for rate cuts align more closely with our projections, suggesting that current 10-year yields are near fair value. Any declines in yields going forward are likely to be marginal as falling inflation expectations and policy rate reductions are counterbalanced by persistent supply and demand imbalances. On the supply side, large fiscal deficits in the US continue to counterbalance any downward pressure on Treasury yields. In Europe, accelerated quantitative tightening by the ECB has a similar effect on German bund yields.

Table 5: Capital market forecasts

EMU	Last*	Unit	2022	2023	2024f	2025f	2026f
Government Debt							
ECB deposit rate	3.00	%	2.00	4.00	3.00	2.00	2.00
10y yield (Bunds)	2.24	%	2.56	2.03	2.20	2.00	2.00
10y EUR swap rate	2.23	%	3.14	2.48	2.20	2.10	2.10
20y EUR swap rate	2.23	%	2.87	2.51	2.20	2.20	2.20
Italy 10y sovereign spread	116	bps	213	168	120	100	90
France 10y sovereign spread	81	bps	55	53	80	80	70
Spain 10y sovereign spread	70	bps	109	97	70	60	50
Corporate Debt							
Investment grade credit spreads	98	bps	166	135	105	105	100
High-yield credit spreads	303	bps	494	395	310	330	330
Equity							
Eurostoxx (total return p.a.)	11 ytd	%	-12	19	11	8	8

US	Last*	Unit	2022	2023	2024f	2025f	2026f
Government Debt							
Fed Funds rate (high)	4.50	%	4.50	5.50	4.50	4.25	3.50
10y yield (Treasuries)	4.50	%	3.83	3.87	4.40	4.10	4.00
Corporate Debt							
Investment grade credit spreads	79	bps	138	104	85	80	80
High-yield credit spreads	273	bps	479	334	280	300	300
Equity							
S&P 500 (total return p.a.)	25 ytd	%	-18	26	26	13	10

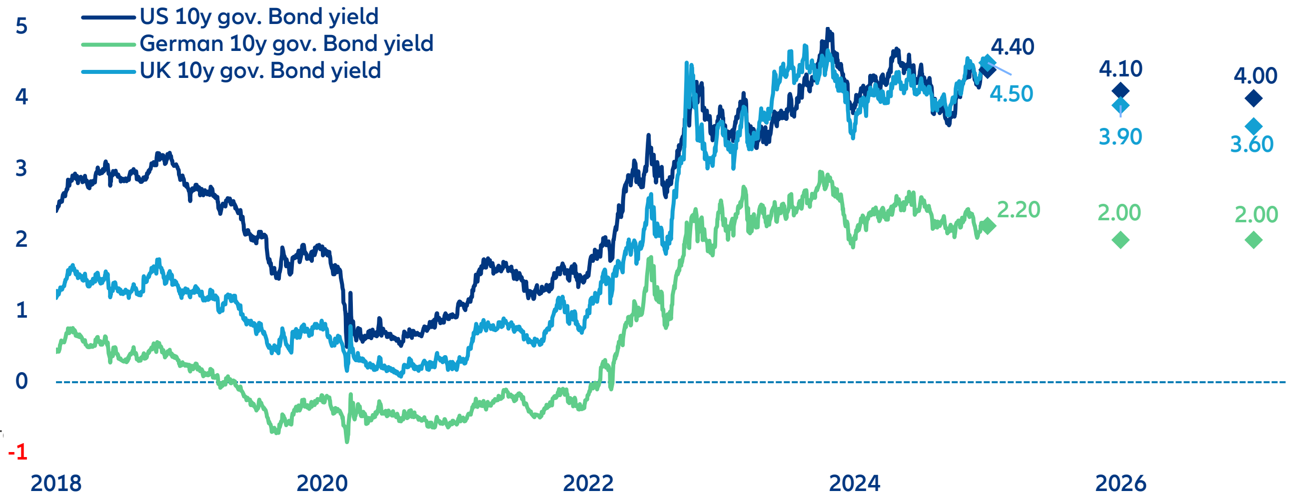
UK	Last*	Unit	2022	2023	2024f	2025f	2026f
Government Debt							
BoE rate	4.75	%	3.50	5.25	4.75	3.25	3.25
10y yield sovereign (Gilt)	4.56	%	3.67	3.54	4.50	3.90	3.60
Corporate Debt							
Investment grade credit spreads	91	bps	192	134	95	95	90
High-yield credit spreads	337	bps	663	515	350	370	370
Equity							
FTSE 100 (total return p.a.)	10 ytd	%	5	8	10	8	7

