
Europe wary of continuing conflict

European equities | May 2026



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- **Oil prices have created a growth shock – with supply impaired and demand inelastic, energy costs will worsen inflation, wages and global growth at least until year-end.**
- **The US has seen ballooning AI-related capex and collapsing free cash flow at the hyperscalers, as well as extreme earnings concentration. Corporate margins remain high.**
- **Markets expected double-digit growth for Europe in 2026, but this has been impacted by the Middle East crisis. However, a weaker economy reduces inflation risk.**
- **Capital markets may be relaxed, but there will be fallout in the real economy as global growth suffers.**

Clients are asking us two questions: “Is the oil price enough to cause a recession?” and “Is the market complacent?”.

US recessions (except for the Covid pandemic) follow an oil shock. US demand for oil is price inelastic: to cut demand by 10% we would need the price to double or triple; even so, oil at \$100 from \$60 still hurts.

A high oil price increases input costs for plastics, fertilisers and helium among other things. Urea prices have risen 40% since the conflict began. Diesel and jet fuel prices have jumped, raising transport costs. Shortages are appearing – Lufthansa has cancelled 20,000 flights. Helium, a by-product of natural gas, is in short supply. These prices will be disrupted for months after an effective ceasefire and will remain so until production normalises.

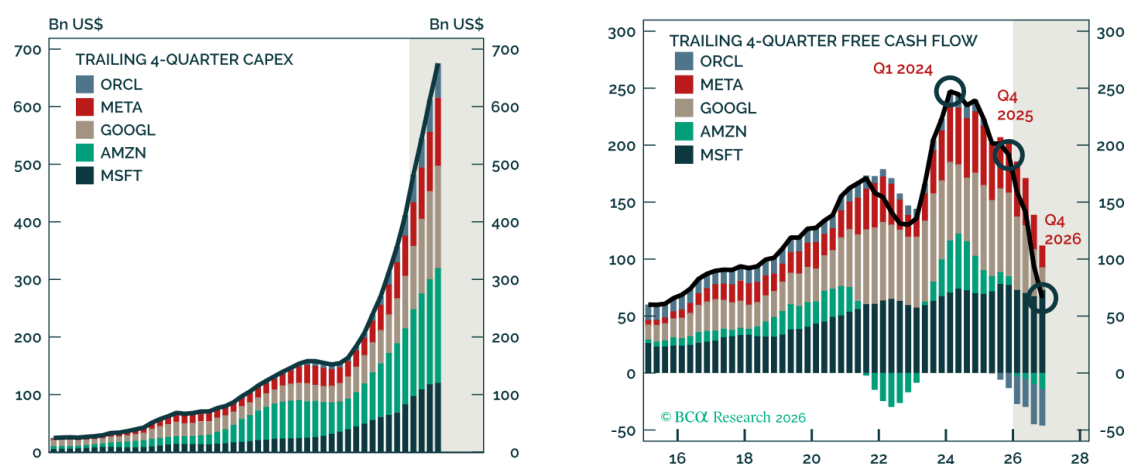
Even if the ceasefire holds, 12% of oil production is offline: it will take months to come back, and years to rebuild destroyed infrastructure. Oil prices may remain high for the rest of the year. Capital markets may be relaxed but there will be fallout in the real economy: the IMF estimates 10% on the oil price shaves 10bps-20bps off global growth. If this crisis lasts until year-end, the Dallas Federal Reserve says global growth will be 1.3 percentage points lower.

Second-round effects will continue – lower discretionary spending, higher unemployment and potentially recession.

The US

From being capital-light free cashflow generators, hyperscalers such as Amazon, Google, Microsoft, Meta and Oracle are now drunk on spending – \$700 billion for those five alone this year. Operating cashflow is rising, cashflow collapsing (Figure 1). However, investors have swallowed their anxiety about an artificial intelligence (AI) capex bubble.

