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Europe: better momentum but structural hurdles remain

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- **AI demand remains strong, but valuations, margins and hyperscaler cashflows are under pressure.**
- **The US consumer picture is fragile, with spending reliant on higher-income households and equity gains.**
- **In Europe, momentum is improving, helped by lower inflation, better credit growth and rising infrastructure and defence spending.**
- **Market leadership may broaden if AI scepticism grows, with Europe a beneficiary.**

The US

Although global growth expectations fell after the Iran conflict started, US growth expectations have crept up. Manufacturing PMIs were bolstered by advance buying, due to worries over supply chains following the AI boom in semiconductors and electrical and other equipment used in data centres, and the immediate expensing of capital equipment under President Trump's One Big Beautiful Bill Act (OBBBA). Service PMIs have fallen, reflecting the energy squeeze.

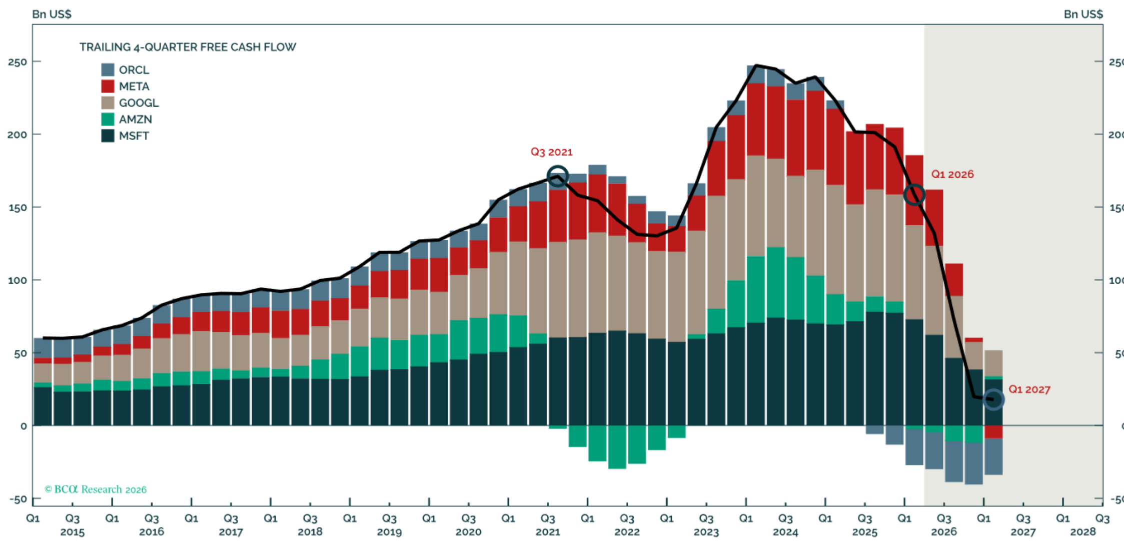
The resilience is not without risk. Oil prices rebounded after the Middle East ceasefire fractured and as Ukrainian strikes on Russian refineries widened crack spreads (the difference between crude oil/refined petroleum product prices). WTI is up 50% since December and gasoline and diesel have doubled, as has natural gas in Europe and Asia. Inventories continue to fall. Rising prices for memory, electricity and AI software have raised US inflation by 0.2%; by year-end, AI spending could boost core inflation by 0.5%. But labour market slack weighs on real wage growth. Real unit labour costs are falling and – despite $50 billion of tax refunds under OBBBA – US real disposable incomes have fallen 0.8% since "Liberation Day" – 2 April 2025.

Even if inflation, below 3%, remains quiescent, it is hard to see real incomes rising unless savings decline. The result is a K-shaped consumer economy. The lower income majority is exhausted, so the upper half – who hold equities – need to increase spending. But that requires further equity gains, which are hard to see when corporate margins are at unprecedented levels. Federal Reserve data shows the top 20% of households by income hiked spending by 4.5% in real terms over three years; the bottom 80% cut by 0.6%.

