Mid-Year Outlook 2026

LBBW Research

Markets between geopolitical uncertainty and reform

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In brief:

- Is Germany on the brink of a reform breakthrough?
- The geopolitical picture remains murky.
- Interest rates still have room to rise.
- Are equities at a turning point?

Can Germany do reforms after all?

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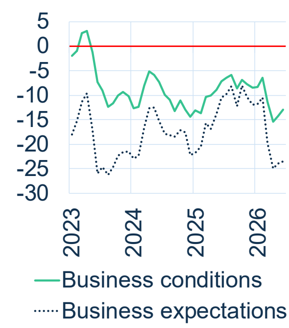
The early exit of Germany's national football team from the World Cup in North America is a fitting image for the German economy. It, too, has seen better days. It is not only Paraguay – whose team sent Germany packing – that has grown faster than the Federal Republic over the past five years. In fact, more than 92% of countries worldwide have done so. At the start of the year, Germany still looked poised for an upswing: incoming orders delivered positive surprises, and expansionary fiscal policy stimulated demand. Then came Gulf War 3.0, launched without any discernible strategy, and landed like a two-footed tackle in the penalty area. Donald Trump really ought to see red for that. But, of course, real life this side of metaphor does not work that way.

This time last year, the trade war threatened by the U.S. was perhaps the biggest worry for Germany's export-dependent economy. That danger has not gone away. But it has now been joined by an actual hot war, one that is weighing on global demand and pushing up prices – and not only because energy has become more expensive. The adversaries are currently negotiating, and hopes of a lasting solution are buoying markets. Investors are already selling the bear's skin before it has been killed. Iran and the U.S., after all, once again seem to be interpreting the course of the talks rather differently. Tehran believes it has the stronger hand in the negotiations. And there is something to that. Genuine peace is therefore anything but assured.

Fig. 1: Ifo business climate index still under water
(seasonally adjusted balances, through June 2026)



Source: ifo Institut, LBBW Research

For central banks, the message is clear: discretion is the better part of valor. After the recent bout of inflation, monetary guardians cannot afford to let price stability slip again. Even under Kevin Warsh's new leadership, Trump's demand that the Fed slash rates, will not be fulfilled. And after the ECB's first rate increase, another is likely to follow. Long-term rates, too, are more likely to trend upward. Wherever one looks, governments are indulging in a debt binge. Even Germany, once the keeper of the seal of fiscal restraint, is likely to run general-government deficits of around 4% of GDP in the years ahead. The resulting higher long-term rates are hardly likely to give private-sector investment much lift.

Yellow card for the equity market

For equity markets, higher rates are an additional burden on top of valuations that are already rather stretched. Accordingly, June brought the first setbacks, despite the supposed easing of tensions in the Persian Gulf. Shareholders have, as it were, been shown a yellow card – one that may prompt them to play a less aggressive game.

In Germany, all eyes are now fixed expectantly on a "summer of reforms" – a phrase that echoes the country's 2006 World Cup "summer fairy tale." Suddenly, the government is showing attacking intent. The ball is on the penalty spot. The coalition now has to hold its nerve. If it misses, the mood will turn sour for good. Failure is not an option!

02 | Geopolitics

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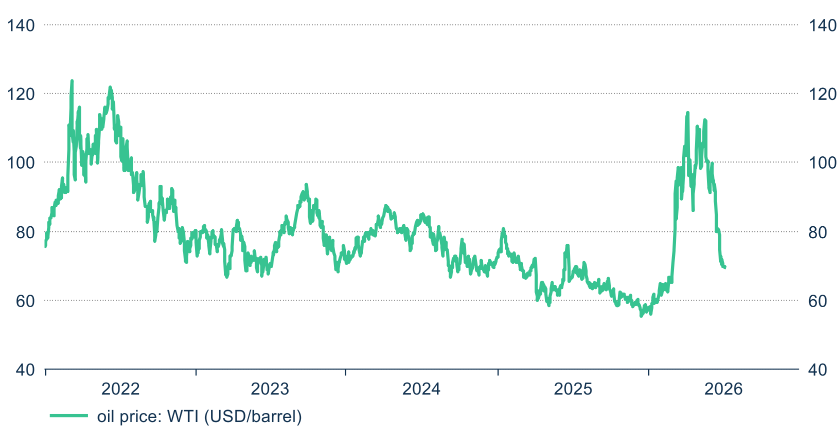
Iran war hits global growth

Hormuz blockade threatens the recovery

No viable peace agreement yet

The possibility of a prolonged closure of the Strait of Hormuz – or of high future transit fees for shipments of oil, liquefied natural gas, fertilizers and the chemical feedstocks used to produce them – remains a risk to the entire global economy. It is still unclear whether the U.S., Israel and Iran will ultimately be able to agree on a peace treaty for the wider region. And even if they do, its substance and durability remain highly uncertain. If, for instance, Israel were to judge that its long-term security interests had not been sufficiently taken into account in the negotiations, the risk of fresh military escalation against Iranian-backed groups in the region would remain. That, in turn, could prompt Iran to respond with another blockade of the strait. Moreover, it cannot be ruled out that Iran may in future, despite a treaty, temporarily or permantly demand transit fees for tankers and cargo vessels, partly to help cover the substantial costs of reconstruction. This could make oil prices more volatile and lift risk premia. Still, the willingness to end the armed conflict appears fairly pronounced on both the U.S. and Iranian sides, which recently led to a marked fall in oil prices (see fig. 2).