Emerging Markets	Last*	Unit	2022	2023	2024f	2025f	2026f
Government Debt							
Hard currency spread (vs USD)	198	bps	273	215	210	220	205
Local currency yield	6.10	%	6.86	6.19	6.3	6.0	5.8
Equity							
MSCI EM (total return p.a. in USD)	10 ytd	%	-20	10	10	7	8

Others	Last*		2022	2023	2024f	2025f	2026f
EUR USD	1.05	$ per €	1.07	1.10	1.05	1.05	1.08
Oil (Brent)	75	$ per bl	83	78	75	78	75
Natural gas (Dutch TTF)	41	€ per MWh	76	32	38	37	34

Sources: LSEG Datastream, Allianz Research
Notes: Year end figures
* As of 18.Dec 2024

Figure 9: 10y government bond yield forecasts, %

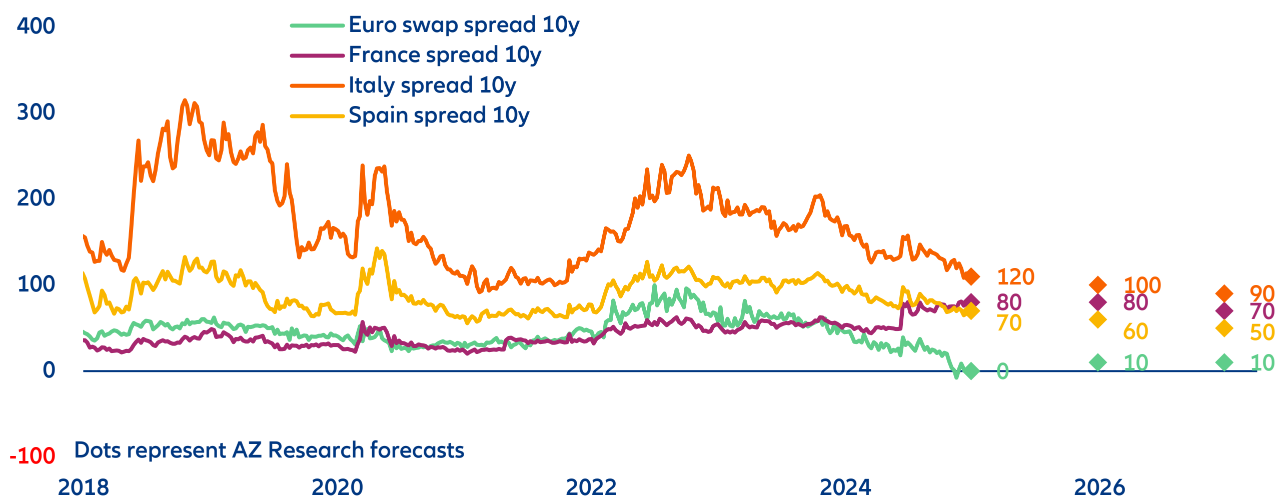


Sources:LSEG Workspace, Allianz Research

Yield curves to steepen, but slopes to remain historically flat. As monetary policy normalization progresses, yield curves are expected to steepen but remain relatively flat by historical standards. While yield curves returned to a positive slope in 2024, they are still far less steep than those seen during the 2010s. This reflects a fundamentally different economic and monetary policy setup. Unlike the prior decade, where policy rates fell to expansionary crisis levels near the lower bound, rates are now expected to stabilize at neutral levels. This shift creates a more balanced dynamic between the short and long ends of the curve, limiting the steepness of the slope.

European government bond spreads to narrow, but France will remain above Spain. Across the Eurozone, 10-year government bond spreads over Germany have narrowed this year, with one notable exception: France. Snap elections in the summer resulted in a parliamentary deadlock, complicating government formation and delaying critical reforms. Of particular concern to investors is France's high fiscal deficit, which, given the political gridlock, is unlikely to shrink significantly. The increased deficit has driven up French government bond supply, pushing spreads to around 80bps. In contrast, southern European countries have performed well. Narrow or positive primary deficits, combined with solid growth – particularly in Spain – have improved debt-to-GDP metrics and outlooks, supporting tighter spreads. Looking ahead, we expect European spreads to narrow slightly further, but French spreads are likely to remain higher than those of Spain.

