Summertime sadness

Mid-year economic outlook 2025-26

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Allianz Research

Content

Executive Summary

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- **"Under Pressure": Global growth will remain under pressure at +2.5% in 2025, the slowest since 2008 outside of recession periods.** The US forecast has been upgraded by +0.8pp to +1.6% in 2025-26 due to the lower effective tariffs. The Eurozone should see growth at +1.2%, largely driven by smaller economies, while Germany is projected to see +1% growth only in 2026 after +0.1% in 2025. Emerging markets show mixed results, some benefiting from FX appreciation and increased investment flows, with currency gains averaging 10% year-to-date. Trade forecasts for 2025 suggest a slight improvement: Global trade in goods is expected to grow by +0.3% (and Global trade of goods and services +1%), driven by continued frontloading and rerouting, though 2026 remains subdued with projected growth of +1.2% due to persistent uncertainties.

- **Trade tensions, geopolitical risks and fiscal challenges could "Rock the Boat".** The path to our US tariff baseline scenario proved to be more rapid, but global uncertainty continues to prevail at record-high levels. This will lead to a synchronized decline in the economic cycle in both developed and emerging markets, last seen in the second half of 2022 during peak inflation. Since our last Economic Outlook on 10 April, the US global import tariff rate has been lowered from 25% to 13% as the trade truce with China brought the US bilateral tariff rate down from 103% to 39%, contributing more to the downside than the higher sectorial tariffs (auto and auto parts at 25%, steel and aluminium at 50%). However, the US global import tariff is still at the highest level since 1940, and looming threats include potential additional tariffs of +50pps on the EU and reciprocal tariff deadlines on 8 July. Sector investigations also continue, with possible additional tariffs on automotive products (incl. trucks), copper, lumber, pharmaceuticals, commercial aircraft, jet engines and parts and critical and processed minerals. Beyond the trade war, the US faces significant fiscal and monetary challenges, with the fiscal deficit projected to exceed 8% of GDP by 2026 and interest payments increasing due to high inflation and fiscal risks, which could lead to nervous bond markets and further USD depreciation. The probability of a recession exceeds 30% and there are rising concerns over stagflation. In Europe, defense spending surpasses the 3.5% of GDP threshold required by the US in most NATO members, but capacity bottlenecks and reliance on debt financing will continue to exert upside pressures on long-term rates. Geopolitical strife, particularly in the Middle East, keeps uncertainty high. While the conflict has pushed oil prices up over 20%, the economic fallout will be limited unless escalation leads to pivotal disruptions, such as a Strait of Hormuz closure, which could see prices spiking to 120 USD/bbl.

- **When it comes to interest rates, the Fed will be "(Sittin' on) The Dock of the Bay" while the ECB will "Drop It Like It's Hot".** Central banks are taking divergent approaches, with the US Federal Reserve maintaining rates at 4.5% until December amid inflation concerns, set to peak at 3.9% by Q4 2025. The Fed is expected to cut rates to 3.5% by Q3 2026. In contrast, the ECB will continue its easing cycle amid low growth and disinflation, cutting rates to 1.5% by year-end. In emerging markets, 32 large economies that account for more than 35% of global GDP will be easing monetary policy in the second half of 2025, supported by ongoing FX appreciation and receding inflation; 23 of them will continue easing well into 2026. We identify four clusters: (i) those boldly leading the trend with an ambitious rate-cut path by end-2026, often coming from double-digit inflation (Mexico, Hungary, Argentina, Türkiye) but at risk of stalling should oil prices rise further and/or FX depreciation accelerate; (ii) those that were initially bolder but are less so now as inflation emerges again (Czechia, Kenya); (iii) laggards that will move ahead of the Fed (Poland, Romania), thanks to FX appreciation and moderating growth leading to back-to-target inflation and (iv) those that will pursue moderate rate cuts (China, South Africa, Morocco, India, Indonesia, Philippines, Thailand, Taiwan, Malaysia, Vietnam) as they approach the end of their easing cycles and balance inflation, growth and currency risks. Brazil remains the EM exception, continuing its own soon to-end hiking cycle to fight inflation.

- **It's a "Cruel Summer" for corporates, which are optimizing inventories and adjusting pricing strategies to maintain profitability amidst sluggish demand.** The labor market shows signs of normalization, with layoffs expected as companies focus on efficiency and cost-cutting. Investment growth remains timid, particularly in Europe, where credit conditions are improving but constrained. Loan growth stands at only +2% despite a 200bps reduction in ECB rates. Insolvency trends also present additional risks, with the global index indicating a +6.5% increase in Q1 2025. In addition, sector-specific risks are emerging, particularly in the automotive industry, due to competitive pressures and technological shifts. The construction sector in the US is under scrutiny due to profitability squeezes from rising wage pressures and immigration cuts, which exacerbate labor shortages and could lead to project delays and payment issues. Meanwhile, the pharmaceutical sector is on a negative watch list due to potential regulatory changes and cost pressures.
- **But capital markets are "Walking on Sunshine" despite geopolitical woes.** Risk markets, especially equities, staged a rapid recovery following the challenges of "Liberation Day". We are revising our forecast to reflect these positive developments, taking the catch-up phase into account but without significant further outperformance for the remainder of the year. This trajectory would still leave European equity markets up +18% year-to-date. Interest rates are expected to stabilize around current levels but will remain volatile, influenced by ongoing geopolitical developments. Despite a recent significant depreciation, we do not foresee a prolonged weakening of the USD, supported by real interest rate differentials and barring news triggering substantial capital outflows from the US. The removal of Section 899 from the latest US tax bill reinforces this outlook.

Tune in to our summer playlist

Global outlook: Slower momentum, yet some resilience amid global tensions

Global growth will remain sluggish at +2.5% in 2025, the slowest since 2008 outside of recession periods. The US forecast has been upgraded by +0.8pp to +1.6% in 2025-26 due to the lower effective tariffs, while the Eurozone should see growth at +1.2%, with Germany projected to see +1% growth in 2026 after +0.1% in 2025 as the “mega” stimulus plan will take time to be implemented. The UK is expected to grow by +0.9% in 2025 and +1.2% in 2026 as the government is prioritizing fiscal discipline over growth. France is set to grow by +0.6% in 2025 and +1.1% in 2026, dragged down by the lack of political agreement on the budget. Italy is forecasted to grow by +0.6% in 2025 and +0.8% in 2026. Spain continues to show strong performance, with growth rates of +2.2% in 2025 and +1.8% in 2026, driven by the buoyant tourism sector, NGEU fund absorption and higher labor productivity due to a rapidly growing foreign-born labor force. China is expected to grow by +4.5% in 2025 and +4.2% in 2026 as the authorities will do “whatever it takes” through monetary and fiscal support and protect growth from slowing more from the trade war impact.

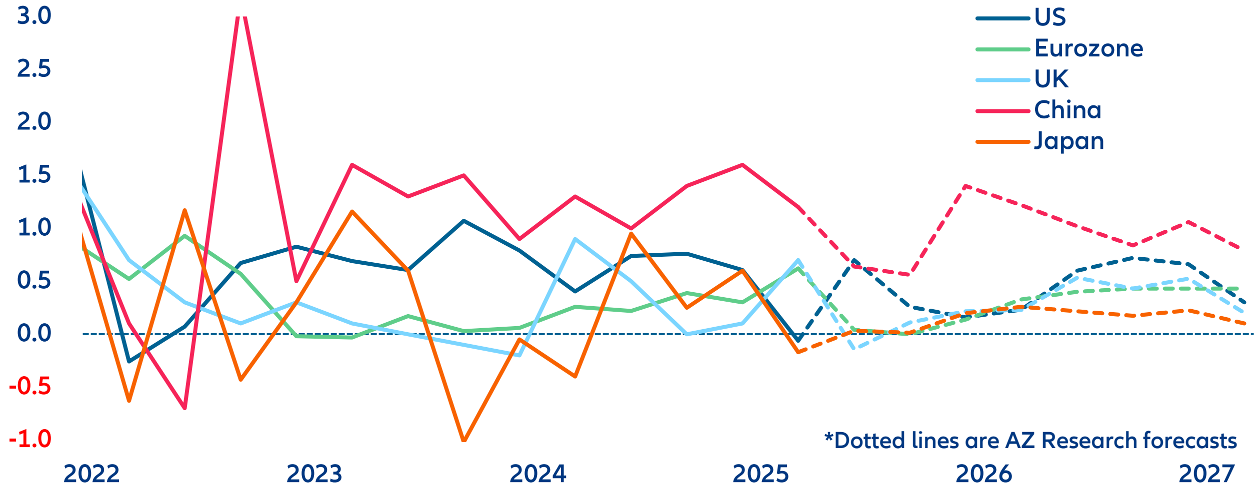
On balance, emerging markets will benefit from FX appreciation and increased investment flows, with currency gains averaging 10% year-to-date. Emerging economies overall are projected to grow by +3.8% in 2025 and +3.9% in 2026, in line with their average performance since 2019. Among major emerging markets, Vietnam stands out with growth rates of +6.0% in 2025 and +6.1% in 2026, making it the fastest-growing large emerging market. India also shows robust economic performance, with consistent growth rates of +6.2% for both 2025 and 2026. Brazil is expected to grow by +2.3% in 2025 and +2.2% in 2026 as the central bank continues to fight inflation. Mexico is anticipated to grow modestly by +0.8% in 2025 and +1.7% in 2026 as a consequence of the trade war with the US. South Africa should record growth of +1.5% in 2025 and +1.8% in 2026, reflecting fiscal consolidation and the negative impact from the higher tariffs. The Gulf Cooperation Council (GCC) countries show varied performance, with Saudi Arabia expected to grow by +3.1% in 2025 and +4.1% in 2026, while the United Arab Emirates is forecasted to grow by +4.5% in 2025 and +6.0% in 2026, indicating strong growth prospects.

Table 1: Real GDP growth forecasts, %

Growth (yearly %)	2022	2023	2024	2025f	2026f
Global	**3.4**	**2.9**	**2.8**	**2.5**	**2.6**
USA	**2.5**	**2.9**	**2.8**	**1.5**	**1.6**
Latin America	**3.9**	**2.1**	**1.7**	**2.2**	**2.5**
Brazil	3.1	3.3	3.0	2.3	2.2
UK	**4.8**	**0.4**	**1.1**	**0.9**	**1.2**
Eurozone	**3.6**	**0.6**	**0.8**	**1.2**	**1.1**
Germany	1.4	-0.1	-0.2	0.1	1.0
France	2.8	1.6	1.1	0.6	1.1
Italy	5.0	0.8	0.7	0.6	0.8
Spain	6.2	2.7	3.2	2.1	1.8
Central and Eastern Europe	**0.9**	**1.4**	**2.2**	**2.4**	**3.1**
Poland	5.5	0.1	2.9	3.0	3.6
Russia	-1.4	4.1	4.3	1.5	2.0
Türkiye	5.5	5.1	3.2	2.5	3.0
Asia-Pacific	**3.4**	**4.5**	**4.1**	**3.9**	**3.8**
China	3.1	5.4	5.0	4.5	4.2
Japan	0.9	1.4	0.2	0.8	0.7
India	7.0	8.8	6.7	6.2	6.2
Middle East	**7.6**	**1.7**	**1.8**	**2.3**	**3.2**
Saudi Arabia	12.0	0.5	2.0	3.1	4.1
Africa	**3.9**	**2.9**	**3.5**	**3.6**	**3.8**
South Africa	2.1	0.8	0.5	1.5	1.8