Figure 1: Hyperscalers ‘drunk on spending’
Capex is rising (LHS), free cash flow is falling (RHS)



Source: Bureau of Economic Analysis (BEA) / BCA Research, January 2026. Shaded areas denote forecasts.

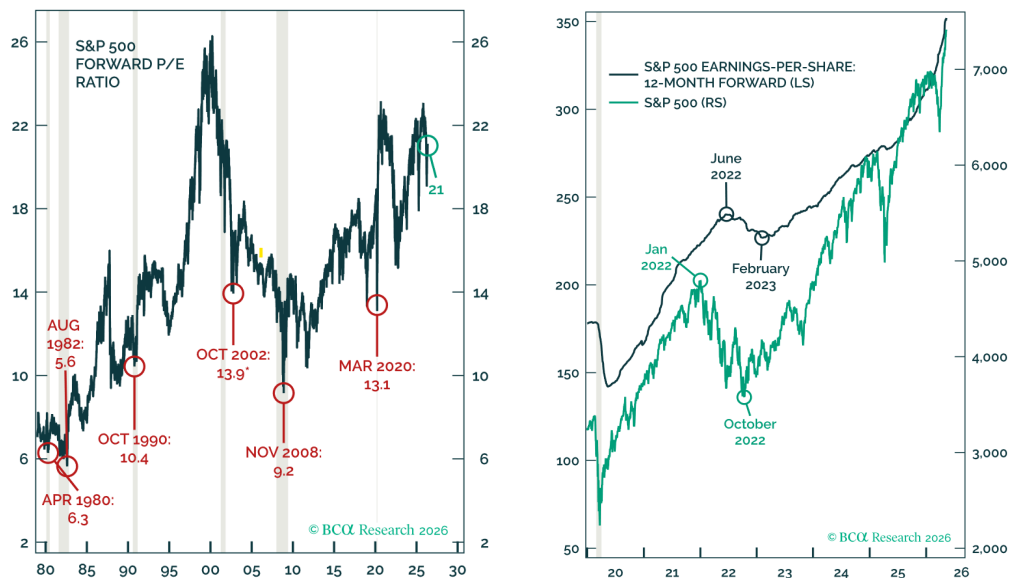
Over 25 years, internet traffic has increased 40% a year, yet investment in internet hardware has collapsed as fibre optics increased the efficiency of infrastructure. This could happen with AI, although graphics processing unit (GPU) rental rates and memory chip prices have increased. Sentiment about software stocks has shifted: though AI cuts programming costs, it means costs fall for customers too, endangering software business models and, potentially, social media. A lot of businesses are at risk.

As a share of GDP, spending on IT is above the 2000 peak, and technology stocks are half the S&P500 – higher than in the dotcom/TMT bubble. Equity valuations have fallen, partly due to the pullback, but mostly because earnings estimates have climbed. Concentration in the US is extreme. Half the growth in Q1 S&P 500 earnings came from two stocks: Nvidia and Micron.

Earnings upgrades are surprising given the Iran conflict. Typically, estimates have lagged macroeconomic developments. For example, in 2022 earnings rose until the middle of the year even though stocks peaked earlier. Earnings then fell until February 2023 despite share prices starting to rise in the second half of 2022. So, there is often a disconnect between earnings and share prices (Figure 2).

Figure 2: Earnings/share price disconnect

LHS: Forward P/E ratio has decreased. RHS: Earnings estimates lag the stock market



Source: BCA Research/Factset/S&P Global, 2026. LHS *Forward P/E trough in October 2002 occurred after the 2001 recession, during which unemployment was still rising. LHS/RHS: Shaded areas denote NBER-designated recession.