Figure 10: Eurozone government bond spreads, bps

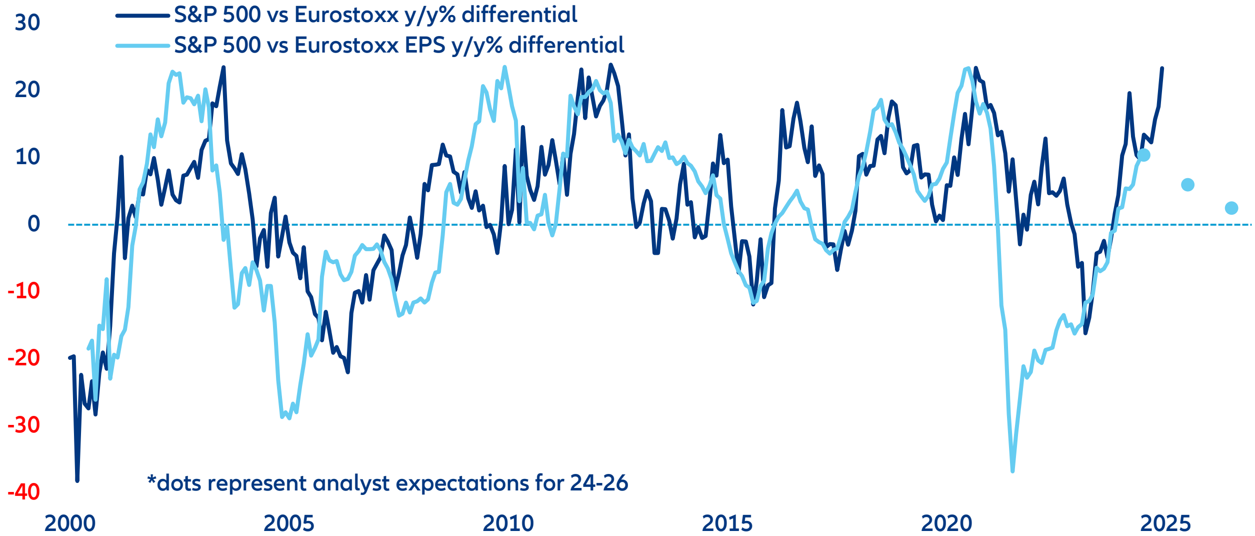


Sources: LSEG Datastream, Allianz Research

The euro has lost ground but is expected to remain above parity with the dollar. The election of Donald Trump has further widened the gap in central bank expectations. For the Fed, markets are now pricing in a higher terminal rate compared to the beginning of the year, while for the ECB it is lower. Meanwhile, economic dynamism also favors the US, while Europe continues to struggle. This rising cross-Atlantic disparity has depreciated the euro against the dollar by -5% this year. With policy rate expectations largely aligned with our view, we believe EUR/USD will hover around the current 1.05 level for the next year or so before the euro will slightly appreciate again given renewed monetary easing in 2026 by the Fed. Additionally, the rising nominal rate divergence between central banks is somewhat offset by higher inflation expectations in the US compared to Europe. Overall, the real interest rate delta between the US and Europe – both for policy rates and long-term rates – is somewhat weaker than the nominal difference suggests.

Bull runs and crossroads: equity markets in transition. In 2024, equity markets have experienced robust growth driven by optimism surrounding economic resilience, declining inflation and prospects of central bank easing. In this context, global equities have risen +20% year-to-date, supported by accommodative monetary policies and strong corporate fundamentals. In the US, equities have marked one of their strongest performances since 1928, buoyed by earnings growth and valuation expansion, particularly in tech and AI-related sectors. However, concerns about high valuations, which are steadily approaching the late 1990s tech bubble mark, and elevated market concentration continue to underscore market vulnerabilities. European markets, meanwhile, have continued to face a more subdued environment, grappling with geopolitical risks, tariff pressures and muted earnings growth. This divergence between the US and Europe continues to persist as the former enjoys sustained inflows and robust corporate buybacks, while the latter continues to struggle with structural headwinds (Figure 11).