The AI cycle matters for more than just the technology sector. Most indicators of AI spending are healthy: GPU rental rates, memory prices and adoption rates. Although hyperscaler capex (Figure 1) generates earnings for chipmakers, it weakens hyperscaler cashflow. Every chip sold is revenue and profit for the chipmaker but is capex not operating cost for the purchasing hyperscaler, so earnings rise but not cashflow. Free hyperscaler cashflow could dwindle to zero this year before recovering to £650 billion by 2030. By then, hyperscalers will hold $2-$3 trillion of AI-related assets, which will depreciate at $550 billion per annum. They made profits of $400 billion last year; to earn what they currently achieve (return on invested capital of 22%) they need to lift profits by $500 billion. Only token prices have fallen as users shift to cheap Chinese open-source models. While these might not be best-in-class, the gap between market-leading models and the Chinese has narrowed. The cost/competency trade-off for US models is the best, but comes at a cost.

Figure 1: Hyperscaler free cashflow is rolling over

Trailing four-quarter free cashflow (US$ billions)

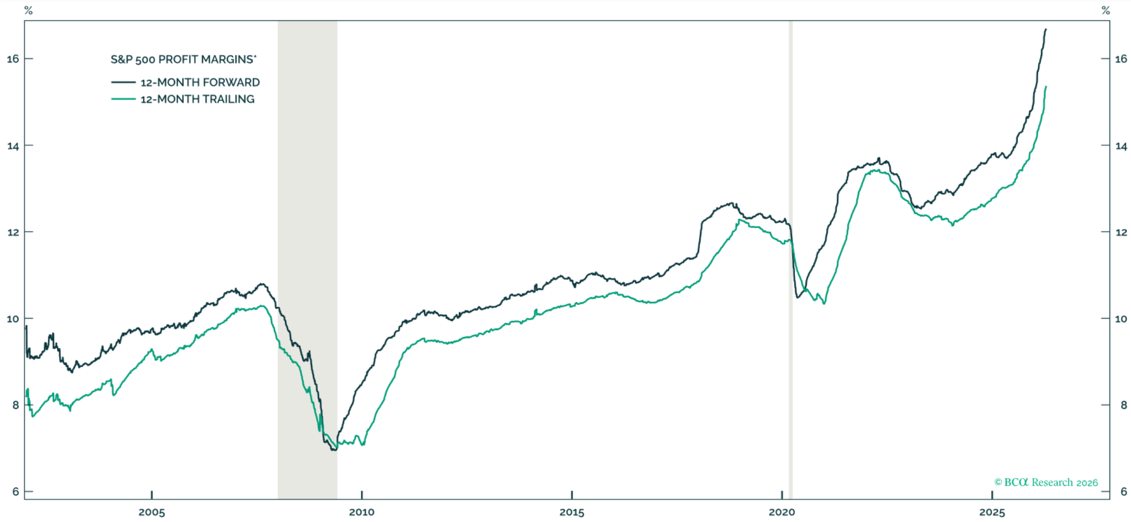


Source: BCA Research/Bloomberg, July 2026.

S&P 500 margins have risen 400bps from pre-Covid levels (Figure 2), but in US tech they are up 1,100bps. Adjusting the US market to pre-AI margins it would be above March 2000 and TMT bubble levels: 27x rather than 20x. Relative to sales and book value, the S&P is 70% and 10% above that bubble peak. Margins are not falling for hyperscalers investing in AI as they treat purchases as capital expenditure not operating expenditure. If AI spending slows, margins would decline in companies exposed to the AI value chain. Whether this happens or the AI boom and labour costs overheat, margins will eventually compress.

Figure 2: S&P 500 profit margins are near record highs

S&P 500 profit margins (%)



Source: BCA Research/Factset, 2026. Shaded areas indicate a recession.

Hyperscaler cloud backlogs are up $750 billion in two quarters, but the sell-off has left their valuations at their lowest in 10 years. We have had two rounds of indiscriminate selling this year: AI losers and then hyperscalers and semiconductor companies. Although markets have not moved to recession pricing, this turbulence questions the durability of AI-led margin expansion. In time, we might see commoditisation, overcapacity and write-offs. But for now they are 10% cheaper relative to the market versus the beginning of the year.

