

Europe: Leader or Laggard?

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After many years of trailing the US, European equities have experienced a strong resurgence in 2025 outperforming many global peers. Optimism has largely been driven by expansionary fiscal policy in countries like Germany, and by rate cuts from the European Central Bank (“ECB”) on generally easing inflation. Despite the equity market optimism and a relatively resilient real economy, questions related to tariffs persist, growth across economies is uneven, and geopolitical tensions particularly in Ukraine linger. Also, a significant part of the recent equity market gains for US investors has been related to a weakening US dollar.

In this paper, we explore emerging positive trends in Europe and highlight potential economic and financial challenges ahead.

GLOBAL MACROECONOMIC
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Key takeaways

- European equities have staged a strong comeback in 2025, outperforming global peers, driven by ECB rate cuts, fiscal stimulus (especially defense spending), and a weaker US dollar.
- Equity gains have largely been driven by multiple expansion and currency effects, not earnings growth. With ECB rate cuts likely ending and external risks looming, the rally may decouple from fundamentals.
- Despite market optimism, Eurozone growth is sluggish and uneven—IMF forecasts GDP at 1.2% in 2025 and 1.1% in 2026, roughly half US levels.
- Fiscal priorities have shifted toward defense and infrastructure spending, unlocking additional spending, while structural gaps in innovation and productivity persist.
- Ongoing trade wars, rising tariffs, and geopolitical tensions create additional uncertainty and weigh on competitiveness.

The economic backdrop

Is Europe's recovery grounded in economic reality, or merely a reflection of investor sentiment and a weak US dollar? While some models have placed the chance of a recession relatively low (around 25%), economic growth across major economies in Europe remains sluggish or falling. At a country level, growth is uneven with Germany (Europe's largest economy) largely stagnant while others like Spain are expected to grow close to 3.0% this year. The IMF forecasts overall growth for the Euro Area at 1.2% in 2025 and 1.1% in 2026, levels roughly half those projected in the US.

Inflation is also forecasted to continue to decline along with growth given slowing economic activity and the quick resolution of trade issues with the US. After remaining in contraction over most of the last few years manufacturing Purchasing Managers Index (PMI) data finally returned to relatively neutral levels in the latest report. Like Gross Domestic Product (GDP) results across the Eurozone-countries were uneven with key economies like Germany (49.6) and France (48.8) still in contraction.¹ Despite a slight improvement in output, new orders and exports remain weak and job cuts continue. By contrast, services PMI data are in expansion territory (53.0) due to domestic demand. Labor markets remain relatively steady

¹ Purchasing Managers Index (PMI) is a survey-based indicator where readings above 50 indicate expansion of activity. Readings below 50 indicate contraction of manufacturing activity indicators.

but are showing some signs of softening. Consumer sentiment is still subdued, with surveys indicating consumers remain cautious when it comes to spending given trade-related inflation concerns. Together, these trends point to a relatively tentative economic backdrop, a sharp contrast to the optimism in the equity markets.

Trade wars and fiscal shifts

At the same time, external dynamics have added another layer of complexity. On the currency front, the euro did not behave as expected in 2025. ECB trade models forecast a steep depreciation of the euro against the US dollar.² Instead, the euro rallied approximately 13% against the US dollar since the start of the year.³ While the stronger euro helped to drive inflation lower and justify further easing from the ECB, it proved to be an additional headwind for Eurozone exporters.⁴

Ongoing trade wars between China and the US have roiled global trade and weighed on manufacturing sentiment, and Europe has not been immune.⁵ The spread of protectionism has intensified originally starting with tensions related to the semiconductor/chip sector, and moving to the energy markets, electric vehicles (EVs), defense companies, and now steel imports.⁶ China's aggressive push to support its own economy through a surge in exports has challenged European manufacturing and competitiveness at home and abroad.

As a response to China's export surge, the European Commission raised import tariffs in October 2024 on Chinese EVs by 35% in addition to the existing 10% tariff.⁷ They also recently imposed a 50% tariff on imported steel to defend domestic steel production from Chinese dumping of highly subsidized and cheap steel into Europe.⁸ The drag from trade wars might be as much as 0.7% of GDP, but thus far the impact has largely been contained to some weaker economic growth without corrosive inflation shocks.⁹

While the eurozone faced a considerable tariff increase from the US Liberation Day Tariffs, the speedy resolution of the trade dispute in July 2025 helped to mitigate some of the worst possible impacts.¹⁰ In 2025, the Eurozone's trade deficit increased by 10% but largely due to weak Chinese demand for Eurozone exports.¹¹

This broader turn towards protectionism has also influenced fiscal priorities. In 2025, North Atlantic Treaty Organization (NATO) members announced a significant increase in their military spending over the next 10 years.¹² Domestic fiscal spending shifted in the Eurozone from a focus on fiscal discipline to national defense and national industrial considerations.¹³ In addition to larger NATO commitments, the

² Source: ECB. C. Lagard, "Trade Wars and Central Banks: Lessons from 2025," September 2025.

³ Ibid.

⁴ Ibid.

