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Europe: renewed momentum, improving prospects

European equities | November 2026



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- **US growth remains resilient, but a weakening labour market, persistent inflation and heavy AI investment present risks.**
- **Chinese equities have rallied despite weakness in property and consumption, leaving the economy increasingly reliant on exports.**
- **Europe's outlook is improving as falling inflation, abundant household savings and German fiscal expansion support growth and investment.**
- **With earnings expected to strengthen, Europe's equity rally could broaden beyond banks and defence, helping it gain ground on the US.**

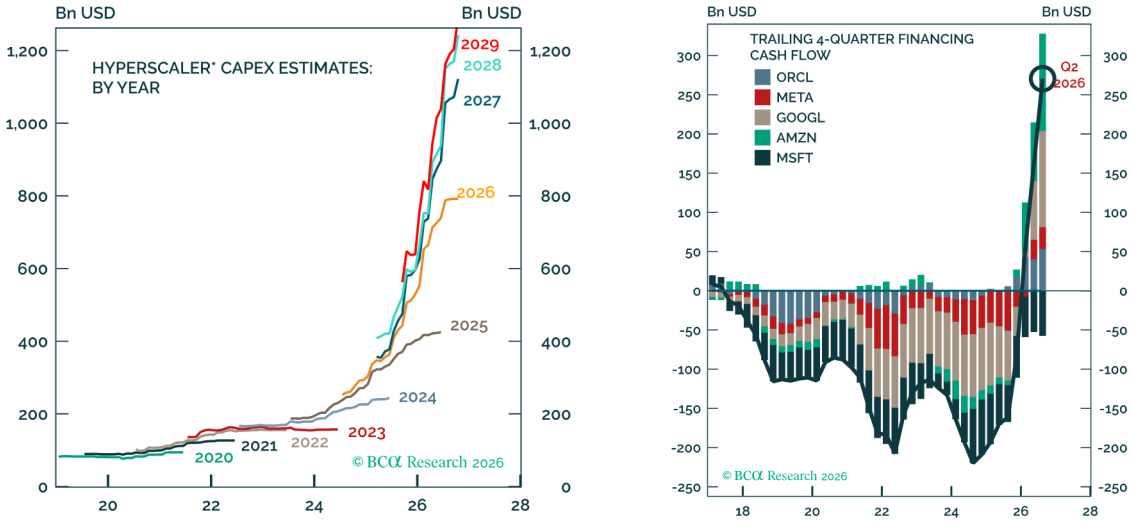
Bond volatility has been a recent feature of markets. Nominal growth in the US, the mid-term elections, French presidential elections in 2027 and conflicts in the Middle East and Ukraine have driven bond yields up by 100bps or more in all markets. Fears of central bank tightening, fiscal incontinence and worries that AI-related issuance will crowd out government borrowing means this is no surprise. But for yields to stay high, the missing ingredient is inflation. Equity and currency volatility are low but may not be spared if bonds resume their sell-off.

The US

AI investments and bond issuance are crowding out government bond issuance and pushing up the cost of buying a home: the US 30-year mortgage rate has topped 7%, up from 6.2% at the start of the year. The five hyperscalers will spend more than $1 trillion in 2027, up from $240 billion in 2024, and are now net borrowers (Figure 1). Investment is rising as the savings rate has fallen to 4% from 7.3% pre-pandemic, while the public sector absorbs what is left: the deficit will top 7% this year and tax receipts are falling because of One Big Beautiful Bill tax breaks. Most of the rise in US yields reflects real yields; elsewhere the driver has been inflation. Energy prices are forcing central banks to tighten, giving bond vigilantes ammunition against those with weak fiscal positions: the US, the UK, France and Italy.

Figure 1: Hyperscaler spending and borrowing

Capex estimates exceed $1 trillion (left chart) as firms turn from cash machines to borrowers (right chart)



Source: BCA Research/Factset (left chart) and BCA Research/Bloomberg (right chart), October 2026.

Corporate earnings coincide with or lead jobs, so growth feeds hiring and wage growth. Nominal private domestic demand grew 6.5% in Q2 and output prices are rising across manufacturing and services. US price inflation (excluding food and energy) has risen ahead of unit labour costs, so margins and profit share of GDP have surged while labour share is at a low. With unemployment down from 4.4% to 4.1%, wage growth should accelerate, boosting spending power but pressurising corporate costs. Companies will pass on price increases, making inflation stickier given a strong economy, high energy prices and AI capex. Interest rates will probably rise.