Sources: national, Allianz Research

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

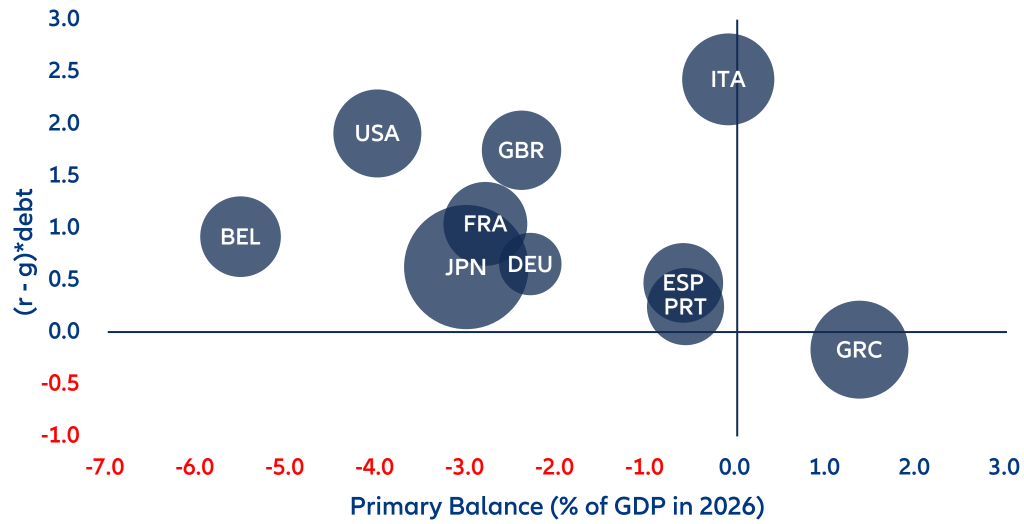


Sources: national, Allianz Research

The balance of risks is skewed to the downside, with the global economy facing stormy waters as trade tensions, geopolitical risks and fiscal challenges shape the outlook. The path to our US tariff baseline scenario proved to be more rapid, but global uncertainty continues to prevail at record-high levels. This will lead to a synchronized decline in the economic cycle in both developed and emerging markets, last seen in the second half of 2022 during peak inflation. Since our last Economic Outlook on 10 April, the US global import tariff rate has been lowered from 25% to 13% as the trade truce with China brought the US bilateral tariff rate down from 103% to 39%, contributing more to the downside than the higher sectorial tariffs (auto and auto parts at 25%, steel and aluminium at 50%). However, the US global import tariff is still at the highest level since 1940, and looming threats include potential additional tariffs of +50pps on the EU and reciprocal tariff deadlines on 8 July. Sector investigations also continue, with possible additional tariffs on automotive products (incl. trucks), copper, lumber, pharmaceuticals, commercial aircraft, jet engines and parts and critical and processed minerals. Beyond the trade war, the US faces significant fiscal and monetary challenges, with the fiscal deficit projected to exceed 8% of GDP by 2026 and interest payments increasing due to high inflation and fiscal risks, which could lead to nervous bond markets and further USD depreciation. The probability of a recession exceeds 30% and there are rising concerns over stagflation. In Europe, defense spending surpasses the 3.5% of GDP threshold required by the US in most NATO members (or 5% if we include the 1.5% of GDP planned for infrastructure-related spending), but capacity bottlenecks and reliance on debt financing will continue to exert upside pressures on long-term rates. Geopolitical strife, particularly in the Middle East, keeps uncertainty high. While the conflict has pushed oil prices up over 20%, the economic fallout will be limited unless escalation leads to pivotal disruptions, such as a Strait of Hormuz closure, which could see prices spiking to 120 USD/bbl.

Fiscal expansion, again. US fiscal policy will turn expansionary in 2026, creating additional fiscal risks. The "One Big Beautiful Bill" fiscal package includes the renewal of 2017 tax cuts, new tax cuts and modest spending restraints, with an expected final cost of 0.4% of GDP compared to current policy. Offsetting extra customs revenues are unlikely to prevent the US deficit from rising above 8% of GDP in 2026 (from around 7% in 2025) amid rapidly rising interest expenses and dynamic federal outlays. In the Eurozone, higher defense spending targets are expected to delay the pace of fiscal consolidation over the coming years. To help alleviate persistent fiscal pressures and provide member states with more flexibility, the European Commission has allowed countries to activate the National Escape Clause within the Stability and Growth Pact. This temporary provision enables governments to increase defense spending by up to 1.5% of GDP relative to 2021 levels for a period of four years, after which they will be required to return to the standard fiscal rules. Germany has so far outlined a clear and credible roadmap to meet its defense spending goal of 3.5% of GDP by 2029, signaling strong commitment to both defense and fiscal discipline. In contrast, countries like France, Italy and Belgium are still trying to strike a balance between new spending needs and long-lasting fiscal constraints, coupled with high debt levels. Complicating the fiscal outlook further is the approaching 18-month deadline for committing funds from the NGEU program, with around EUR180bn still expected to be disbursed. The tight timeline adds further pressure on governments to accelerate project implementation and execute investment plans efficiently, while the risks of underutilization and delays have risen.

Figure 2: Fiscal policy situation of major economies

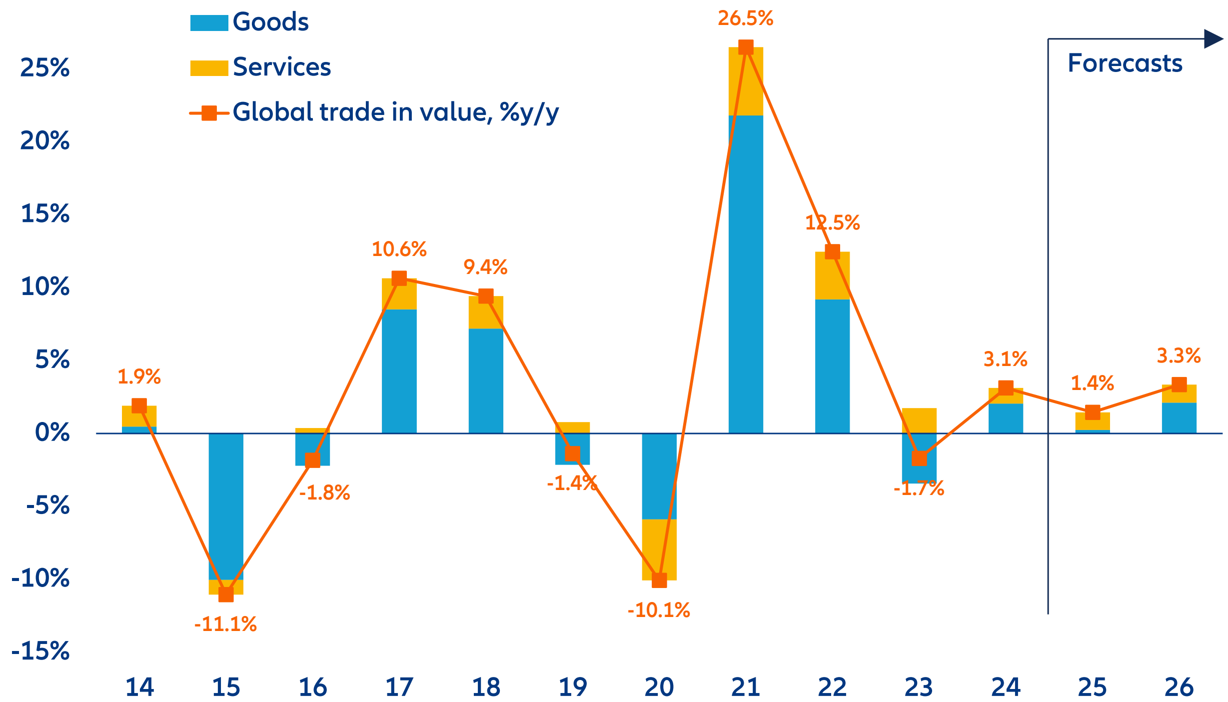


Sources: AMECO, Allianz Research

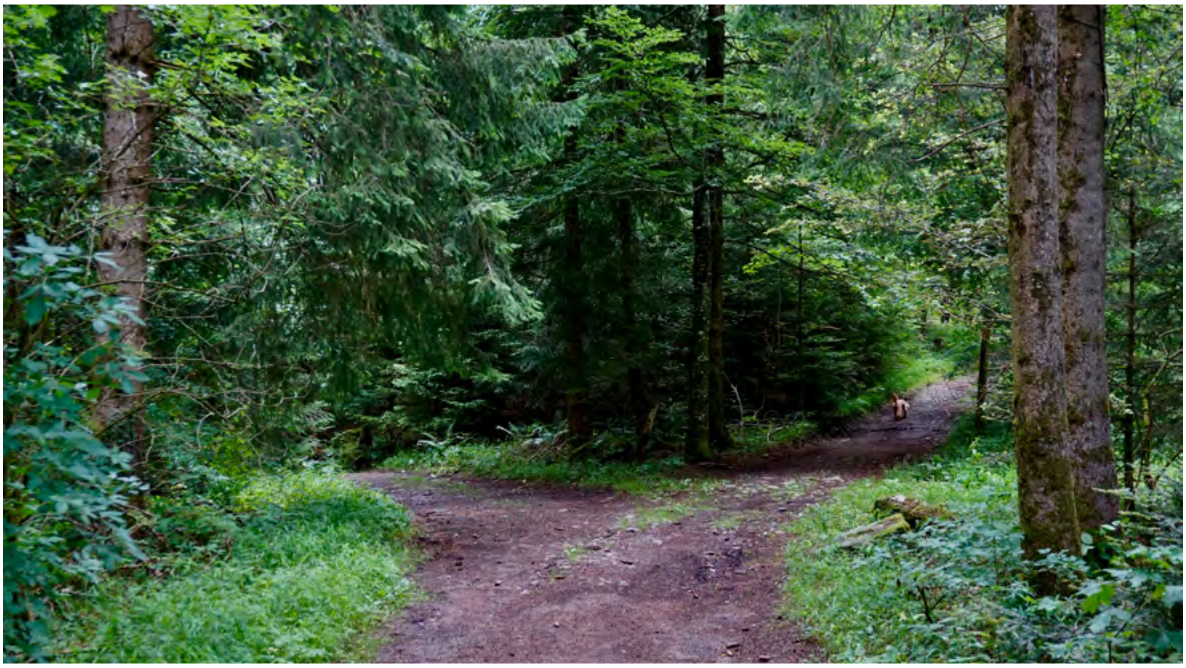
Notes: Bubble size corresponds to debt-to-GDP ratio. Primary balance is Allianz Research projection for 2026, (r-g)*debt is the difference of the effective nominal interest rate on government debt and trend nominal GDP growth times the debt-to-GDP ratio.

Global trade in goods may avoid a full-year recession in 2025, but uncertainty and the trade war could continue to weigh into 2026. Since April, the global economy has stepped away from an intense full-fledged trade war, with the US effective global import tariff rate dropping much faster than previously expected: from 25% in early April to 13% in mid-May, when a temporary truce was found between the US and China. The US also found a deal with the UK to avoid further tariff hikes, and recent news suggests that agreements with other countries may be on their way. Additionally, frontloading of US imports and rerouting of shipments (we find that rerouting through India and ASEAN covered around 40% of the shortfall in Chinese exports to the US in May) are also helping to somewhat dampen the hit from tariff hikes on global trade. At the same time, the threat of an escalating trade war and uncertainties continue to weigh: US tariffs on imports of steel and aluminum were raised from 25% to 50% in early June, and Section 232 investigations on copper, timber and lumber, semiconductors, pharmaceuticals, trucks and commercial aircrafts and jet engines are ongoing. The deadline to find deals to avoid the "Liberation Day" tariff hikes is also looming. Ultimately, we expect the US effective global import tariff to settle at 10%, much higher than the 2.5% it was before the start of the second Trump administration. This means that while global trade may perform better than previously expected this year, growth is still likely to be muted and the outlook for next year remains dim. We expect global trade of goods and services to grow by just +1% in 2025 and +0.9% in 2026 in volume terms, and +1.4% and +3.3% in value terms, respectively. Global trade of goods in value terms is expected to grow by +0.3% in 2025 (vs. -0.7% forecast in our April scenario) and +2.8% in 2026 (in part supported by the USD remaining weaker than previously anticipated).