Inflation and tightening fears should ease. This would allow liquidity to remain and equities to rally. The number of stocks outperforming the benchmark over three months is at a record low: the market is very narrow. Cars, luxury, airlines and housebuilders have been out of favour, but consumer confidence is turning. Gold has bottomed since the start of the conflict. Its recovery is consistent with interest rates and US dollar weakening – and a bounce in consumer stocks.

Europe

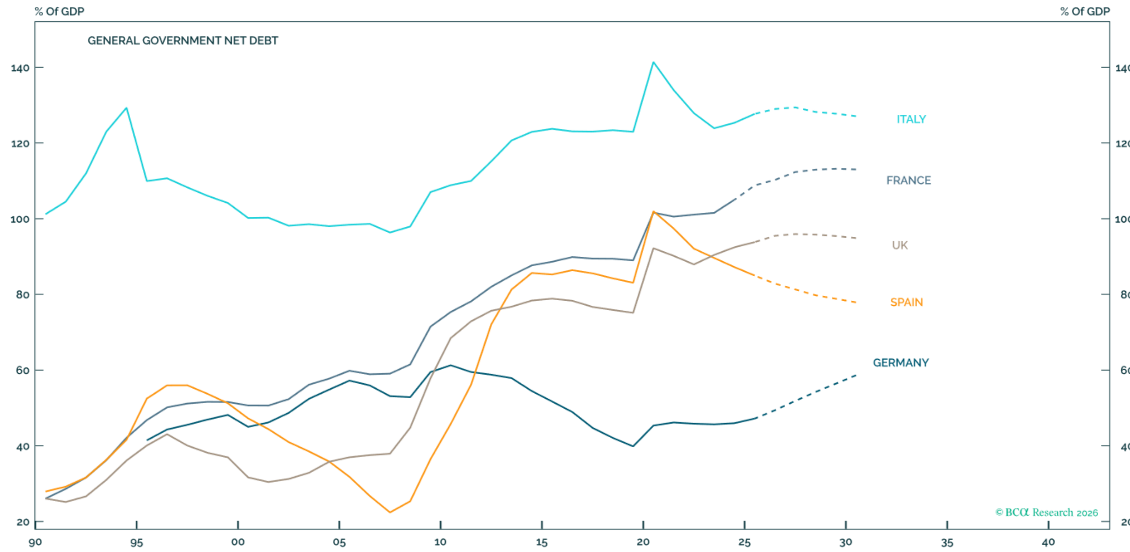
Earnings growth expectations for Europe have been cut from 1.2% to 0.6% because of Iran and spiking oil and gas prices. But there are positive signs. Inflation should return to target next year: the European Central Bank implied “one and done” after June’s hike. German retail is improving, credit growth is positive (particularly for non-financial companies), and balance sheets are stronger than 15 years ago. The Germans are increasing infrastructure and defence spending.

European cyclicals-versus-defensives earnings momentum against leading indicators (like Taiwan export orders) is improving. This is good for financials and industrials. When the oil price spikes, it is not healthcare or telcos that outperform, but industrials, miners and semiconductors. The labour situation has changed since 2022: then wages were accelerating, the job/workers gap was negative and there was demand and excess liquidity from money printing. Real interest rates were low and wages growing. It is different now. The global jobs/workers gap closed a year ago: there is no shortage of workers, so wage growth has decelerated.

Structural challenges remain for Europe. China continues to take market share from European exporters, and a 14% appreciation of the euro versus the renminbi over four years made this worse. Tax and regulation stifle EU and UK entrepreneurship, while public debt prevents stimulus (Figure 3). Demographics do not help: the eurozone has 37% (Germany 69%) more people aged 55-64 than 15-24. UK employment growth is weak and job openings lower, and housing is pressurised as mortgage rates hit affordability. The European opportunity is cyclical not structural – better near-term momentum but no decisive improvement in long-term growth.