Fig. 2: Oil price (WTI, USD per barrel)



Source: LSEG, LBBW Research

Conflict cannot be contained regionally

The conflict in the Gulf has once again shown that a confrontation of this scale cannot be contained regionally in a globalized economy with finely divided production chains. Its effects on commodity markets, inflation, global supply chains, financial-market conditions and even the world food situation are causing damage around the globe.

The International Monetary Fund's (IMF) latest World Economic Outlook (WEO), published in April 2026, still assumed that the conflict would dampen global economic activity only moderately. In its baseline scenario, however, the Fund assumed that war-related disruptions would have faded by the middle of the year. In that case, growth in global output would slow from 3.4% in 2025 to 3.1% this year and 3.2% in 2027.

Drifting toward the downside scenario

Peace now seems within reach. But the economic effects of the conflict are likely to be felt for some time yet. It can therefore be said that the IMF's premise for its baseline scenario has not been met, especially as fully clearing the mines in the Strait of Hormuz is likely to take months. Accordingly, a more negative scenario has become significantly more likely. In the downside case described by the IMF as an “Adverse Scenario”, toward which current developments are now moving, global growth would slow to 2.5% in 2026. Our own forecasts for the global economy have for some time reflected the more negative trend now under way. We expect global GDP to expand by 2.7% in 2026 and by 2.8% in 2027.

Asia hit hardest by the blockade

For Asian countries, the situation is the most challenging. Following the closure of the Strait of Hormuz, they had to find replacements quickly for lost oil and gas supplies from the Middle East. While the region’s large and financially stronger economies – such as China, Japan and Korea – were in most cases able to draw on domestic reserves or, despite high prices, secure supplies on the world market thorugh alternative channels (with increased U.S. oil exports serving as a buffer), poorer countries, especially in South Asia, were often left with little choice but to significantly curtail economic and social activity as a way of adjusting to the crisis.

Financial strength determines room for adjustment

Despite their greater dependence on energy imports, however, the risk of an inflation shock like that of 2022 should remain low. In the world’s second-largest economy, China, persistently weak domestic demand is preventing higher input costs from being fully passed on to consumers. In Thailand, too, the economic slowdown as well as structural problems (such as high household debt) are dampening price pressures. In addition, extensive government fuel subsidies – especially in Malaysia (which, as a net energy exporter, is also better schielded from the recent turmoil) and in Indonesia – protect households from excessive cost increases. In economies experiencing more pronounced price pressures, central banks have already begun to counteract them with initial rate hikes, as in the Philippines, or are likely to do so soon, as in Korea.

Inflation shock less severe than in 2022

The fact that most economies will likey escape with only minor damage is essentially due to still robust industrial dynamics. Massive investment spending by the U.S. tech sector is generating a veritable export boom for Asia’s electronics industry and driving a marked increase in corporate profits. Lower U.S. tariffs since late February are also having a positive effect on global production. The growth forecasts for global chip heavyweights Taiwan and Korea, some of which have even been revised upward, also highlight a fundamental problem. In many Asian economies, the pattern of a so-called “K-shaped economy” is becoming more pronounced, in which a few booming sectors stand opposite an increasingly large part of the economy that is growing only weakly. This strong dependence on a small number of growth drivers creates substantial concentration risks for the global economy. The recent energy-price shock has further exacerbated these imbalances. In the worst case, new geopolitical shocks could turn out to be precisely the triggers that bring AI-driven growth dynamics to a halt. Only a stronger diversification of growth drivers would be able to counteract this.

Geopolitical crises fuel imbalances

03 | Economic policy

Full throttle with the handbrake on

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Last year, in this space, I gave a positive assessment of the coalition agreement between the CDU/CSU and the SPD. By now, it has once again become clear that promises on paper do not always translate into action and that what is written on it does not always come to pass. I am not the only one whose expectations the federal government has disappointed – and continues to disappoint. The coalition's and the chancellor's poll ratings have fallen to an almost unprecedented level (see fig. 3).

Germany is in a foul mood

Germany is part of a pan-European pattern. In Britain and France, too, the respective governments are deeply unpopular. Only in Italy – once a byword for political instability – does Prime Minister Giorgia Meloni still lead the polls. Voters in many places seem dissatisfied with the status quo and eager for change, albeit with little clear vision of which concrete form this "change" should take. Populist currents at both extremes of the political spectrum promise radical change. This is all the easier for them because they have never had to put their promises into practice.