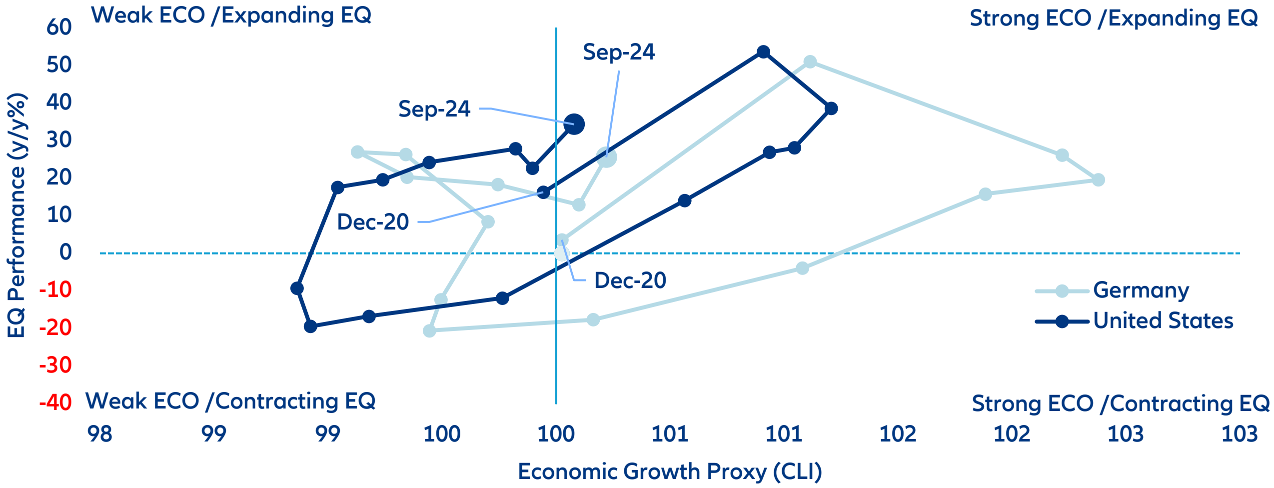
Figure 11: US vs EUR equities



Sources: LSEG Datastream, OECD, Allianz Research

Looking ahead, 2025 and 2026 will see key themes shaping equity markets. In the US, equities are expected to sustain growth but a much lower level, with the S&P 500 projected to reach 6,500 by the end of 2025, driven by steady earnings increases and robust buyback activity and 7,000 by the end of 2026. However, valuation constraints and potential inflationary pressures could temper returns moving forward, and it is key to remember that three consecutive years of above +20% returns is an extremely rare occurrence, especially in a mid-to-late cycle stage (Figure 12). Moving down in size, a case can be made for US mid- and small-caps as these companies are expected to benefit from robust domestic momentum, lower taxes and capital investments outside the tech sector, with potential upside from reshoring and infrastructure initiatives. However, elevated funding costs and tighter liquidity conditions may constrain performance for weaker players. Moving across the Atlantic, European equities are likely to perform albeit at a lower level than their US counterparts as the economic recovery proves more challenging than for the US. In this scenario, we expect defensive sectors to outperform. Taking all this into account, and given the fairly cheaper valuations, we expect the European earnings recovery to send the Eurostoxx towards the 540 mark in 2025 and 570 in 2026, posting an average +8% total return per annum.