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



Sources: LSEG Datastream, Allianz Research



Inflation and central banks: Transatlantic divergence continues

In developed markets, inflation divergence will remain a dominant feature of this business cycle in 2025. In the US, inflation had softened noticeably in the first half of 2025. There is evidence that tariff-induced rising intermediate and final goods costs were first absorbed into businesses' margins in an environment of heightened uncertainty over US trade policy[1]. However, we expect that an increasing share of businesses will pass along the higher costs on to their customers, as strongly indicated by an array of business surveys. We forecast US CPI inflation to peak at +3.9% by Q4 2025, from +2.6% in Q2 2025. In the UK, inflation is expected to remain well above the Bank of England (BoE)'s target, fueled by elevated wage growth and rising utility prices. Both US and UK inflation should normalize gradually through 2026 but the 2% target is not likely to be reached before Q4 2026. In Japan, inflation is also above-target and likely to remain elevated at 2.7% on average in 2025 (unchanged from 2024), before receding to 1.5% in 2026. Strong food prices and wages have been driving inflation, but a disinflationary trend is likely to emerge in the second half of this year on the back of slowing demand and government subsidies. In contrast, in the Eurozone, inflation has hovered around 2% since Q3 2024. Soft growth, a looser labor market and a strong euro have pushed down price and wage pressures. We expect Eurozone inflation to drop below 2% in the coming quarters on base effects and a still negative output gap.

Labor markets are loosening only gradually, with headline figures not yet sounding alarm bells. In the US, the labor market has dodged the effects of the tariff hikes and elevated uncertainty. The unemployment rate has remained at around 4.2% and job vacancies have stabilized. The private sector layoff rate is still low, indicating that businesses are holding on to their employees. Working hours per employee have even picked up a bit. Very tight immigration policy will increasingly weigh on labor supply in the coming quarters, while demographics trends continue to increase labor scarcity. As a result, despite softening growth, we do not expect unemployment to pick up by much, rising to 4.6% in the first half of 2026. In the Eurozone, the labor market remains

[1] See our analysis here 2025_06_12_what_to_watch.pdf. We estimate that US manufacturers took an around -1pp hit to their margins (in % of current sales) in Q2 2025.

notably resilient in 2025, with the unemployment rate reaching a record low of 6.2% in April, down from 7.2% before the Covid-19 pandemic. However, labor shortages and job vacancies are gradually declining and firms' labor hoarding – driven by past recruitment challenges – is beginning to ease. The pace of job creation has softened, though Southern Europe remains a relative bright spot. Contrary to the US, hours worked per employee continue to underperform, partly due to a shift toward lower average working hours in new positions. Looking ahead, unemployment is expected to rise only slightly, as prolonged economic uncertainty weighs on hiring decisions and demographic trends continue to restrict labor supply, making firms reluctant to cut jobs. Although wage growth remains elevated, it is expected to ease significantly over the course of 2025 to return to pre-Covid levels.

We expect the Fed to resume its easing cycle in December, past the tariff-induced inflation peak. The tariff-related increase in inflation, in an environment where households' medium-term inflation expectations are already elevated, is a risk to the Fed's anti-inflation credibility. Downside risks to growth would have to increase substantially for the Fed to deprioritize inflation risks and act earlier than expected. Although we do expect a significant slowing of growth in the second half of 2025, if the economy avoids a recession, we think that the Fed will prioritize the inflation part of its dual mandate. In fact, steering a growth adjustment is a necessary condition for inflation to cool post tariff effects. This sets the stage for the Fed to keep interest rates at their currently high level of 4.25-4.5%. FOMC officials and the Fed Chair himself have repeatedly emphasized that high inflation strains the poorest households the most and weakens the economy,

Table 2: Inflation forecasts, yearly, %

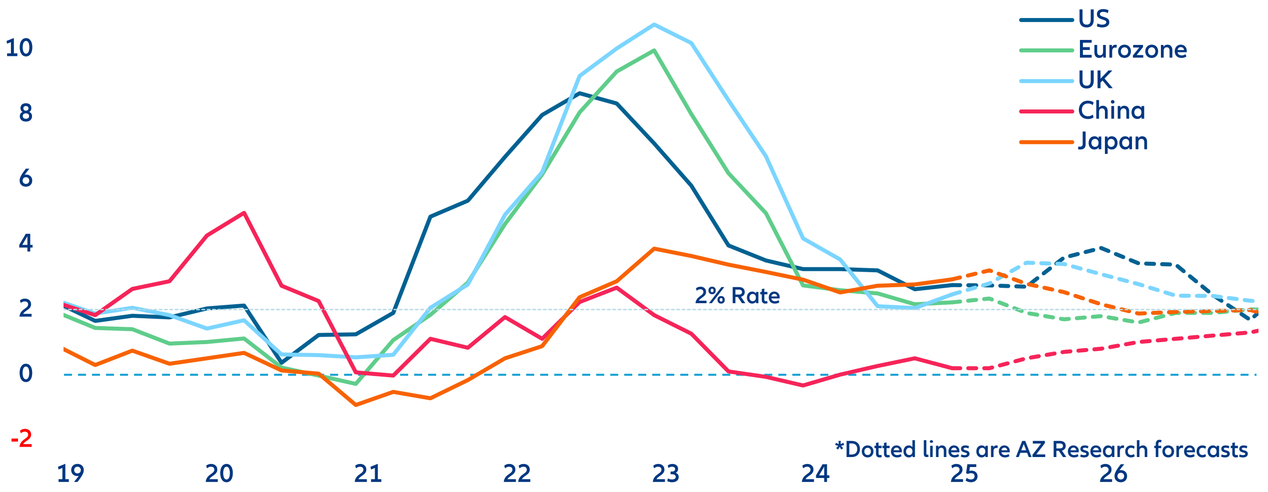
Inflation (yearly %)	2022	2023	2024	2025f	2026f
Global	8.2	6.1	4.5	4.0	3.4
USA	8.0	4.1	3.0	3.2	2.7
Latin America	14.2	14.8	16.6	7.2	4.8
Brazil	9.3	4.6	4.4	5.0	4.5
UK	9.1	7.3	2.5	3.2	2.5
Eurozone	8.4	5.4	2.4	1.9	1.9
Germany	6.9	6.0	2.3	2.0	1.9
France	5.2	4.9	2.0	0.9	1.3
Italy	8.2	5.6	1.0	1.8	1.9
Spain	8.4	3.5	2.8	2.2	2.0
Central and Eastern Europe	9.1	11.0	3.9	5.0	4.0
Poland	14.4	11.4	3.8	4.6	3.8
Russia	13.8	5.9	8.4	9.5	8.0
Türkiye	72.3	53.9	58.5	32.4	18.8
Asia-Pacific	4.0	3.0	2.1	1.4	1.9
China	2.0	0.2	0.2	0.2	1.0
Japan	2.5	3.3	2.7	2.7	1.5
India	6.7	5.7	5.0	3.8	4.2
Middle East	17.5	17.0	10.9	16.2	12.5
Saudi Arabia	2.5	2.3	1.7	1.7	1.7
Africa	14.6	17.1	15.3	12.2	8.9
South Africa	6.9	5.9	4.4	3.3	4.5

Sources: national, Allianz Research

meaning that brining inflation back to target as early as possible will also diminish downside risks to growth and the labor market, which we agree with. Following a first cautious 25bps rate cut in December, we expect the Fed to adopt a slow pace of easing through 2026 as inflation should cool but remain above target in the first half of 2026. A balanced strategy would be for the Fed to cut 25bps per quarter through 2026. We expect the Fed Funds Rate to settle in the 3.25-3.5% range in July 2026.

The ECB will pause in July but continue easing its policy rate by two more cuts to 1.5% in 2025 amid low inflation and economic headwinds. Over the past 12 months, the ECB has cut its policy rate from 4.0% to 2.0% – a self-proclaimed neutral level. Given the economic headwinds from tariffs and uncertainty that are pushing both consumer and company sentiment into subdued territory, we foresee a further reduction of the policy rate to a slightly accommodative stance. With headline inflation dropping below 2.0%, a strong euro affecting the competitive advantage of the export industry (on top of our baseline assumption of 10% tariffs against the most important trading partner, the US) and easing wage pressures, the path to further easing is clear. Meanwhile, the ECB is on the more hawkish side when it comes to its quantitative policy tools. Compared to the Fed, which has almost stopped the passive roll-off of US treasuries from its books to USD5bn per month, the ECB has been reducing its bond holdings by an average of EUR55bn per month ever since it stopped all reinvestments at the beginning of this year. In order to avoid another round of large losses, the ECB has a strong incentive to continue letting bonds roll off its balance sheet. However, to avoid the negative effects of higher rates in the economy, in particular in times of rising fiscal spending, it will be forced to lower its policy rate further, thereby pushing the yield curve down from the front end. Risks are fairly balanced. We expect the latest salvo of tariff threats from the US (up to 50%) to be negotiated down. Should this scenario instead materialize, or should ongoing uncertainty affect the economic outlook in a more severe way, we could easily see the ECB cutting rates further. On the other hand, if inflation surprises to the upside, there is a high chance the ECB will stop cutting from its current level.