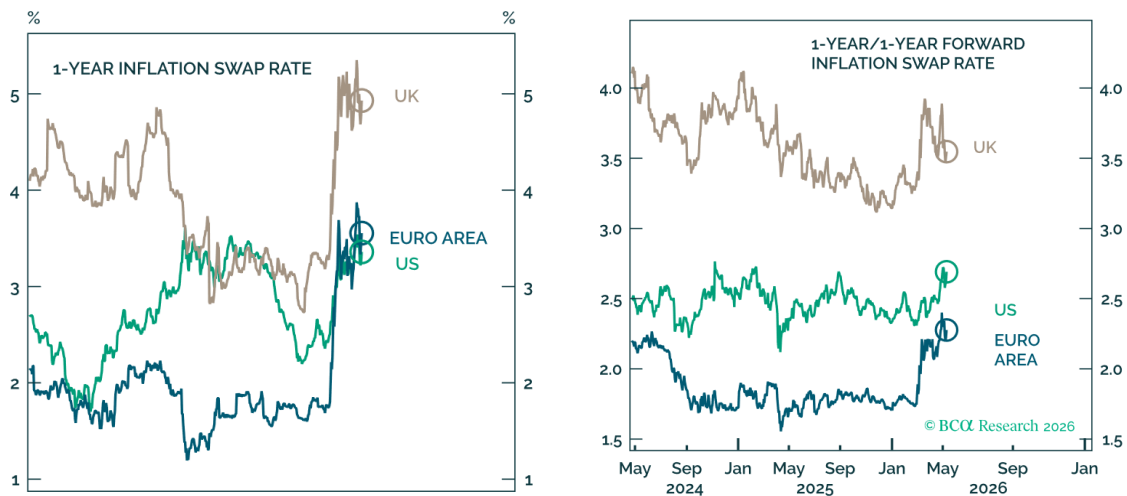
US households hold \$70 trillion in equities. This is 220% of GDP, up from 130% in 2000. This wealth has powered consumption even as labour has weakened. But most consumption comes from salaries, and non-farm payrolls have been rising by a modest 60,000 a month, with wage growth moderate and hours worked flat. The strain on spending has cut the savings rate to 3.9% – low, but not as low as the 1.4% before the global financial crisis (GFC).

Without higher nominal wage growth, energy inflation will depress real wages and households will cut spending. We may not see the wage-push inflation of 2021-22, though, because labour markets then were tight due to pandemic retirements. Since then the jobs/workers gap has closed.

The oil price is feeding inflation. CPI swaps are pricing more than 3% in the US and Europe over the next 12 months. If this transpires, since 2020 consumer prices will have risen 3.9% a year in the US and 3.5% in Europe, unwinding the undershoot following the GFC. Despite the spike in oil, long-term inflation expectations are anchored (Figure 3) as wage growth is slowing while job openings move sideways. This means the Fed is likely to cut rates. Hawkish rate expectations are unlikely to be realised.

Figure 3: Inflation expectations

(LHS) Short-term inflation expectations have jumped ... but (RHS) long-term remain anchored



Source: BCA Research/Bloomberg Finance LP, 2026

It may take time for bond yields to fall, as supply shocks due to the Middle East situation have prompted higher term premiums. Supply shocks mean higher stock-bond correlations, pushing up term premiums. As bond hedging benefits decrease, excess returns on bonds need to increase.

Unlike past supply shocks, US corporate margins are high: so companies can absorb losses and will not sack workers, which would otherwise prompt a vicious circle and recession. But the ability to pass input cost rises is uncertain, so profit margins could suffer. Fuel costs are a tax on consumers, so earnings upgrades might get reversed.