Figure 3: High European debt levels limit ability of governments to stimulate

General government net debt



Source: BCA Research/IMF World Economic Outlook, April 2026

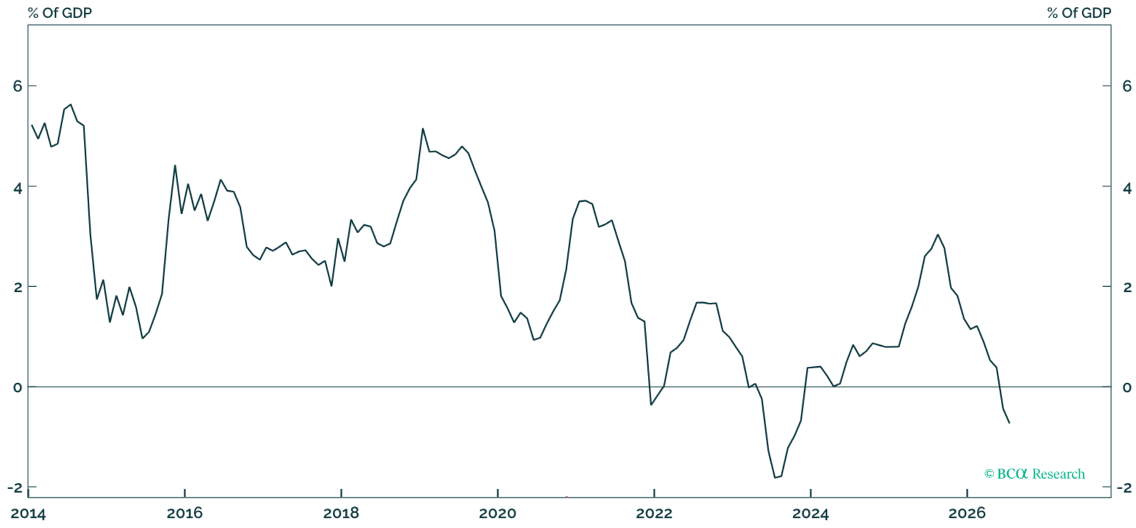
China and Asia

Chinese export strength masks weak domestic demand and imports, while housing, consumption and retail sales are declining. H1 fixed asset investment fell and the credit impulse has rolled over. Housing starts are down 77%, sales down 60%, and house prices are falling. The bright spot is technology with progress in AI, robotics and biotech. The problem is the savings rate, which is above 40% – double that of elsewhere. This exacerbates deflation and incites protectionism abroad. Fiscal easing might help but large stimulus is unlikely (Figure 4). China will use existing measures to prevent domestic demand from weakening.

China's anti-involution strategy has worked, curbing price competition and restraining capacity in over-supplied industries. Producer prices are positive, but as in the US profit performance is K-shaped. AI investment has lifted demand for semiconductors and high value manufactured goods. Raw material prices have risen due to AI spending, tariffs and energy shocks. This

Figure 4: Chinese fiscal policy should ease after a period of tightening

Aggregate government spending growth (impulse) as a percentage of GDP



Source: BCA Research, 2026

benefited the upper part of the K – mining and high-value manufacturing – while downstream manufacturers and those facing the consumer suffer. But those in the upper part of the K are specialist and too few in number to improve a flatlining economy. Capex in high tech industries increased 7% in H1 but is just 13% of the manufacturing total.

Japan is set to grow 1.8% in 2026 as exports, public investment and consumption are strong. Nominal wage growth of 5% is sustaining the consumer. But the working population could decline 30% over the next 30 years. Although public debt has fallen by 30 basis points over five years thanks to nominal GDP growth, interest costs and stimulus will widen the deficit.

The bottom line

History does not repeat itself, but it does rhyme. The last time IT capex saw such a boom – the TMT bubble – rotation began before the recession started. It is too early to say whether semiconductor turbulence marks the end of the AI boom but worries about returns from AI capex are weighing on performance. As in 2000-01, liquidity is shifting from past winners to stocks previously ignored. US households hold $75 trillion in equity assets, around 230% of GDP – way above the 130% of 2000. More of that is invested in tech than in 2000. There is no evidence of impending recession, but we need to re-examine confidence after the July semiconductor stock rout.

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

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