Figure 12: Economic-equity performance clock



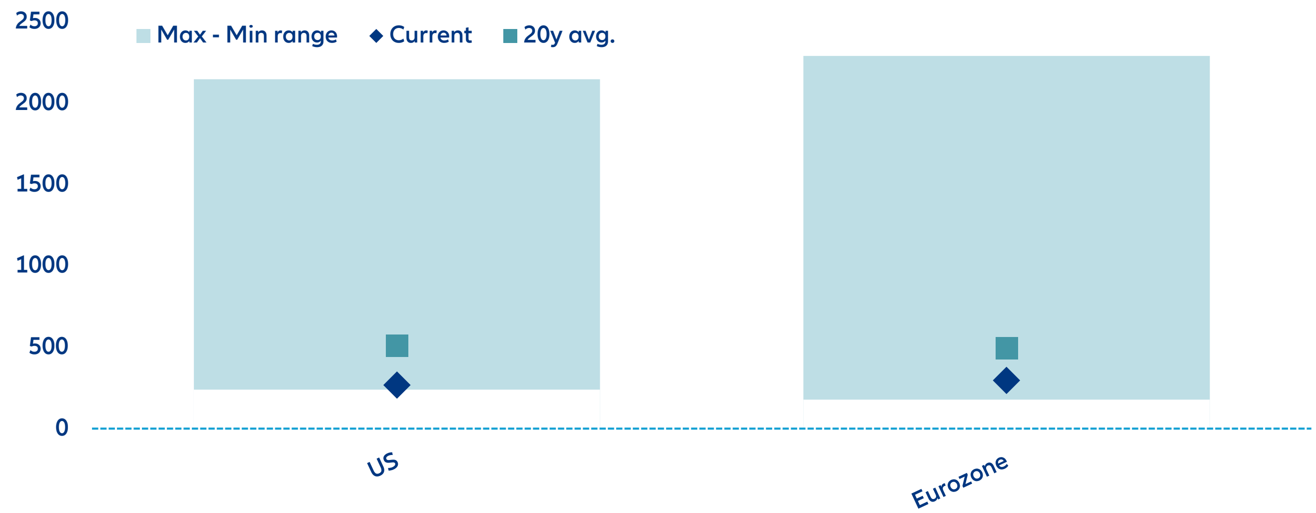
Sources: LSEG Datastream, OECD, Allianz Research

Credit markets in focus: resilience amid tight valuations. In 2024, corporate credit markets have exhibited resilience despite significant valuation constraints, with investment grade (IG) and high-yield (HY) spreads at historic lows, reflecting strong fundamentals and high investor demand. US credit markets have been supported by robust economic growth, easing financial conditions and declining delinquencies, while European credit has benefited from record inflows and subdued net supply. However, tight valuations continue to rise concerns about future performance, particularly as global growth faces headwinds from geopolitical tensions, potential tariff escalations and structurally more restrictive monetary policies in the long run (Figure 13).

Looking ahead to 2025 and 2026, the credit landscape is expected to be shaped by macroeconomic and technical factors. In the US, IG spreads are projected to reach 80bps and HY spreads 300bps by the end of 2025 and remain stable in 2026, driven by rising issuance, fundamentals resilience, strong demand and attractive risk-adjusted return. European credit, while starting 2025 at cheaper valuations compared to the US, will continue to face structural vulnerabilities tied to geopolitical uncertainty and tariff risks but could benefit from easing ECB policies and potential fiscal expansion. With this in mind, we see EUR IG stabilizing at around 100bps for the next two years and the HY spread landing around the 330 mark.

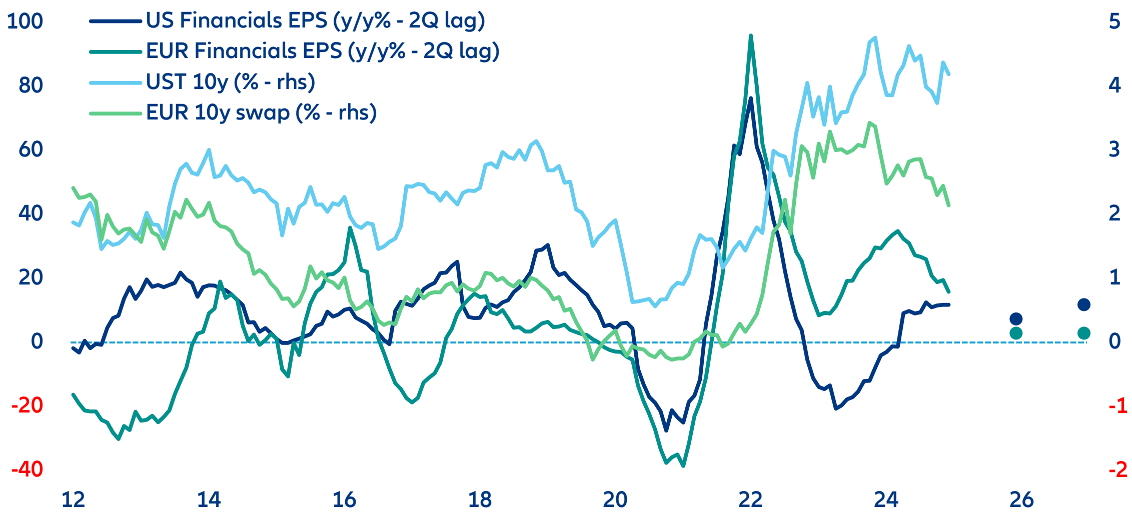
The credit market is expected to continue showing resilience, thanks to the high concentration of financials and defensive sectors, which are likely to act as buffers against economic and market uncertainty. The financial sector in particular stands to benefit from higher interest rates that support net interest margins, along with strong fundamentals and robust capital positions that enhance credit quality. This adaptability to changing macroeconomic conditions adds further stability, maintaining investor confidence and keeping credit spreads relatively steady. However, pricey valuations leave little room for further spread compression, increasing the likelihood of spreads widening. This places greater importance on resilient fundamentals to counteract these pressures (Figure 14).