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

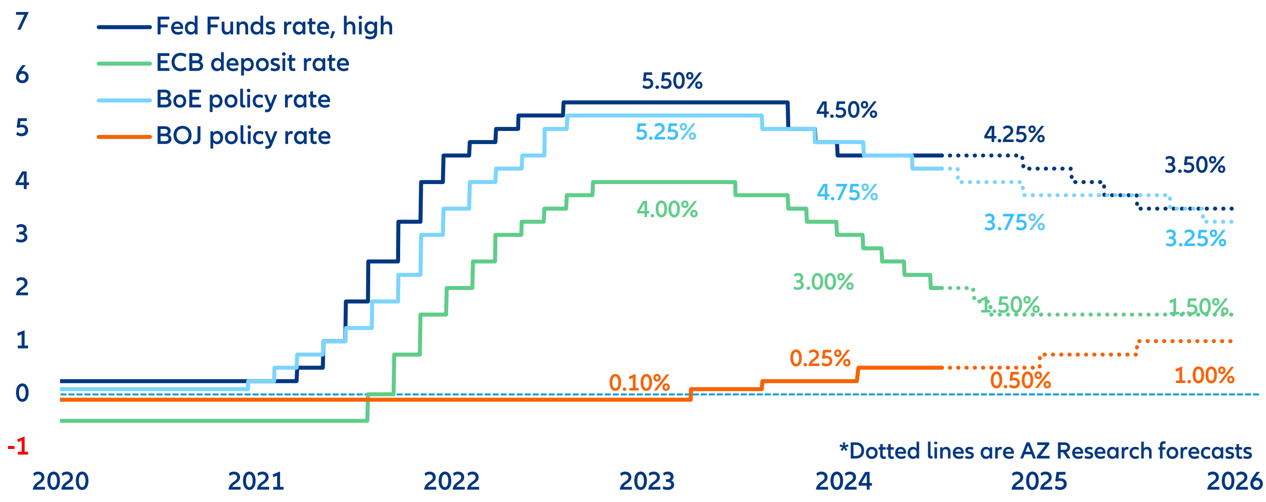


Sources: national, Allianz Research

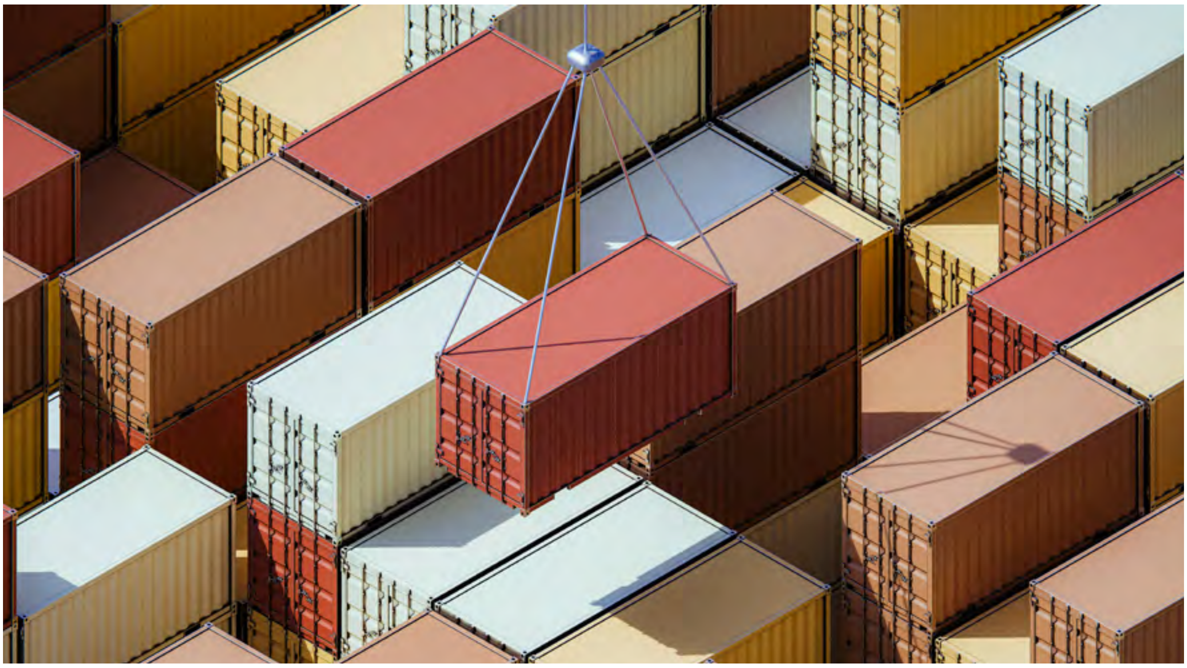
The Bank of England (BoE) is expected to continue its gradual easing cycle in 2025, but to pause for most of 2026. The BoE is contending with a cooling labor market but persistently above-target inflation. Since October 2024, inflation has been picking up but the Bank has proceeded with 75bps of cumulative rate cuts. In this context, we think the BoE's stance has been too loose. We expect inflation stickiness to persist through early 2026 and growth to be soft but not underwhelming. Therefore, while we expect the Bank to carry on with its 25bps cut, quarter-by-quarter approach in 2025 – we see August and December as the most likely – persistently above-target inflation should prompt BoE policymakers to pause for most of 2026. In all, we see the BoE's Bank rate coming down to 3.75% in December 2025, from 4.25% presently, followed by a prolonged pause between December 2025 and September 2026. We have penciled in two 25bps rate cuts in the September and November meetings, taking the Bank rate at 3.25% in end-2026.

The Bank of Japan (BoJ) is likely to stay cautious in policy normalization and continue the hiking cycle only next year. The BoJ has delivered three rate hikes in this cycle so far (March and August 2024, January 2025), bringing the policy rate from -0.1% to 0.5%, and is likely to stay put until the end of the year. This means we are delaying our expectation for the next rate hike to January 2026 (instead of this summer in our previous scenario) and forecast another one in summer 2026, thus reaching the terminal rate of 1%. This cautious path of tightening reflects the Japanese central bank aiming to find a balance between its inflation mandate and the need to support economic growth amidst headwinds. A wait-and-see approach is likely to prevail as the BoJ is likely not in a hurry to raise rates (long-term inflation expectations remain below 2%) but needs to gain further visibility in the context of uncertainties caused by US trade policies. In parallel, the BoJ will also steadily scale back its Japanese government bond purchases – reducing by JPY400bn every quarter until March 2026 and by JPY200bn thereafter to reach JPY2tn purchases per month in Q1 2027.

Figure 5: Monetary policy key rates, %



Sources: LSEG, Allianz Research



Developed markets: Feeling tariff pain but lifted by fiscal support

The US economy is expected to grow modestly at +1.6% in both 2025 and 2026 amid disruptive macro policies. The expected loss of momentum is substantial. After growing a close to +3% in 2023 and 2024, and against a 10 year-average of +2.5%, US GDP growth is projected cool down to only +1.6% in both 2025 and 2026. In 2025, the main policy shock is the very steep, across-the-board tariff hikes on imported goods that are increasing the price of inputs for companies and the price of goods and foodstuffs for consumers. In this environment, we expect sequential GDP to grow below +1% annualized in each quarter from Q3 2025 to Q1 2026. Higher industrial subsidies will likely only partially soften the blow. High prices for consumers are likely to keep sentiment weak and weigh on business investment. Past the inflation shock, growth is expected to recover but very sluggishly. Tight immigration policy will increasingly weaken US growth, by weighing both on demand (eg. consumer spending) and supply (less labor available). On the other hand, the deregulation agenda could provide some tailwinds to growth, but those are more likely to be felt over several years and will not be enough to offset major tariff and immigration headwinds to growth. We expect the ''Big Beautiful Bill'' fiscal package of tax cuts to have a modest impact on growth in 2026 as rising fiscal imbalances could prompt the private sector to save rather than spend most of the proceeds. Against this backdrop, strong underlying productivity growth – supported by solid digital and equipment investment – and relatively solid private sector balance sheets provide important buffers to US growth.

Eurozone growth looks solid but will be diluted by front-running tariffs and distorting figures from Ireland. The Eurozone has grown by a solid +0.6% q/q in the first quarter of 2025, the fastest growth rate in three years, thanks to strong investment and net export growth. However, this growth number was again largely driven by an extraordinary contribution from Ireland, which itself posted +9.7% q/q growth in the first quarter. Despite representing only a small share of the entire Eurozone economy (5%), its strong growth was nevertheless responsible for two-thirds of Eurozone growth in the first quarter. Excluding Ireland, Eurozone GDP only grew by a low +0.2% q/q in Q1 after +0.1% in Q4 (instead of +0.3% including Ireland). The ECB has frequently warned that Eurozone GDP is increasingly shaped by the activities of large multinational companies based in Ireland. In particular, the large-scale relocation of intangible assets like patents and software by foreign firms to Ireland has inflated output figures. These shifts are primarily motivated by tax considerations and remain largely unrelated to the underlying Irish or Eurozone economic dynamics. If we exclude Ireland from our economic outlook for the Eurozone, we end up with meagre +0.6% annual growth rate for 2025 instead of the headline +1.2%. This supports our view that despite low inflation, the underlying Eurozone economy is still in a bad shape and needs further monetary policy support.

Germany is reshuffling the cards, with its fiscal package and investment incentives key to its economic recovery. The country is emerging from recession with modest growth and a bold fiscal plan aimed at economic recovery. Despite external risks such as the potential for a trade war with the US and ongoing global fragmentation, the newly elected government is promoting structural reforms and public investment in order to stimulate growth. Key measures include generous depreciation rates, tax incentives for R&D, a EUR500bn infrastructure fund, increased defense spending and future corporate tax cuts totaling -5pps from 2028 onwards. Although there was a surprise GDP uptick of +0.4% in Q1 2025, full-year growth will remain subdued at +0.1%. The recovery and the full impact of the fiscal boost and investment incentives are expected from 2026 onwards, with growth reaching +1.0%. To ensure a sustained recovery, Berlin must streamline bureaucracy and invest in the green and digital transitions to boost productivity and long-term growth potential. If this is achieved, momentum could even improve earlier.

In France, 2025 will be a cyclical trough for growth (+0.6%). Momentum should improve heading into 2026 (+1.1%), but political instability remains a key downside risk. French GDP has barely grown since Q4 2024. Domestic political instability and policy unpredictability have likely contributed to weak economic performance. The US's disruptive trade policy has added headwinds to the French economy since early 2025. We expect the Bayrou government to survive no-confidence votes, notably on the 2026 Budget, with opposition parties extracting key concessions. Nevertheless, there is a risk that it does not, which would trigger a political crisis and a potential adverse negative market reaction, given large fiscal imbalances. We expect growth to pick up to +1.1% in 2026. Tight fiscal policy will be headwind to growth, but this will be partially offset by fading US trade policy uncertainty and ECB-induced loose monetary conditions being increasingly supportive.

Despite heightened global trade policy uncertainty, Italy's economic activity held up well in the first quarter of 2025, with real GDP growing by +0.3% q/q and employment reaching a record high. Investment activity was solid (+1.6% q/q) across all components, with particularly strong growth in transport equipment (+2.3%), likely reflecting US tariff frontloading. While ongoing uncertainty is expected to weigh on the investment outlook, NGEU-related spending should help partially offset the drag on activity. Household consumption is set to continue, as suggested by the gradual decline in both the savings rate and intentions. The better-than-expected fiscal outturn in 2024 – driven by higher direct tax revenues but also by one-off measures – is now facing new spending pressures, including increased defense targets. We expect the primary balance to slip back into a slight deficit this year, though the government's fiscal commitment remains intact. Overall, we forecast GDP growth of +0.6% in 2025, followed by a modest rebound to +0.8% in 2026.

Political turmoil continues to shape Spain's landscape. GDP growth has been revised down for the past three quarters, signaling a slowing pace of activity, though the economy remains relatively resilient. Domestic consumption and investment are expected to support growth this year, with a significant portion of the EUR80bn from the NGEU funds likely to flow in over the next 18 months. We project a solid +2.2% GDP expansion for 2025, despite the challenging global backdrop. However, business sentiment is weakening – particularly in the services sector. While retail sales rose +4% in May and tourist arrivals increased by +11% year-on-year in April 2025, PMI data point to a continued moderation in service sector momentum during Q2.

UK growth should remain soft through early 2026, before strengthening a bit sequentially. We expect +0.9% in 2025 and +1.2% in 2026. After recording a soft +1.1% in 2024, UK growth is projected to slow down to +0.9% in 2025. Besides US-related international headwinds, the UK economy is contending with tax hikes, high inflation and elevated borrowing costs. Nevertheless, real wage growth has been dynamic recently, helping to support a recovery

[2] See Intangible assets of multinational enterprises in Ireland and their impact on euro area GDP

in household spending. The cyclical weak spot has been residential investment, plagued by high mortgage rates and a stamp duty hike. Business investment growth has been strong, but this is partially due to one-offs prior to tax hikes. It is expected to slow down in the next quarters. With more tax hikes likely to be announced in the autumn budget, business sentiment could deteriorate, which is a key downside risk for the 2026 growth outlook. Sequential growth should nonetheless improve through 2026. Public capital spending is braced for a sharp acceleration. Lower, though still high, borrowing costs should start to prop up the residential sector.

Japan: After narrowly escaping recession in 2024, growth will remain sluggish in 2025-2026. We have revised our GDP growth forecasts for Japan downwards again, to +0.8% in 2025 (-0.2pp compared to our previous economic outlook) and +0.7% in 2026 (-0.1pp). This reflects a patchy economic recovery after barely any growth in 2024 (+0.1%). The first half of 2025 will likely have been supported by resilient external activity (as part of frontloading in global trade flows), a tailwind that is likely to fade going forward. Domestically, the high cost of living and an environment of uncertainties weigh on private consumption and investment. Further fiscal support will help but may not be able to fully make up for downside pressures.

