

GLOBAL MACRO VIEWS

Five reasons to bet on Europe

Scepticism on Europe's growth renaissance is fading as conviction builds around fiscal spending.

1. Europe's fiscal boost is real

After a muted 2025, Germany's fiscal expansion is set to accelerate meaningfully in 2026. Infrastructure and defence spending are ramping up, with early signs of transmission already visible in rebounding manufacturing and defence-linked orders.

While planned deficit spending fell short of target in 2025, spending accelerated sharply in the fourth quarter as constraints eased. The budget passed in September and the €500bn infrastructure fund became operational from October. The 2026 ramp-up materially changes the outlook. Infrastructure spending targets total €37bn, up from €24bn in 2025. Defence expenditure, already at €20bn last year, expands further under the uncapped framework. In addition, €8.3bn in state transfers is likely to trigger near-term spending, reinforcing the fiscal boost.

Manufacturing orders rose 10% quarter-on-quarter in the fourth quarter, which is one of the strongest increases in unified Germany's history. In the defence industry, new orders for military vehicles surged 113% and fabricated metals (weapons and ammunition) rose 17%. Domestic orders were up 20% on a three-month basis, with metal goods demand rising 25% year-on-year.

As momentum builds into 2026, the fiscal impulse in Germany can serve to underpin a cautiously upbeat outlook for Europe.



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Germany's fiscal revolution also creates powerful spillovers for their European trading partners.

2. Inflation risks remain contained

Fiscal spending, however, has the potential to be inflationary, notably via energy markets. Low gas inventories, combined with rising power demand from defence, infrastructure and electrification, are likely to keep wholesale electricity prices above €80/MWh through 2026. This is well above the €60/MWh industrial competitiveness threshold.

Strengthening order books suggest raw material and power demand in energy-intensive sectors, such as chemicals, will re-accelerate from mid-2026. After years of decline, German power consumption is now on track to rise around 10% by 2030.

These dynamics raise the likelihood of further cost-containment measures, including price caps or electricity tax reductions, which in turn, could cap upside price pressures.

Even so, a higher inflation backdrop alongside elevated bond issuance to finance fiscal spending point to sustained upward pressure on bund yields through 2027. We expect 10-year bund yields at 3.15% by year-end 2026, with upside risks.

3. Continued spread compression in Spain and Italy

Improving economic activity makes the case for further spread tightening in these countries. Spain delivered 2.8% growth in 2025, while Italy recorded a surprisingly firm 0.3% print despite manufacturing headwinds.

Beyond near-term cyclical strength, the structural picture for these countries is compelling. Italy is projected to see the greatest improvement in macro fundamentals through 2030, according to the IMF. Employment is at record highs and the fiscal picture has improved materially with the deficit slipping below the 3% of GDP threshold a year earlier than expected.

Germany's fiscal revolution also creates powerful spillovers for their European trading partners. Germany is poised to increase its budget deficit to around 4% of GDP, which will push gross eurozone issuance to record highs in 2026. The planned €800bn 2030 'ReArm Europe Plan' alongside the €150bn EU-funded SAFE defence loans programme will also provide a further boost for European growth.

As the region appears to be entering a new phase, this supportive macro backdrop could drive further spread tightening, including narrowing the 10-year BTP-bund spread toward 50 basis points.

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Currency strength is unlikely to be problematic unless it feeds into inflation.

4. The ECB on extended policy pause

The European Central Bank (ECB) held its benchmark interest rate at 2% for the fifth meeting in a row in February. While policymakers acknowledged a “still uncertain” outlook amid a “challenging” trade environment and the euro’s recent rally versus the U.S., the ECB President Christine Lagarde again emphasized that policy is “in a good place”. Her assessment followed generally positive economic news for the eurozone. Headline inflation fell below the ECB’s 2% target in January, core inflation dipped to 2.2% and fourth-quarter GDP growth registered a slightly better-than-expected 0.3%.

While the euro’s rise hurts the region’s manufacturing and export sectors and could be disinflationary, we think currency strength is unlikely to be problematic unless it feeds into inflation.

The improving growth outlook and potential inflationary pressures reinforce the ECB’s current bias toward an extended policy pause, and underpins our view for a modest tightening cycle to begin in early 2027.

5. Betting on gilts as easing bias builds

In the U.K., the Bank of England could take a more supportive policy stance with softer growth and inflation cooling from elevated levels. Fiscal policy is restrictive, acting as a drag on growth, and limiting the risk of a renewed inflation impulse.

Pension demand for long-end U.K. bonds is less price-insensitive than in prior cycles, term premiums remain sticky and political uncertainty continues to demand compensation, which is making investors wary of long-dated gilts.

The belly of the curve remains the sweet spot in our view. Valuations are more compelling, carry dynamics are stronger and there is scope for additional rate cuts to be priced. Our base case remains for two rate cuts in 2026, taking the benchmark policy rate to 3.25%.

Fiscal drag and soft demand support the easing bias, with risks skewed toward more cuts should labour market deterioration accelerate. The greater risk for policymakers is delaying cuts as growth momentum continues to erode. Against this backdrop, long-end gilts can still play a tactical role, but conviction remains limited due to uncertainty around the stability of the government. This leaves our 4% 10y year-end forecast skewed to upside risks.

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Endnotes

Sources

All market and economic data from Bloomberg, FactSet and Morningstar.

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