Fuel prices do not help: crude is below its April peak, but refined product prices have rocketed. While petrol affects headline inflation, diesel feeds into the core through transport and the running of agricultural, industrial and construction equipment. The shift from one global hegemon (the US) to several powerful regional players also means the repackaging of supply chains, energy, defence and trade infrastructure, raising prices and introducing supply shocks. Long-term inflation expectations remain contained, but the longer prices stay high, the more likely expectations are to rise. The Federal Reserve (Fed) has missed its 2% target in every one of the past five years: now it needs to act to arrest upward inflation pressure.

The US is in the opposite position to Japan under Abenomics: inflation above target, a growing economy and a current account deficit funded by foreign portfolio flows. Foreigners own a third of listed US stocks and a quarter of debt securities, so if equities fell, the Fed could not remedy this by slashing rates: a weak dollar would derail flows and feed a vicious circle of selling and depreciation. Real rates need to stay high until the economy cools and the deficit narrows.

Share prices and bond yields have become negatively correlated (as in 2022 and the 1990s): higher yields are seen as an inflationary or discount rate shock, not a signal of stronger growth, which makes duration risk acute for high-multiple and growth equities. Worries about AI capex have set off selling in semiconductor stocks. Without tighter financial conditions, such as lower

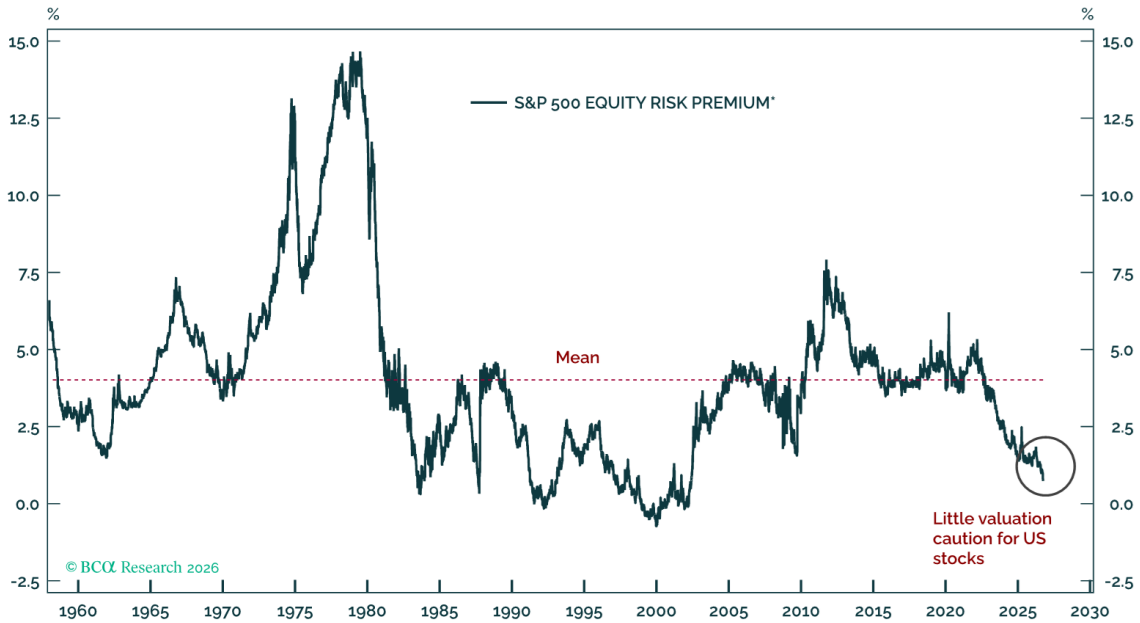
share prices, growth and inflation will not slow and the bond sell-off will not reverse: something will have to break. An equity correction is likely if the next rise in yields comes from inflation break-evens rather than real yields. Longer term, AI should raise productivity and bring disinflation; shorter term it raises the cost of electricity, memory chips and other components while boosting profits.

The US economy is K-shaped. Interest rates are too high for housing, commercial real estate, parts of manufacturing and poorer consumers, but not for AI sectors or for rich households owning equities, who can simply save less, so that consumption outpaces real income growth. It will take a stock market crack to rein in those high-end consumers sustained by equity wealth. AI has added 50bps to US growth over the past four quarters, partly through that wealth effect.

The S&P500 is close to its all-time high despite 10-year yields rising from 4% in February to a high of 5.3%, but outside large tech the market is drifting: the equal-weight index is 6% off its August high. The key data point is yields relative to nominal growth, which exceeds the 10-year Treasury yield by 100bps; unless that threshold is crossed, higher yields rarely inflict much damage. Nominal GDP growth is expected to be 6.3% in Q3, 5.6% in Q4 and 4.7% in 2027. But valuations are stretched: the equity risk premium is at a two-decade low and equities are the most expensive versus bonds since 2002, so an earnings shortfall would bring a severe sell-off (Figure 2).