Europe and China

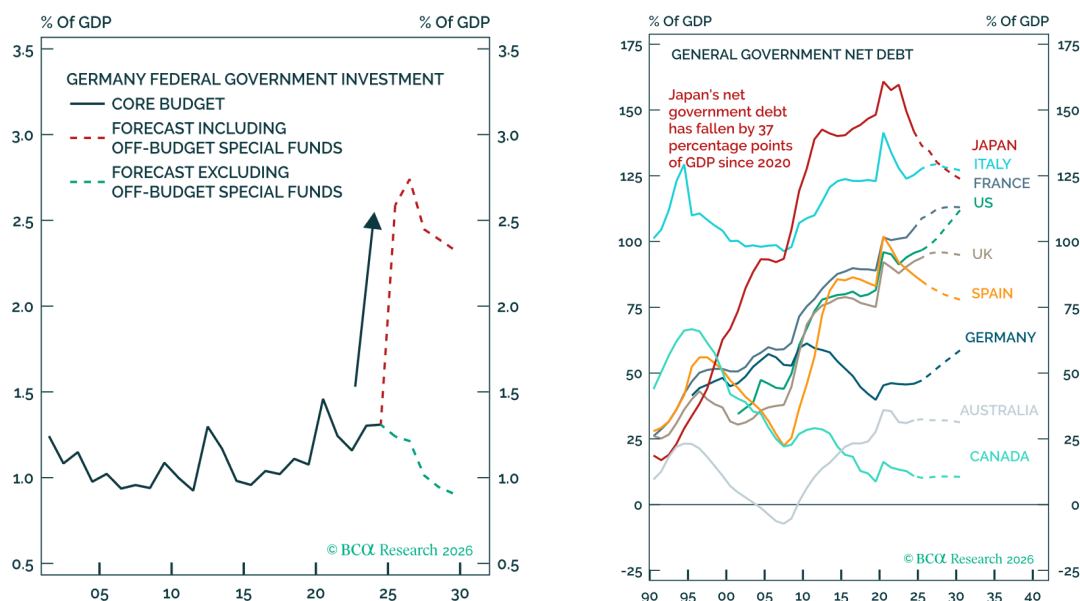
In 2022, Europe had to find oil and gas outside Russia, but there was no shortage. At the time, energy price rises exacerbated already-present inflation from post-Covid supply chains, higher demand following the reopening, and easy fiscal and monetary policy.

Europe rallied strongly in 2026 until the conflict started. But earnings are once again likely to lag US earnings. At the start of the year, we were expecting double-digit growth for 2026. Now, depending on the length of the crisis, we forecast between 5% and 10%. The consensus expects rate rises from the European Central Bank (ECB), but it could be a policy error. Germany is continuing to ease fiscal policy, but other European countries cannot follow suit (Figure 4). French banks have rebounded, so that market is stronger.

Value has outperformed growth in both the US and Europe this year – last year that was only true in Europe. The US is also getting cheaper but the gap between it and the rest of the world remains huge.

Figure 4: Divergence in Europe

LHS: Germany is stimulating its economy. RHS: Government debt levels remain high



Source: BCA Research and (LHS) Ministry of Finance, Germany. Note: 2025-2029 forecasts are based on draft medium-term fiscal plan. RHS: IMF World Economic Outlook, October 2025

China is still seeing overbuilding and high prices. Housing starts may be down 75% from the highs of 2019 but completions have only fallen 44%, so there is a backlog. Rental yields are the lowest in the world, implying further price falls. The country's demographics do not help – the working age population could fall 70% by the end of the century to 700 million.

China also has worries about overcapacity limiting any stimulus – the latter has declined, and the fiscal/credit impulse is barely positive. Anti-involution measures – aimed at combating excessive competition and overcapacity in various industries, as well as promoting sustainable growth and improving profitability – are hitting investment across the economy.

Looking ahead

Although the oil shock does not guarantee recession, it raises the risk. With oil impaired, inflation rising at the margin and wage growth no longer cushioning households, the drag on demand is likely to intensify as the year progresses. Corporate margins provide a temporary buffer, but fuel costs are a tax on consumers, making earnings optimism vulnerable to reversal.

The European economy is weaker than it was, reducing the inflation risk. It faces more chance of a recession, so the ECB will hesitate before raising rates. If the Gulf situation continues, upticks in manufacturing PMI may reverse so the European economy will stutter.

The US is more resilient. Earnings expectations continue to rise and although valuations remain stretched and risk concentrated, growth – albeit more fragile – will continue.

Unless specified, all data is Bloomberg, as of May 2026

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