Figure 13: High-yield credit spreads 25-year ranges, bps



Sources: LSEG Datastream, Allianz Research

Figure 14: Financial sector growth expectations



Sources: LSEG Datastream, OECD, Allianz Research

Cyclical challenges for EM assets to persist in 2025. EM assets experienced a dramatic turnaround in the recent quarter, from a favorable recovery trajectory – supported by the start of the Fed easing cycle – to renewed pressure following Trump's re-election. We expect the "Trump trade", characterized by expectations of a stronger USD and a higher-for-longer US rate environment, to extend into 2025. In this context, EM assets have emerged as clear "losers", grappling with a triple challenge: currency depreciation, constraints on monetary policy easing and potential trade disruptions. EM economies have seen a sharp decline of portfolio flows in October, and we expect persistent pressure in 2025 as the relative attractiveness of riskier EM assets continued to be undermined by high-yielding US assets and the risk-off sentiment amid rising uncertainties. Against the backdrop of narrowing rate differentials and potential higher tariffs, EM currencies are expected to face persistent depreciation pressures, which have dragged down EM equity total returns by -30% and turned local currency debt returns slightly negative for USD investors this year.

Nevertheless, we expect resilient performance, given improving fundamentals of EM economies. Despite significant challenges during the last hiking cycle, EM assets have delivered robust performance relative to DM assets. The unprecedented earlier move of LatAM and CEE central banks in this round of the easing cycle has showcased a marked improvement in EM policy frameworks, a structural change we expect to persist. Additionally, we see credit quality improving across EM regions in terms of current account and fiscal balances. The evolving composition of EM indices – particularly the growing share of higher-quality issuers from the Middle East – is also enhancing the overall credit quality of hard currency debt indices, a large driver of tightening hard currency spreads despite the challenging macro backdrop. Moreover, with only a few economies still battling sticky inflation, most EM economies are now in easing cycles and the focuses are shifted towards growth as inflation remains broadly on track toward central banks' targets, providing a supportive environment for economic growth.

Stay mindful of idiosyncratic risks in major EM economies and acute market stress. In China, a key driver of EM equity and local currency debt performance, the delivery and effectiveness of the country's stimulus programs will be pivotal. While there are hopes that these measures could lift equity markets, upside potential remains limited due to weak fundamentals that require time to recover. Persistent headwinds, particularly the potential escalation of trade tensions with the US, pose additional risks and could significantly affect other EM economies with close trade ties to China. Brazil's fiscal challenges, which have a notable impact on the broader LatAm region and the local currency debt performance, and the ongoing political tensions in the Middle East, also remain critical areas of concern. These dynamics could exacerbate regional instability and weigh on investor sentiment. Moreover, we expect a fatter tail amid rising political uncertainties, where acute market stress could trigger sharp fund outflows and significant corrections in EM asset prices. Against this backdrop, we stay cautiously optimistic on EM assets. We expect total returns for EM equities at +7% in 2025 and +8% in 2026, EM hard currency debt spreads to widen to 220bps in 2025 before tightening to 205bps in 2026 and local currency yields to continue their downward trajectory to 6% in 2025 and 5.8% in 2026.