Figure 2: US equity risk premium: little compensation for risk

S&P 500 Equity Risk Premium



Source: BCA Research, October 2026. *Calculated as operating earnings yield minus 30-year tips yield. Pre-1998, real 30-year yield is calculated as 30-year Treasury yield minus four-year moving average of US Core CPI lagged by four years.

The durability of AI capex is the main concern. Its contribution to US GDP growth exceeded 80bps in Q1, but the boom is three years old versus nine for TMT in the 1990s, and in 2000 tech stocks topped out nine months before IT capex. AI adoption is rising, but token prices have

fallen as spending flattens and output per hour (2.2%) is barely above the 10-year trend (2%). AI needs to generate trillions of revenues to justify the investment. Margins should surge next year given the lack of computing capacity, but they could reverse in 2028. A bust would need higher rates and tighter financial conditions, and higher inflation is the missing ingredient. Hyperscaler ROE has reached 27% and profits growth is in the 20s, leaving price/earnings-to-growth ratios at an average 0.7x and valuations the cheapest for 10 years.

For equities, inflation is not yet a problem: PMIs and ISMs are positive and margins continue to rise. September ISM services, at 54.9, showed the US growing, not overheating, although prices paid increased. The backup in yields has tightened financial conditions and strengthened the dollar, which is self-limiting. Over the past 11 cycles there has been no downturn while margins were rising, and since 1945 no recession has followed strong and accelerating profits growth: profits and margins contract before a slowdown. Wages are growing more slowly than nominal GDP. Faster wage growth would be a threat, but margins would need several quarters of pressure before problems start. Earnings are rising in all regions and upgrades within the S&P500 are at a high, yet the market has gone sideways since the summer. Cyclicals have done better – until the recent correction.

Europe

Europe is doing better. Since Trump's second inauguration it has outperformed the US by 12%, despite a trade war, Iran (expected to be awful for Europe because of energy prices) and a US-driven AI boom. But every market has derated since the Iran conflict started, with PE multiples falling for nine months. Consensus earnings growth is mid-teens, against 20%+ in the US, and margins are 250bps above pre-Covid levels. Outside computing and software, investment is barely growing.

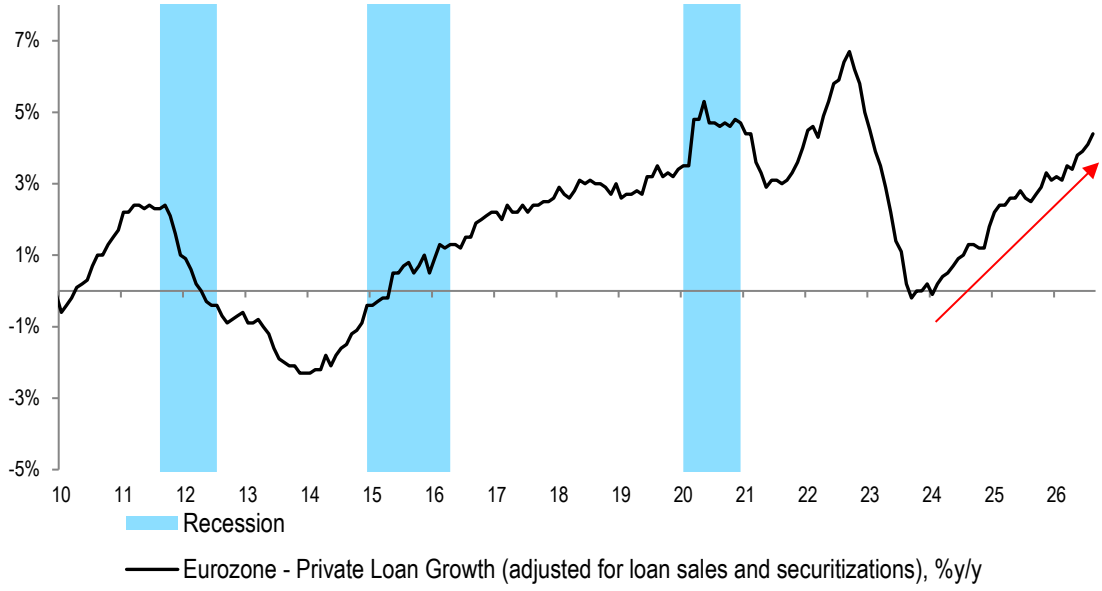
The European Central Bank (ECB) is the most credible central bank in the West, beating even the Swiss. Since 1998 it has kept inflation at its 2% target with minimal overshoots: while US prices overshot by 16%, eurozone prices have stayed spot on target despite major energy crises. That credibility creates a virtuous circle: it limits the need for tightening, compresses the term premium, lowers the cost of capital and flattens the Phillips curve, so unemployment does not need to rise much to control inflation.