Emerging markets: China stable amid trade relief, while regional divergence widens

China: The trade war truce and other mitigating factors that support exports mean that there is no urgency to step up stimulus significantly anymore. Nevertheless, policy support will continue. We are keeping our GDP growth forecasts for China unchanged at +4.5% in 2025 and +4.2% in 2026 – which the consensus has now caught up to. The drag from net exports is likely to be smaller than previously anticipated, thanks to the trade truce with the US (in our baseline scenario, we expect the US effective import tariff rate applied on China to ultimately stay at the Geneva truce level of 39%, down from 103% before the truce but above 13% at the end of 2024) as well as trade diversification and rerouting. This means that Chinese authorities may not need to step up policy support further than what had already been announced (amounting to a fiscal impulse of 1.7pps in 2025, compared with 0.7pp in 2024). On the monetary side, we have also scaled down our expectations for further easing, forecasting just one more -10pps cut in policy rates this year, followed by -20pps in total next year.

Emerging market economies overall are performing better than previously expected this year but headwinds are picking up, including global uncertainties, US protectionism, energy market volatility and geopolitical tensions. Growth in emerging markets (EM) excluding China is forecast to reach +3.3% in 2025 and +3.7% in 2026 (after +3.5% in 2024). However, the aggregate numbers mask regional divergences, with Asia in particular likely to face a continued economic slowdown going into 2026. Most central banks in that region will keep on cautiously cutting rates, mostly in 2025, while others in Latin America, emerging Europe and Africa can afford to ease monetary policies more boldly into 2026. On the fiscal side, EM economies overall face relatively low risks for now (with a few isolated exceptions in each continent), allowing for an accommodative stance to support economic activity. Downside risks to the EM outlook mainly arise from US trade policies and geopolitical tensions.

Table 3: Key drivers and challenges for emerging market economies

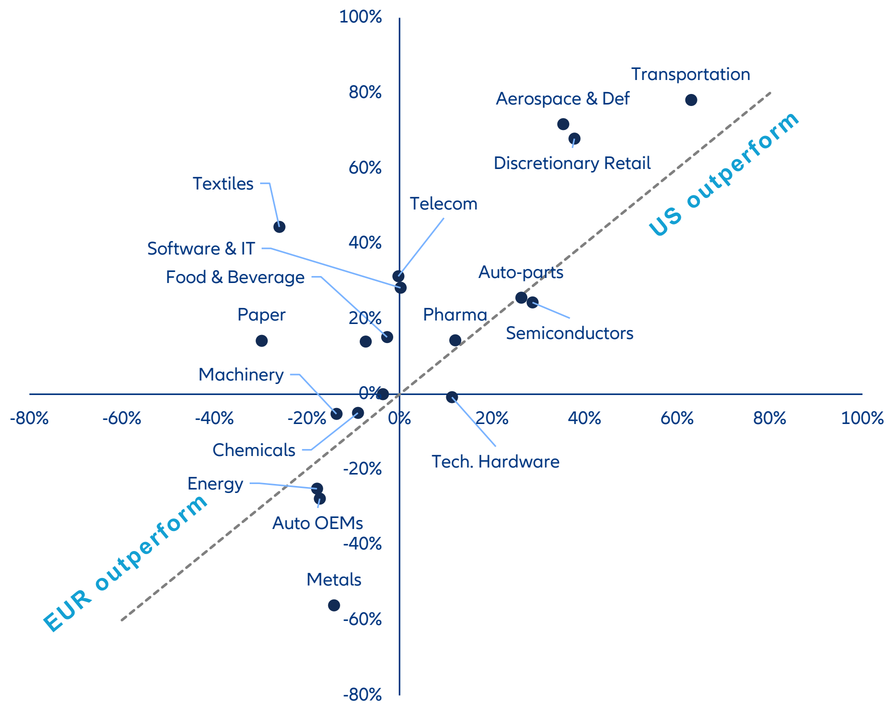
Emerging Asia, excluding China	We are keeping our growth forecasts for Asia-Pacific overall unchanged at +3.9% in 2025 and +3.8% in 2026 (after +4.1 in 2024) – though that masks divergences in the region. The economic outlooks were revised on the downside for South Korea, Singapore and a few other Southeast Asian economies (such as Malaysia, Thailand and Vietnam), while upwards revisions were applied to India, the Philippines and Taiwan. In all cases, though, the second half of 2025 is likely to prove more difficult as tailwinds from export frontloading in the first half fade and policy support helps but does not fully make up for downside pressures. Inflation is generally contained in the region, being comfortably within central banks' target ranges in many cases (e.g. India, Indonesia, the Philippines and South Korea) while others see below-target inflation or even deflationary pressures (e.g. Taiwan, Vietnam, China and Thailand). On aggregate, inflation for Emerging Asia excluding China overall is forecast at 2.4% in 2025 and 2.7% in 2026 (after 3.2% in 2024). This means that most central banks in the region will likely carry on with their cautious easing cycles this year before pausing next year, balancing inflation, growth and currency risks. On the fiscal side, most governments will likely see widening deficits in the context of growth headwinds, albeit to varying degrees (e.g. India will likely maintain its fiscal-consolidation targets). In terms of geopolitical risks, developments in the Taiwan Strait, between India and Pakistan, in the South China Sea and in the Korean peninsula constitute the main potential flashpoints in the region.
Emerging Europe	The region's economic growth is projected to reach +2.3% in 2025 and +2.9% in 2026. After a slow start to 2025, economic activity in CEE is expected to recover gradually throughout 2026. However, performance across the region is expected to diverge: Czechia and Poland are set to outperform, while Romania and Hungary are likely to underperform. The recovery will face headwinds from US reciprocal and sector-specific tariffs, particularly in the automotive sector. Although direct demand from the US accounts for about 1.5% of GDP across CEE economies, the impact is amplified through integrated supply chains, particularly those linked to Germany. Inflation is forecast to remain above central bank targets in most CEE countries until the end of 2025, primarily due to expansionary fiscal policies, despite a recent moderation in wage growth. While this will temper household spending momentum, it will also support central banks in their efforts to contain inflation. Regional inflation is expected to average 4.0% in 2025 and 3.3% in 2026. While an improving inflation outlook may permit some monetary easing, persistently high core inflation will restrict the scope for interest rate cuts in 2025. Some central banks, such as in Poland, are expected to adopt a more dovish stance, while in Hungary and Romania, there is limited scope for rate cuts. Overall, tight labor markets, loose fiscal policy and elevated inflation suggest that monetary policy across the region will remain cautiously restrictive. The Turkish central bank is facing persistent cost-push inflation and intensifying political pressure to loosen policy. Yet any premature easing risks reigniting lira volatility and undermining the progress on stabilizing inflation, while economic growth prospects remain within +2.5-3% per year in the medium-term.
Latin America	Latin America's economic outlook remains mixed but resilient. Growth continues to surprise on the upside in several areas, particularly in Argentina – where stabilization efforts are gaining traction – and across the Andean economies. Brazil is also seeing modest but steady momentum, supported by potential rate cuts later this year. While Mexico has navigated US protectionism more effectively than expected headwinds from weaker remittances and slowing consumption are emerging. Region-wide, lower commodity prices and tighter fiscal policy are likely to weigh on growth, especially in economies like Chile and Colombia. Fiscal risks remain elevated, notably in Colombia, where deficit concerns persist. Even with a potential shift toward more market-friendly leadership in upcoming elections, investors should not expect an immediate easing of fiscal pressures. After a period of strong asset performance, markets may now enter a phase of repricing, but the region's improving macro fundamentals continue to offer selective opportunities for medium-term investors.
Africa and the Middle East	Uncertainty continues to dictate growth patterns across Africa and Middle East. In Africa, energy market volatility, trade tensions and underinvestment are trimming growth, expected at +3.4% in 2025 and +3.7% in 2026. Inflation is projected to decrease to 12.2% in 2025 and 8.9% in 2026 after several years of skyrocketing inflation in key markets such as Egypt, Ghana, Nigeria or Ethiopia. The continent continues an easing cycle in different speeds, while the aid cut off from Western economies is causing higher fiscal slippages across the board. The Middle East continues to be impacted by the ongoing conflict as the conflict between Iran and Israel disrupted economic activity across the area. The region is expected to grow by +2.3% in 2025 and +3.1% in 2026 on the back of increased oil and natural gas production, as well as public-led investment plans that are driving activity in the Gulf region. The Middle East will continue to mirror the Fed's moves, while countries continue spending heavily to meet their oil-diversification visions. Saudi Arabia is expected to be among the largest EM international borrowers in 2025.

Sources: Allianz Research

Corporates: Resilient US profits and inventory discipline meet Europe's warehousing of uncertainty

The US-Europe earnings divide is narrower than we think. Corporate earnings in Q1 2025 once again reflected a transatlantic divergence: In the US, aggregate industry EPS rose by +14.6% y/y, while European peers managed a modest +5.5% increase. However, this gap is driven by a handful of sectors and firms. In 14 out of 20 sectors, European firms managed to post better earnings growth than their US competitors (see Figure 6). European aerospace and defense led the earnings charge, with a close to +72% EPS surge and almost +19% revenue growth, underscoring continued tailwinds from the region's defense push amid geopolitical tensions. Transportation (+78% EPS) and telecom (+31%) also outperformed as structural shifts boosted demand. However, these gains contrast with steep earnings contractions in core industrials: auto OEMs cratered (-28%), energy slumped (-25%) and metals collapsed (-56%). This reflects fragile demand and price deflation across commodities and manufacturing inputs. The US landscape offers a more consistent picture, albeit still fragmented. Transportation (+63%) and discretionary retail (+38%) were strong performers, benefiting from a resilient consumer base. Semiconductors delivered a +29% earnings bump. But industrial cyclicals are flashing amber: Machinery (-14%), building products (-7%) and chemicals (-9%) all posted earnings declines. Meanwhile, investment remains subdued. Despite easing credit conditions – such as the 200bps reduction in ECB rates – European loan growth remains tepid at just. The US, although better capitalized, is choosing dividends and buybacks over bold investment: more than USD1trn in share buybacks is expected this year, with USD234bn already announced in Q1 2025. This reflects not only policy uncertainty and geopolitical jitters, but also a calculated bet by corporates: better to return cash than to deploy it on a foggy future.

Figure 6: Q1 2025 earnings growth (EPS y/y% – US horizontal axis, Europe vertical axis)

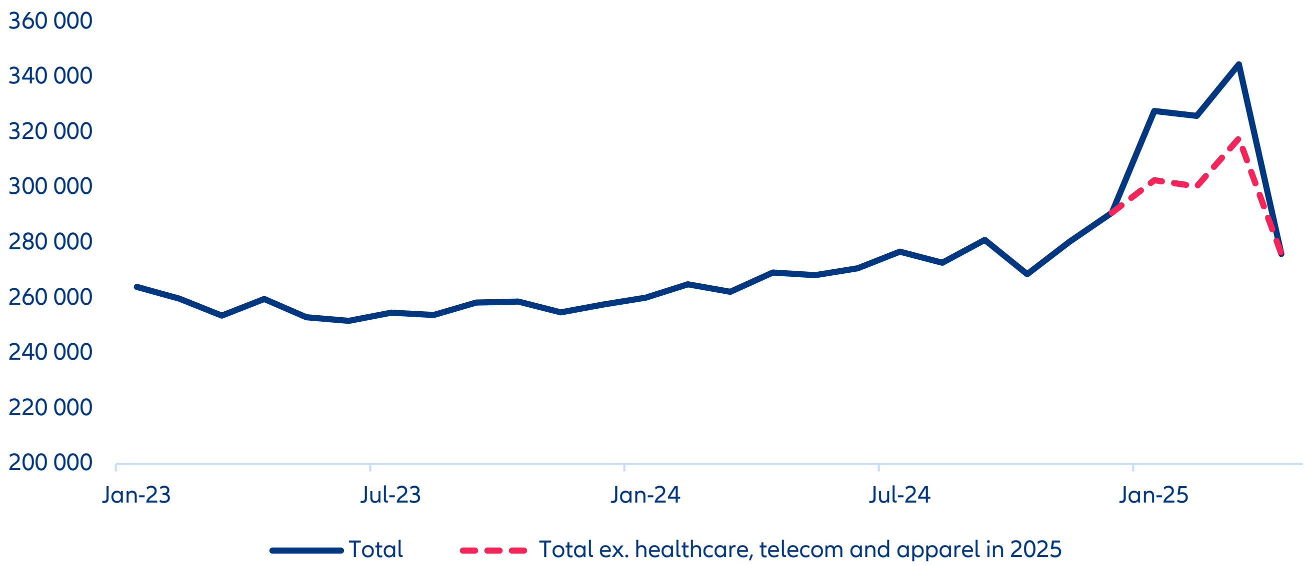


Sources: LSEG Workspace, Allianz Research

The US dollar has weakened notably in recent months, with mixed effects on corporate revenues across regions. For US-based multinationals, the weaker dollar is generally supportive of earnings as foreign revenues translate into higher dollar amounts when consolidated, and exports become more price-competitive globally. In contrast, European companies, particularly those with significant exposure to the US market, are experiencing a currency headwind. Their dollar-denominated revenues now convert into fewer euros, weighing on reported earnings. Additionally, a stronger euro can erode the global competitiveness of European exporters. As long as the dollar remains under pressure, this divergence is likely to persist, offering relative upside for US corporates while creating margin challenges for their European peers.