⁵ Source: The New York Times, P. Cohen, "Trump's Trade War with China Catches the World in its Crossfire," October 14, 2025.

⁶ Ibid.

⁷ Source: Reuters, "EU Slaps Tariffs on Chinese EV's Risking Beijing Backlash," October 29, 2024.

⁸ Source: The New York Times, P. Cohen, "Trump's Trade War with China Catches the World in its Crossfire," October 14, 2025.

⁹ Source: ECB. C. Lagard, "Trade Wars and Central Banks: Lessons from 2025," September 2025.

¹⁰ Ibid.

¹¹ Ibid.

¹² Source: Reuters, J. Klement, "European Defence [SIC] Supercycle Means Scrapping Deficit Fears," June 10, 2025.

¹³ Ibid.

European Commission initiated the "ReArm Europe Plan" which included plans to issue 150 billion euros worth of long term debt to finance rearmament of the Eurozone.¹⁴ In addition, the European Commission urged member states to invoke the 'national escape clause' of the Stability and Growth Pact 2025-2028 to increase defense spending at the national level.

¹⁴ Source: European Commission, "ReArm Europe Plan/ Readiness 2025-2030," 2025.

Altogether, the plan to rescind the fiscal constraints of the Stability and Growth Pact is expected to unlock an additional 650 billion euros in defense spending of which 65% must be domestically sourced. The ECB estimates that the new defense spending will boost the Eurozone's GDP to add 0.25% annual GDP between 2025 and 2027.¹⁵ On the one hand, governments in Europe are willing to do more to foster domestic strategic industries with protectionism and fiscal spending. On the other, the collective impulse toward deglobalization and self-sufficiency has inadvertently hampered export opportunities and competitiveness.¹⁶

¹⁵ Source: ECB. C. Lagard, "Trade Wars and Central Banks: Lessons from 2025," September 2025.

¹⁶ Ibid.

Europe's pause, America's pivot

As the US Federal Reserve remained on hold until recently on interest rate cuts, the ECB reduced rates four additional times this year as trade war related inflation fears never materialized.¹⁷ Since December 2024, the ECB cut its policy rate by 100 basis points to 2.0%, roughly half the level of the US.¹⁸ On balance, the dissipation of inflation pressures to target levels and additional fiscal spending on national defense could help support growth and keep rates low. However, economic growth may prove vulnerable with the IMF forecasting just 1.1% annual GDP growth for 2026 down slightly from 2025 growth rate of 1.2%.¹⁹ Looking ahead, with the ECB expected to pause its rate cuts and the Fed likely continuing its recent reductions, uncertainty remains over whether US policy easing and comparatively stronger economic growth will dampen the momentum of Europe's equity market rally.

¹⁷ Ibid.

¹⁸ Source: ECB as of October 17, 2025.

¹⁹ Source: International Monetary Fund, World Economic Outlook, October 2025.

Europe's equity revival

After many recent years of lagging the US stock market, European equities have staged an impressive comeback in 2025 outperforming many other countries and reaching record highs. Key drivers of the recent run include the ECB interest rate cuts, the increased fiscal stimulus especially for defense, attractive valuations, improving corporate earnings, and the weakening US dollar. So far year-to-date through September, the MSCI Europe Index returned 28.4% in local terms and 12.4% in US dollar terms and 12.4% in local currency returns illustrating the strong tailwind in the weakness of the US dollar (Figure 1). While the technology sector has driven the rise in US equities traditionally value sectors like defense and financials (banks) have done well given increased government spending and other structural reforms (Figure 2).

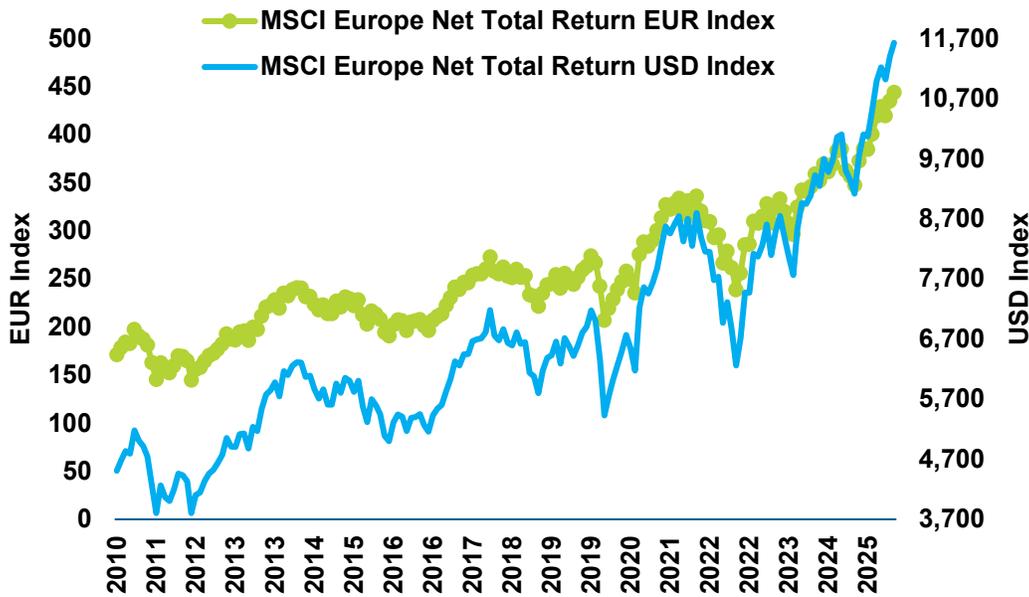


FIGURE 1
MSCI Europe TR (USD) and
MSCI Europe TR (euro)
(Last Price)

Source: Bloomberg as of
 September 30, 2025.