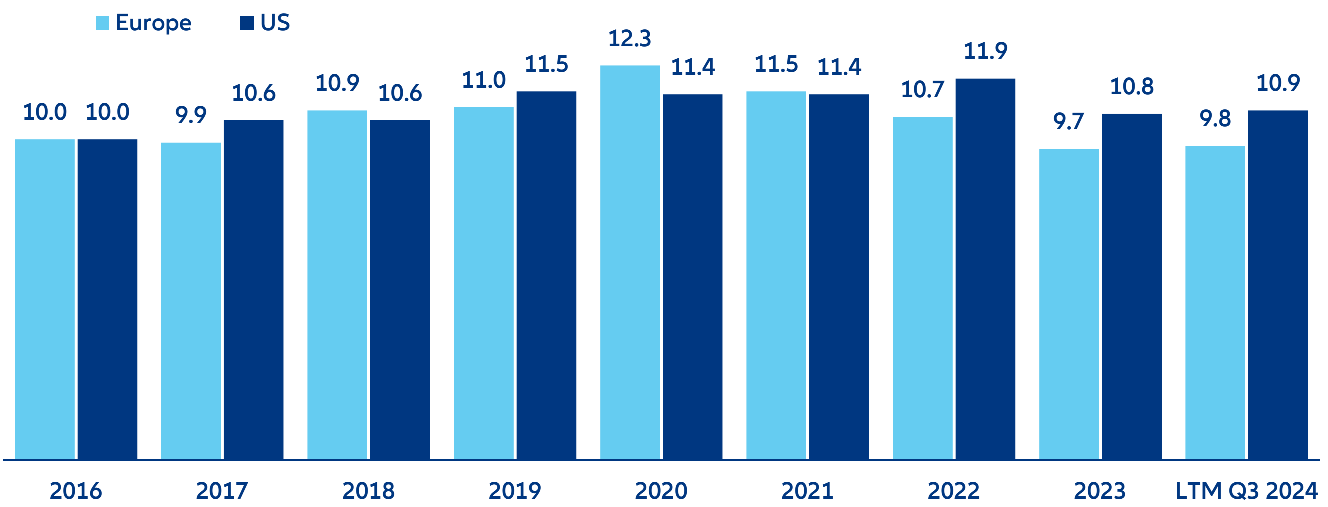
Global real estate markets are broadly on track for further recovery, although the higher-for-longer rate environment in the US may slow this process. With most major economies entering a monetary easing cycle, mortgage rates are expected to decline further, stabilizing demand for housing loans. In the commercial real estate market, trends show softening credit standards and steady demand for loans in both the US and Eurozone. The occupier market remains relatively robust, with rental growth supported by limited supply in key sectors, though challenges persist in office spaces due to shifts in workplace dynamics. Transaction volumes are stabilizing but remain at subdued levels, partly due to the persisting gap between buyers' and sellers' expectations. However, with mortgage rates coming down, valuations are likely to improve, gradually narrowing this gap and facilitating more transactions. Additionally, improved sentiment and capital availability could bolster activity in both residential and commercial sectors.

Unlocking value: private assets remain a resilient opportunity. By the end of 2024, private credit markets demonstrated resilience and continued expansion, even in the face of earlier economic challenges. Direct lending remained a cornerstone, with strong investor interest, though trends like the increased use of payment-in-kind (PIK) loans revealed both the flexibility of the market and potential cash flow pressures for lenders. If these trends persist, private credit could remain a reliable funding source, especially as defaults stay low and partnerships with traditional loan markets strengthen. However, tighter returns and varying fund performance suggest that asset and manager selectivity will remain a key driver of returns.

By the end of 2024, private equity markets showed early signs of recovery, supported by easing interest rates and robust economic activity, particularly in the US. While lower rates offered relief to the buyout space by reducing financing costs, their full benefits are yet to materialize as entry multiples remain slightly elevated compared to pre-pandemic levels. In the secondaries market, reduced discounts and increased focus on GP-led strategies, such as continuation funds, highlight growing investor interest in long-term value creation. However, geopolitical uncertainties and a cautious approach to exits continued to weigh on activity (Figure 15).

Looking ahead to 2025 and 2026, private equity could experience renewed momentum if lower interest rates and economic fundamentals sustain deal-making and exit opportunities. The gradual recovery of IPO markets and a potentially favorable M&A environment under the Trump administration might further boost activity. Yet, structural challenges such as elevated valuation levels, political uncertainties remain. Success will likely depend on embracing technological innovation, focusing on operational improvements and navigating sector-specific opportunities with selectivity.

Figure 15: Private equity buyout entry valuation, price-to-earnings ratio



Sources: Partners Group, Pitchbook, Allianz Research

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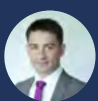

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