Inventories also tell two different tales. Since the tariff announcements, frontloading and inventory build-up have been touted as resilience tools in the current environment. But looking closely at the data, we see a clear divergence in strategy between the US and Europe. US firms have shed inventories aggressively – Days Inventory Outstanding (DIO) fell by 2.6 days in 2024, contributing to a rare three-day decline in Working Capital Requirements (WCR) . Despite a +27% y/y surge in imports in Q1 2025, inventories barely moved, up just +0.1% m/m in March. In sectors like apparel and pharmaceuticals, companies raced to frontload purchases ahead of tariff threats but inventory levels remained flat. Instead of hoarding, US firms routed goods straight to consumers and distributors. Pharmaceutical imports alone surged to USD50bn in March 2025 – equal to 44% of 2024's total (see Figure 7) – but much of that landed in hospital systems and drugstores, not corporate stockrooms. The inventory narrative here is one of agility, not accumulation, and this discipline has freed capital and allowed US firms to show strong earnings. Europe tells a different story. Days Inventory Outstanding increased by +1.4 days, marking the fourth consecutive annual rise. European corporates are effectively warehousing risk: Sluggish demand and poor factory order books have left warehouses full, even as order flows dry up. More strikingly, European firms are acting as "hidden banks." Days Sales Outstanding (DSO) increased by 2 days in 2024, and DPO declined, resulting in a widening financing gap. Companies extended about EUR11bn in trade credit to their clients between Q4 2024 and Q1 2025, a sum nearly equal to monthly bank lending across the Eurozone. These deferred receivables mean cash is stuck in warehouses and customer ledgers – leaving corporates vulnerable if rates or insolvencies spike.

Figure 7: US imports adjusted for selected products (USD thousands)



Sources: LSEG Datastream, Allianz Research

A clear set of sector fault lines. Under the surface of headline growth, sector-specific cracks are widening. Insolvencies rose +6.5% globally in Q1 2025, and risks are more concentrated in a handful of sectors. Automotive remains under immense pressure. In Europe, auto OEMs reported a staggering -28% drop in EPS and close to -2% revenue contraction. In the US, OEMs also declined sharply (-17%), with soft revenue and rising competitive pressure. Construction is another sore spot. In the US, rising wage costs and a tightening immigration policy are strangling margins. Machinery earnings plunged (-14%) and building products followed suit (-7%). With project delays mounting and skilled labor scarce, developers face growing liquidity issues. Pharmaceuticals are on a regulatory watch list. While the sector still shows positive EPS growth (Europe +14%, US +12%), margins are under threat. Moreover, the frontloaded inventory strategies driven by tariff fears could flip into overhangs if demand softens. Finally, chemicals and metals are flashing red. Both sectors posted widespread EPS declines in Europe (-5% and -56%, respectively) and in the US (-9% and -14%). Metals also face a WCR burden, with inventory ratios exceeding 70 days of turnover and almost a quarter of firms holding stocks worth over 90 days of revenues. As commodity prices stagnate and capex wanes, these sectors risk becoming liquidity traps.

Against this backdrop, we expect corporate insolvencies to increase by about +7% in 2025 globally, with three out of four countries above 2016-2019 levels. Our Global Insolvency Index, which accounts for the economic weight of each country, indicates a +6.5% y/y increase in Q1 2025, following a +7.4% y/y rise in Q4 2024 (+11% for the full year 2024). This global trend is notably driven by an uptick in China and the rest of Asia, excluding India, which is experiencing a prolonged downturn. The US is also contributing to this trend, whereas Canada is recording a pronounced decline from historical highs. Western Europe also shows mixed trends, with a larger upside trend in Switzerland, Finland and Germany, as well as Italy due to a significant increase in amicable procedures, while the number of insolvencies softened in the Netherlands, Portugal, Finland and to a lesser extent the UK. Overall, we expect three out of four countries to face a rise in insolvencies for the full year – and to record more cases than averaged over the 2016-2019 period. This upward trend is likely to continue into 2026 globally, though at a slower pace (+3%). However, projections are more severe for the US (+13% and +5% in 2025 and 2026, respectively), and APAC (+6% and +5%) despite a mixed picture. Western Europe will face a larger increase than previously anticipated for 2025 (+7%) before a moderate but broad-based decrease across countries in 2026 (-3%).

[3] See our report “Cash back to shareholders or cash stuck to finance customers? American and European firms deal with trade war differently.”

Capital markets outlook: Resilience amid geopolitical woes

Despite volatility, capital markets have demonstrated remarkable resilience this year in the face of heightened geopolitical tensions and ongoing tariff uncertainty. Equity markets in particular have rebounded sharply following "Liberation Day", posting one of the fastest recoveries in over five decades. As much of the catch-up appears to be behind us and there is still considerable uncertainty ahead, we see limited scope for further outperformance in the near term. However, volatility will remain elevated depending on the news flow in all markets. This is reflected by option markets, which continue to price in a broader range of potential outcomes. With high fiscal deficits in the US and the prospect of more defense spending in Europe, investor sentiment has shifted from inflation concerns toward fiscal credibility. While capital outflows from the US have challenged the dollar's traditional safe-haven status, fair-value models anchored in real interest rate differentials suggest the recent depreciation may not continue. Overall, the capital market environment reflects a balancing act between inflation pressures, shifting policy narratives and lingering geopolitical uncertainty.

Table 4: Capital market forecasts

EMU	Last*	Unit	2022	2023	2024	2025f	2026f
Government Debt							
ECB deposit rate	2.00	%	2.00	4.00	3.00	1.50	1.50
10y yield (Bunds)	2.57	%	2.56	2.03	2.36	2.30	2.30
10y EUR swap rate	2.48	%	3.14	2.48	2.39	2.20	2.20
20y EUR swap rate	2.61	%	2.87	2.51	2.39	2.30	2.30
Italy 10y sovereign spread	90	bps	213	168	117	100	90
France 10y sovereign spread	68	bps	55	53	83	80	70
Spain 10y sovereign spread	64	bps	109	97	70	60	50
Corporate Debt							
Investment grade credit spreads	89	bps	166	135	101	100	90
High-yield credit spreads	310	bps	494	395	311	330	310
Equity							
Eurostoxx (total return p.a.)	14 ytd	%	-12	19	10	18	7

US	Last*	Unit	2022	2023	2024	2025f	2026f
Government Debt							
Fed Funds rate (high)	4.50	%	4.50	5.50	4.50	4.25	3.50
10y yield (Treasuries)	4.25	%	3.83	3.87	4.57	4.50	4.20
Corporate Debt							
Investment grade credit spreads	84	bps	138	104	82	100	90
High-yield credit spreads	291	bps	479	334	292	350	320
Equity							
S&P 500 (total return p.a.)	6 ytd	%	-18	26	25	4	7

UK	Last*	Unit	2022	2023	2024	2025f	2026f
Government Debt							
BoE rate	4.25	%	3.50	5.25	4.75	3.75	3.25
10y yield sovereign (Gilt)	4.46	%	3.67	3.54	4.57	4.40	4.10
Corporate Debt							
Investment grade credit spreads	95	bps	192	134	91	105	100
High-yield credit spreads	435	bps	663	515	364	410	380
Equity							
FTSE 100 (total return p.a.)	10 ytd	%	5	8	10	12	7

Emerging Markets	Last*	Unit	2022	2023	2024	2025f	2026f
Government Debt							
Hard currency spread (vs USD)	206	bps	273	215	202	220	200
Local currency yield	6.34	%	6.86	6.19	6.4	6.0	5.8
Equity							
MSCI EM (total return p.a. in USD)	16 ytd	%	-20	10	8	15	6

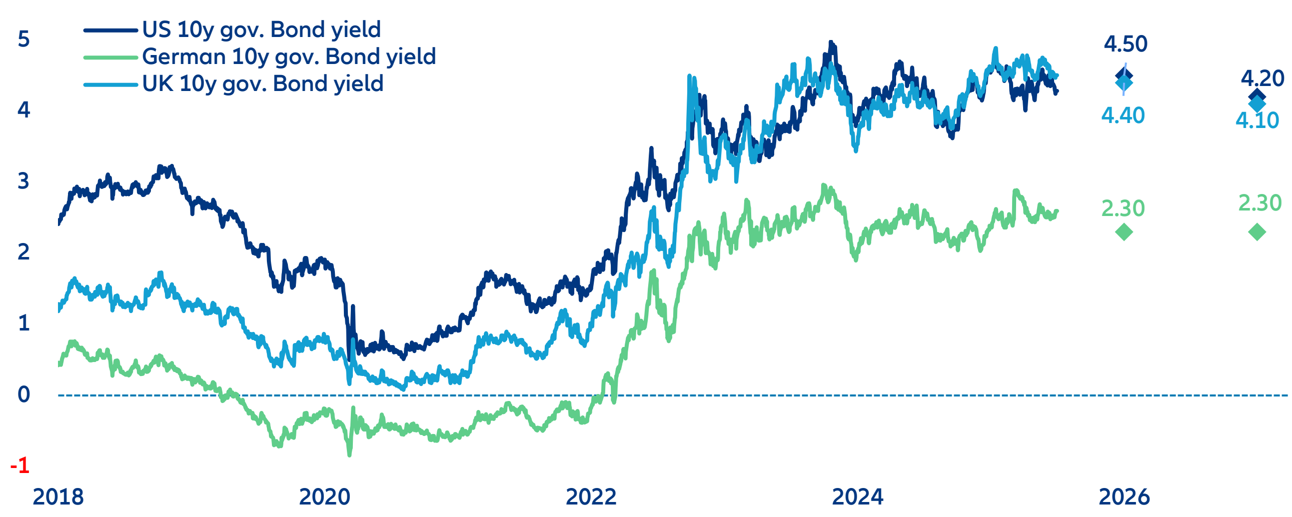
Others	Last*		2022	2023	2024	2025f	2026f
EUR USD	1.18	$ per €	1.07	1.10	1.04	1.15	1.15
Oil (Brent)	68	$ per bl	83	78	75	66	68
Natural gas (Dutch TTF)	33	€ per MWh	76	32	49	38	36

Sources: LSEG Datastream, Allianz Research
Notes: Year-end figures, *As of 1. Jul 2025

Government bond yields remain volatile on a daily basis but are expected to remain in the wider trading range of the past two years going forward. Despite the heavy news flow, 10y government bond yields continued to hover in their recent trading corridors of 3.6% to 4.8% in the US and the UK, and between 2.0% and 2.8% in Germany. Longer-term market-based inflation expectations (10y inflation break-evens) have remained relatively steady, suggesting a certain level of trust that central banks keep inflation under control. But that is in stark contrast to consumer inflation expectations, which have risen strongly this year in the US. Fiscal developments – given large deficits and further tax cuts in the US and increases in defense spending in Europe – are complicating the picture. Going forward, we expect US 10y rates to remain elevated, mainly because of high deficits, less appetite from foreign investors to jump in and a more hawkish Fed view compared to markets amid high inflation. In Europe, rising swap spreads signal stronger relative demand for Bunds and therefore reduced fears that higher fiscal slippage translates into higher rates. At the same time, we have a slightly more dovish view on the ECB compared to markets. Still, the outlook for interest rates globally remains uncertain, with opposing forces such as inflation expectations, fiscal credibility and central bank posture all pulling in different directions. Yield curves have recently begun to stabilize following a period of pronounced steepening. Getting closer to terminal rates, two-year yields are now closer to the medium-term projection. With longer term maturities also remaining range-bound in our outlook, we do not see much more steepening ahead unless some downside scenarios materialize that would push the front end further down amid a more aggressive policy easing.