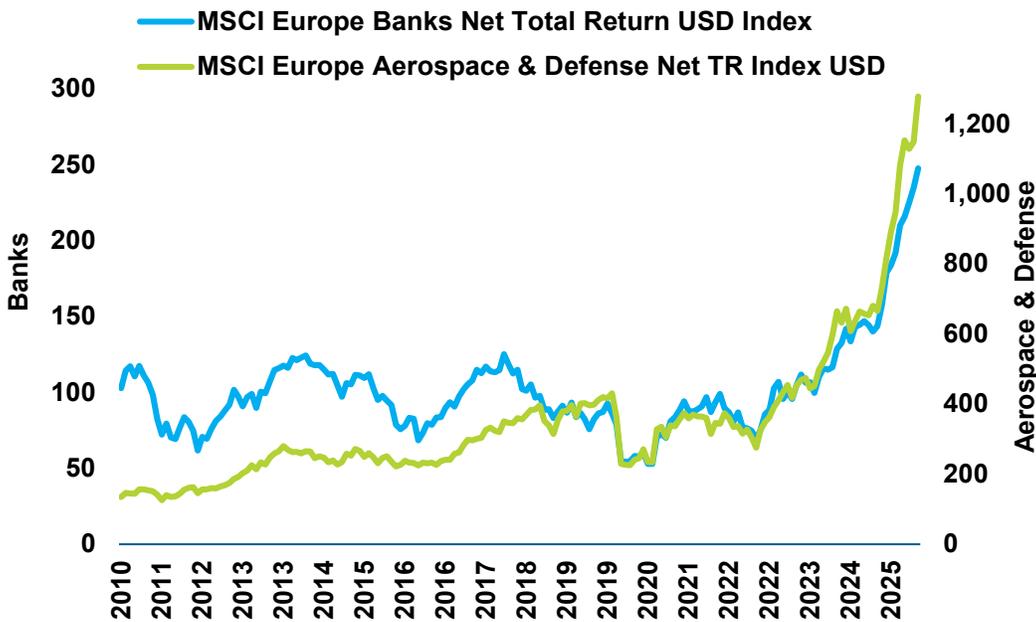


FIGURE 2
MSCI Aerospace/Defense and
Bank Sector Price Returns

Source: Bloomberg as of
 September 30, 2025.

Valuations also remain attractive relative to US equities, with forward P/E ratios of 14.6x compared to 22.8x in the US, reinforcing Europe’s appeal as a value play. Despite the relatively attractive valuations, gains this year have largely been driven by multiple expansion and a weaker US dollar not earnings growth like in the US. Given these dynamics, the likely end of ECB rate cuts, on-going tariff risks, and geopolitical tensions particularly related to Ukraine suggest caution despite the recent momentum. Also, the lackluster high-level earnings growth expected (roughly 3%) with some sectors expected to have much higher earnings suggests a more focused approach to European equities going forward.

Looking ahead

Europe's markets have enjoyed a strong year, yet questions remain about whether performance can outpace fundamentals. While many models are not forecasting a recession in Europe, growth is likely to remain sluggish and uneven across economies. This is a sharp contrast to the strong year in the European stock market leading to questions about its sustainability. As we move ahead there are several key areas we will be monitoring.

Key factors as we move forward:

- **Economic Growth:** If growth remains subdued or uneven across member states, the equity rally may lack a solid macro foundation, increasing the risk of decoupling from fundamentals.
- **Earnings:** Monitor whether earnings growth becomes a more meaningful part of returns and if so, does it come from reducing costs or actual demand.
- **Path of the USD:** A stronger US dollar, driven by relatively robust economic growth, could pose a headwind going forward.
- **Track of Monetary Policy:** The Fed continuing its recent path of interest rate cuts while the ECB likely pauses could influence flows and sentiment.
- **Geopolitical Risks:** Escalation of the war in Ukraine particularly as it relates to energy supply could be impactful.

Europe's equity market recovery has been welcomed by investors, but caution is warranted. Fiscal support, lower rates, and a weaker dollar have reignited investor confidence, but the underlying economy remains uneven and exposed to external shocks. Sustaining momentum will depend on whether temporary tailwinds, policy easing, fiscal expansion, and favorable currency trends can be supported by more meaningful earnings and economic growth. With the balance between optimism and reality still delicate, investors may be best served by being selective: focusing on quality companies, sectors aligned with structural reforms, and strategies resilient to shifts in policy or geopolitics. Europe's next phase will likely be defined not by stimulus, but by its ability to convert policy-driven optimism into lasting economic strength.

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