This rests on independence by design: the ECB answers to no politician, a concession to the Germans when the euro was created. It raised rates twice this year to anchor inflation expectations, taking them to the upper end of estimates. With no sign of second-round effects, further hikes are unlikely. Because the rise in the cost of capital is small, eurozone monetary conditions are tightening less than elsewhere, so the eurozone is outpacing the US in the Global Industrial Production Nowcast (Figure 3).

France is the exception. French spreads are high and the violent move in French and German swap spreads points to a rotation within Europe. But this is a French re-pricing, not a re-run of the eurozone crisis: corporate spreads are contained and Italian spreads have hardly moved. The ECB's untested Transmission Protection Instrument (TPI) can limit contagion, but it cannot fix France's 5%+ budget deficit, with public debt set to reach 120% of GDP in 2027, up from 98% in 2019. The French could not even agree on raising the retirement age above 64. Growth has barely reached 1% per annum since 2023 and real output per hour has grown 1.5% over 11 years, compared with more than 20% in the US. Until France deals with its deficit, its yields will remain under pressure.

Figure 3: Eurozone private loan growth

S&P 500 Equity Risk Premium



Source: European Central Bank, October 2026.

A lower term premium helps eurozone public finances: apart from Italy, most members pay little in interest compared with the US. Credibility on inflation lets the ECB focus on easing where policy is not transmitted correctly because of redenomination fears, and its balance sheet is larger than the Fed's, with the TPI in reserve. Although we have in the past criticised the ECB's policy "mistake" when it hiked and set off the eurozone crisis, that policy was the price of admission to the "Credibility Club", giving Germany a competitive currency and Italy, Spain and Portugal low yields – the Greek 10-year bond has yielded 60bps-120bps below the US equivalent for years. These achievements compound through shallower business cycles and a lower cost of capital, so we need not fixate on the French presidential election: any French crisis will stay in France. A credible central bank is good for the euro, and fiscal headroom is a tailwind for growth and assets.

Many investors write Europe off because regulation and bureaucracy hold the economy back, but unity will deepen in the face of tough geopolitics. The war in Ukraine serves US, not European, interests: US energy exports to Europe have soared, and Europe has bought more US than European weapons and now shoulders the whole burden of Ukraine. Realpolitik is taking hold as the US has abandoned Ukraine. Europe will support a ceasefire to lower energy prices and free it up to concentrate on structural reform.

Europe has a frictionless market in goods and is now breaking down service sector barriers: Unicredit taking over Commerzbank would be a step on this road. Europe runs a €300 billion current account surplus and has exported that sum in capital each year for a decade, holding $4 trillion of foreign direct investment in the US, $12 trillion of its equities and $3.2 trillion of its

bonds. Integration leading to scale would raise returns and keep savings at home: this positive cycle could kick in from the 2030s if Draghi's and Letta's structural reforms are put into action.[1]

China and Asia

China continues to weaken. Its investment-led model makes slower capital formation inevitable: capital stock as a share of GDP exceeds almost any other country. Property is the biggest drag on fixed asset investment, and China is further down the road of housing adjustment than Japan was in the 1990s: five years after the peak, Chinese house prices have fallen further, albeit from a higher peak (home price to income ratios in Chinese cities topped 30x, versus 20x for Japan). Demographics are worse and per capita income is lower than it was in Japan in the 1980s.

Infrastructure investment is losing steam: it is now in line with developed markets but far exceeds countries with comparable per capita income, so a capex boom is unlikely. Manufacturing is contracting, offsetting the property slump, which is now ending; China has held output and global market share at the expense of pricing and returns. The shift from property to technology is supply-side, not demand-led: investment in technology, aerospace and electronics rose this year, but it is capital- and R&D-intensive with few spillovers into the wider economy.

Manufacturing concentration, scale, infrastructure, labour productivity, cheap energy and deflation keep China competitive despite a stronger currency, but import costs are growing faster than export prices, squeezing profits and investment. Government stimulus helps but more is needed: interest rate subsidies for home purchases are a small but important signal of a change in policy, the first time the government has subsidised homebuyers.

The bottom line

Rate-hiking and higher bond yields will not sound the death-knell for this bull market: they reflect a strong business cycle and growing capex. In the seven rate-hiking cycles since 1980, the S&P500 Index wobbled at first, but advanced strongly over the rest of the cycle. More problematic would be supply-side inflation, fiscal sustainability and monetary policy uncertainty. If bonds resume their sell-off, the US looks most exposed, with equities expensive versus bonds and AI capex vulnerable to tighter financial conditions. Europe, backed by a credible ECB, is better placed to contain a French wobble, while China's weakness continues.

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

[1] The 2024 reports by Mario Draghi and Enrico Letta serve as "strategic roadmaps for securing Europe's economic resilience and future prosperity" (EESC, March 2025).

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