Eurozone sovereign spreads have performed well, reflecting improving fiscal fundamentals, strong demand and higher Bund yields. But a rise in defense spending could test market resilience. With countries like Italy and Spain approaching a primary fiscal surplus, Eurozone 10y government bond spreads versus Germany continued their downward trajectory from their crisis-era highs. Comparatively higher Bund yields after Germany's U-turn on its debt brake are reflected in lower swap spreads. This also helped to lower the narrowing of Eurozone spreads. However, the prospect of structurally higher defense spending poses a medium-term risk. Annual increases in defense budgets of 1-2pps of GDP would raise debt ratios mechanically by at least 10-20pps over a decade if financed via debt. Unlike one-off stimulus packages, a country cannot outgrow a structural rise in its deficit ratio. Even if the fiscal multiplier on defense spending were greater than one, the resulting higher GDP level would simply raise spending further as a share of GDP. A 1pp rise in the debt-to-GDP ratio typically matches spreads to widen by 1-2bps. Over 10 years, that could mean a 10-40bps jump in borrowing costs, depending on country and credit rating. One potential offset: global geopolitical uncertainty. As US politics has become more unpredictable, investors may seek alternatives to Treasuries. European sovereign debt could emerge as a safe-haven substitute, providing a window of lower borrowing costs even amid rising issuances. Our outlook therefore sees spreads narrowing at a slower pace, or even moving sideways.

Figure 8: 10y government bond yields, %



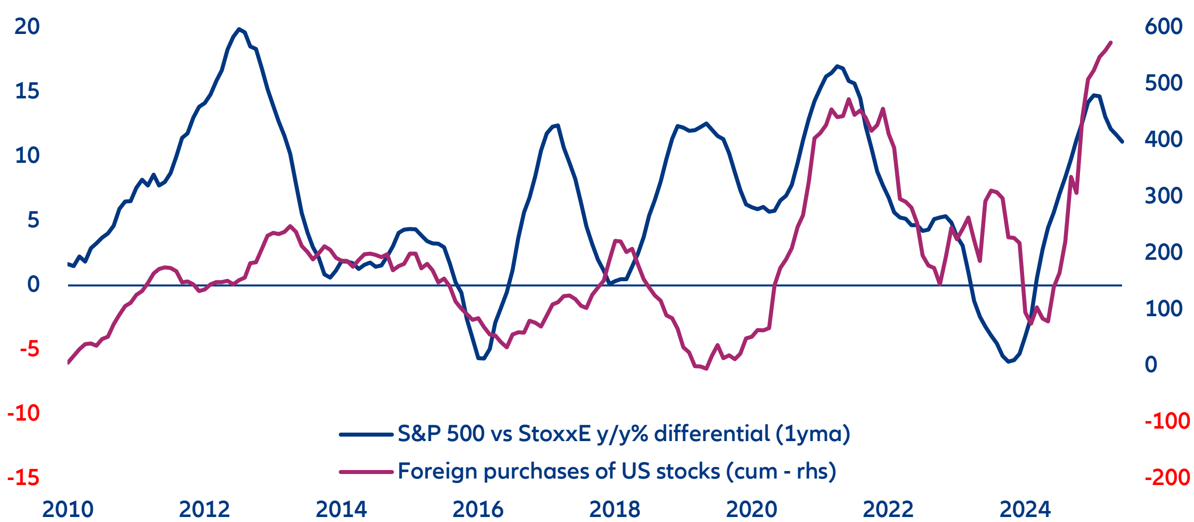
Sources: LSEG Datastream, Allianz Research

Euro strength may stall as interest rate differentials favor the dollar, but valuations and politics leave room for upside risks. So far in 2025, the euro has gained more than 10% against the USD. After "Liberation Day", the dollar depreciated despite more attractive expected returns on US assets, as reflected by real and nominal interest rate differentials – an unusual pattern. This paradox has been attributed to capital outflows from the US and growing investor concerns about the long-term viability of US fiscal policy. However, flow data suggest limited outflows from the US and point more toward temporary positioning, which could dissipate over time. Additionally, as interest rate differentials and inflation expectations still indicate USD strength, our baseline outlook does not anticipate much further USD depreciation, with the EURUSD rate hovering around 1.15. Nevertheless, longer-term valuation concepts, such as purchasing power parity and deviations from long-run real effective exchange rates (REER), still indicate substantial dollar overvaluation highlighting a risk of further depreciation. This risk could increase if the Fed takes a more dovish approach than anticipated or if political developments again erode investor confidence. On a positive note, the threat of a foreign investor tax on US asset holdings, commonly referred to as "Section 899" in the latest tax bill, has been taken off the table for now. This supports our view that there will be no further substantial ouflows from the US exacerbating the dollar's depreciation.

President Trump's tariff escalation on "Liberation Day" significantly impacted global equity markets, underscoring the complex interplay between political actions and economic consequences. Initially markets reacted sharply, pricing in a high recession risk due to President Trump's aggressive stance. However, this bear-market opportunity was brief as the administration shifted from escalation to negotiation, leading to a recovery in market levels. Yet, the administration's policy volatility still poses risks to the global economy. The 3% downward revision in 2025 earnings expectations over the past three months do not look exaggerated in this environment. Nevertheless, technology remains a global growth engine, confirmed by recent company reports.

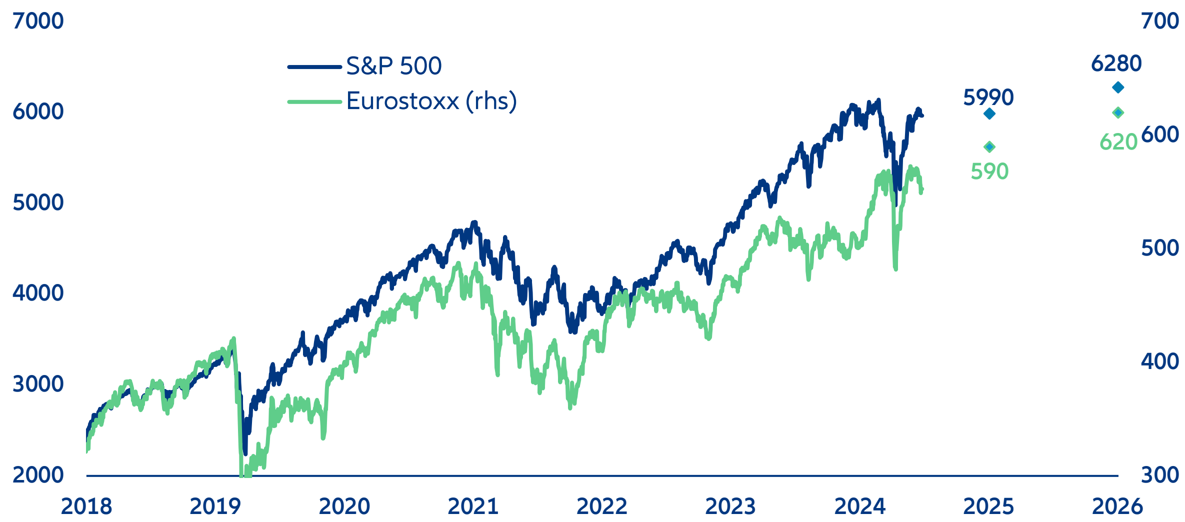
Equity markets are expected to stabilize following a V-shaped recovery, with a rangebound market anticipated until political clarity improves by year-end. In the short term, high US valuations, trade frictions and political turmoil pose challenges, leading to a cautious outlook. However, as 2026 approaches, the equities outlook will strengthen due to a favorable US political landscape. The Fed may adopt a decisive stance on interest rate cuts, influenced by President Trump's potential appointment of a dovish Fed chairman, while the mid-term elections might restrain reform ambitions temporarily. Meanwhile, the European economy is set to recover, supported by increased fiscal flexibility, especially in Germany. This supports the strong outperformance of EMU equities over US equities, with US total returns expected at 4% and total returns for EMU at 18% in 2025, plus USD depreciation against the EUR. By 2026, we expect normalized performance, with both US and EMU total returns at 7%, reflecting a more stable global economic environment.

Figure 9: Relative performance Europe vs US and foreign purchases of US stocks



Sources: LSEG Datastream, Allianz Research

Figure 10: S&P 500 and Eurostoxx Forecasts, index



Sources: LSEG Datastream, Allianz Research

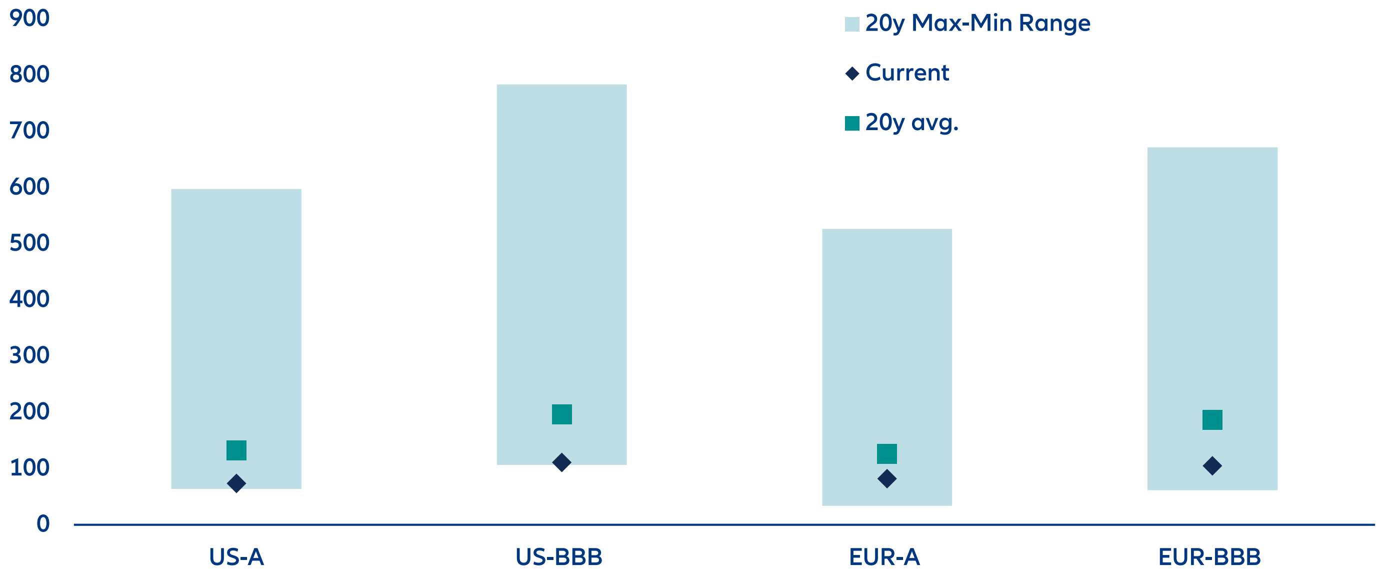
Q2 saw significant volatility in credit, with spreads blowing out from historical lows in early April, following the US administration's tariff announcement. In Europe, investment-grade (IG) credit spreads widened to 125bps, while in the US and in the UK spreads widened to 121bps and 130bps, respectively, reflecting the global impact of these tariff announcements. Our view at the time was that spreads would recover as the initial tariffs seemed merely a starting point for negotiation and investors' demand driven by all-in yields would support the asset class. In addition, fundamentals remained strong, though showing some deterioration from a solid base, namely in interest coverage ratios for corporates and non-performing loans and interest margins for banks. This expectation proved correct, with spreads rallying since April highs, reaching 94bps in EUR, 87bps in USD and 102bps in the UK. In Europe, higher beta instruments such as financials and junior debt did particularly well and have outperformed their non-financial peers. As Q2 ends, spreads have fully reversed the tariff-induced widening and in EUR are tighter by approximately 10bps year-to-date, with US and UK IG both showing only small increases of approximately 6bps.

Current spread levels are remarkably low, bearing in mind the increased geopolitical tensions in the Middle East and a record month for new issues this year. After a muted April, when primary markets nearly froze, May saw a very strong recovery in new issue volumes in both EUR and US, bringing year-to-date new issues 2.4% and 5.2% ahead of the previous year in EUR and US, respectively.

Companies seem to gauge the risk of higher financing costs ahead, while investors seem less concerned. US investor demand is exceptionally strong, as illustrated by bid-ask spreads in the second percentile (eight-year period) while EUR demand is strong but at the 25th percentile less extreme. Such demand strength will be hard to reinforce and is more at risk of reappraisal.

Looking ahead, we expect a mild upwards pressure in both EUR and US credit spreads from the current low levels as long as the uncertainty triggered by tariffs and geopolitical tensions is not resolved. Additional bouts of volatility are still expected and could again emerge once the tariff truce announced by the US administration comes to an end, or by US politics (e.g. a re-opening of the Section 899 debate), the conflict in the Middle East or new risk events. Given that the current high valuations barely reflect the level of macro risks it would be justified to move up in quality within the asset class and reduce spread duration. In this environment, covered bonds and asset backed securities look more attractive. In line with our upgraded growth forecasts, we expect volatility in fixed income markets to normalise and spreads to continue trading range bound during 2026 before a more friendly picture is likely to emerge into the next year.

Figure 11: Investment grade spreads stay near historical tights, spread ranges by IG rating, bps



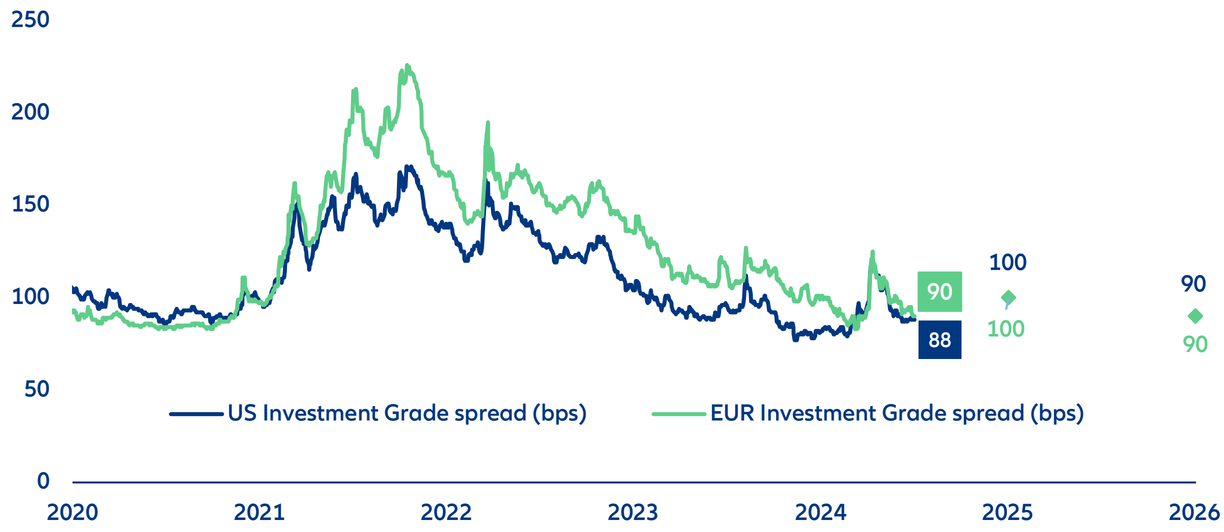
Sources: LSEG Datastream, Allianz Research

EM sovereign-debt fundamentals remain resilient, but tight spread levels on hard-currency (HC) bonds and a possible reversal of the FX trend might limit upside potential going forward. EM sovereign debt has delivered strong performance despite heightened uncertainty and geopolitical tensions: HC debt has returned around 5%, while local currency (LC) debt has rallied more than 10%. In addition to sound fundamentals as suggested by the positive net-credit-upgrade trend across the region, the challenged thesis of US exceptionalism and the broad depreciation of the dollar have played key roles. Dollar weakness is especially beneficial for LC debt as the FX component has accounted for more than half of the total return and gives EM central banks more room for further rate cuts. Portfolio flows into EM debt have noticeably improved to net inflows in recent months as sentiment turns more positive toward this historically under-allocated asset class. Nevertheless, headwinds remain: HC spreads have compressed to the tightest levels in over five years while geopolitical risk is still elevated, and LC returns could be undermined if the dollar gains ground again. We remain cautiously optimistic about EM sovereign debt but expect more modest risk-adjusted returns in the second half of the year.

EM equity outperformed developed market (DM) stocks as a rare bright spot over the past five years, marking a decisive turnaround. EM stocks had consistently underperformed DM stocks for four years and staged an unexpected comeback in a year of uncertainty. In addition to milder-than-feared tariff headwinds, domestic factors also contributed to the strong performance of several heavyweights: Chinese tech has rallied since DeepSeek's launch, and the political situation stabilized in South Korea with the election of a reform-minded President. Dollar weakness has played a significant role as well, especially for Taiwanese equities, where the local-currency return was slightly negative but the dollar-based gain exceeded 10%. Brazilian stocks, like other LatAm equities, rebounded strongly after last year's sharp drawdown and were less affected by or even benefited from US tariffs. Valuations for EM stocks are now approaching one standard deviation above their long-term average, yet they remain heavily discounted versus DM counterparts, particularly in the US. The positive momentum is likely to attract additional capital to this structurally under-allocated segment. A reversal of the FX trend and any renewed escalation of the trade war remain the main risks.

Private markets began 2025 with renewed confidence – deal activity was picking up, fundraising was stabilizing and sentiment was improving. However, this reviving momentum was disrupted by "Liberation Day," when new tariffs triggered a sharp rise in geopolitical and trade uncertainty. This led to a broad, if temporary, halt in dealmaking across asset classes, especially in cross-border and supply chain–exposed sectors. Despite the setback, structural demand for private assets remains strong. LPs are allocating more selectively, favoring managers with operational depth, sector expertise and flexible capital.

Figure 12: Investment grade spreads, bps



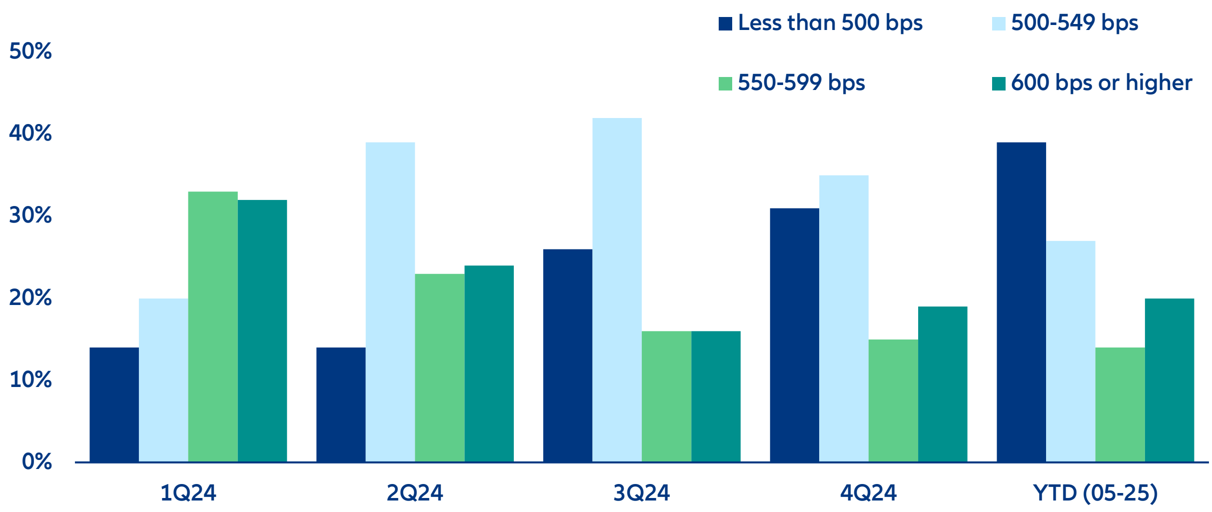
Sources: LSEG, Datastream, Allianz Research

Valuation resets and continued dislocation between public and private markets are also creating entry points for high-conviction investors. In a more fragmented and risk-aware environment, adaptability and precision are likely to define outperformance.

The private equity rebound has hit turbulence just as it was gaining altitude. After two quiet years, 2025 began with improving distributions and renewed deal activity, especially in Europe. But the post-tariff environment has introduced fresh uncertainty – particularly around exit timing, regulatory shifts and tax exposure under a possible second Trump administration. Sponsors have responded by embracing more complex structures such as continuation vehicles and carve-outs and public-to-private deals are back in focus. While headline volumes and exits may falter limiting distributions, opportunities are likely to persist in resilient sectors like healthcare, business services and tech, still providing some tailwind for the asset class as a valuable risk-adjusted return proposition.

When volatility returns, direct lenders tend to shine, and 2025 is no exception. As syndicated loan markets stalled post Liberation Day, direct lending stepped in to offer certainty and speed. Activity has held up strongly despite macro headwinds, with lenders concentrating on high-quality credits in sectors less vulnerable to trade frictions, thus leading to tighter spreads (Figure 13). While borrowers in industrials and consumer sectors face growing scrutiny, overall sentiment remains constructive. With abundant dry powder, rising refinancing needs and cautious sponsors seeking reliable partners, despite being a bit overcrowded, private debt continues to offer an appealing risk-reward profile in private markets.

Figure 13: Direct lending spread distribution for PE-backed borrowers



Sources: PitchBook | LCD, Allianz Research (Geography: US and Europe)

Real estate is finding its footing, but the ground remains uneven. Early 2025 brought some relief: Logistics and multifamily assets saw improving sentiment and a modest uptick in deal volume. However, tariff-driven cost increases, interest rate uncertainty and global capital retrenchment are dampening the recovery. Core fundraising is still weak and the bid-ask gap persists. Yet, opportunity is brewing in segments tied to demographic and structural demand – urban logistics, student housing and selected distressed assets – all requiring patience and deep operational involvement.

Infrastructure has moved from defensive allocation to an offensive strategy in 2025. Governments are doubling down on investment in energy transition, digital infrastructure and resilient transport, creating a rich pipeline of opportunities. While "Liberation Day" brought renewed focus on national ownership and supply- chain security – raising hurdles for cross-border deals – local infrastructure players and GPs with strong public-sector relationships are well-positioned. With inflation-linked cash flows, long durations and a strategic role in economic policy, infrastructure is drawing increased attention from LPs seeking long-term stability in a turbulent macro environment.

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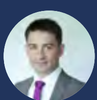

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