Fig. 3: Satisfaction with the federal government's performance (June 2026)

Source: ilium.de, LBBW Research

The lack of public support can also be traced to the entirely justified feeling that little, or at least far too little, is moving in the country. LBBW Research has analyzed, by way of example, the reasons for Germany's weak economic performance and found a wide range of causes. Not all of them can be solved by politics. Demographic decline, deglobalization or matters of mindset – such as intrinsic risk aversion – can scarcely be influenced even by a capable, forceful government, and if at all, only over a very long horizon.

But there are also obstacles to growth that policymakers could effectively tackle: infrastructure that in many places has become dilapidated, dysfunctional education and labor market integration systems, as well as excessive regulation with its attendant bureaucracy. And although Germany's rapid aging can no longer be reversed, reforms of the social-security systems could at least put public finances on a more sustainable footing and restore some confidence among citizens. The coalition had, after all, announced that it would address all of this. But the Merz government has discovered that many things are easier said than done. And they become harder still once the electorate's trust has been lost. Reforms always involve sacrifices, and people are less willing to make them if they have little faith in the government asking for them.

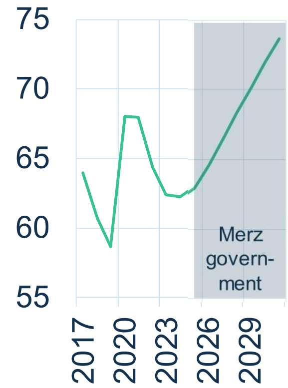
Full throttle

Budget deficit heading for 4% of GDP!

Still, it would not be fair to say that the Merz government has done nothing. In fiscal policy, the black-red coalition has pressed the pedal to the metal and granted itself a generous borrowing framework. The OECD forecasts a general-government budget deficit of 4% of GDP in 2027 and an increase in the debt ratio to 68% of GDP, under the Maastricht definition, from just over 62% in 2024, the final year of the "traffic-light" coalition of Social Democrats, Greens and Free Democrats (see fig. 4). By international standards, these are not yet dramatic figures. Compared with France, Britain or the U.S., Germania is a one-eyed lady among the fiscally blind. Nor would this be quite so worrying if the borrowing flowed exclusively into infrastructure investment. That could, after all, raise growth and generate future returns in the form of tax revenues with which the federal government could service the debt.

But in fact the bulk of the borrowing is seeping into current spending. A substantial share goes to the growing defense budget. I do not deny that the new geopolitical realities require stronger defense capabilities. At the same time, defense costs are current expenditures and should therefore be financed from the regular budget, not permanently on credit.

Fig. 4: General Government gross debt
(in % of GDP, 2017-2031)



Source: IMF, LBBW Research

The fact that the government is apparently also using funds from the debt-financed Special Fund for Infrastructure and Climate Neutrality (SVIK) for projects that do not meet the constitutional requirement of additionality casts the federal debt binge in an even dimmer light. The Federal Court of Auditors has criticized the SVIK's lack of transparency. What the coalition has certainly achieved is a rise in long-term interest rates, owing to the growing supply of government bonds. But that is hardly something that will stimulate companies' willingness to invest.

Handbrake

So while spending is all full throttle – and the government-spending ratio, defined as public expenditure as a share of GDP, is likely this year to cross the 50% threshold for the first time, the point at which former chancellor Helmut Kohl once said "socialism" begins – the government's approach to structural reform has been, shall we say, measured. One might also say the handbrake is firmly applied. The repeatedly promised "autumn of reforms" has not materialized. If the government does not visibly clear the reform backlog, private-sector investment paralysis is likely to persist. It will certainly not be easy. The Merz-Klingbeil duo already looks as divided – vulgo: at loggerheads – as the traffic-light coalition did only after two or three years. And to repeat: the lack of backing among voters will not help.

The autumn of reforms never came

The measures taken so far have been notable either for burdening public finances over the long term, as with pensions, or for amounting to little more than populist symbolism, such as the fuel-price brake and the mothers' pension. But as the saying goes, the night is darkest just before dawn. Perhaps Berlin has by now internalized that timidity on reform policy hurts no one as much as the parties involved themselves. That could provide a strong incentive for a late bid to break free. For all our sakes, let us hope so.

Now or never

In the few days remaining before parliament's summer recess, Chancellor Friedrich Merz now wants to step hard on the gas once more. In early July, the leaders of the governing parties – the CDU/CSU and the SPD – presented a reform package that few had still thought possible. It has everything: pensions, labor-market policy, cutting red tape, tax reform. In many cases one can sense that the coalition has forged compromises that blunt the impact of the reforms. But still. The ministries must now turn the measures into laws, and parliament must approve them. The coalition is spreading optimism everywhere. Yet even on the home stretch, it is still possible to veer off course. What is now needed is the chancellor's strong leadership, which he had so far coyly been hiding. For muddling through as before – or worse, an abortion of the proposed reforms – would inevitably send the governing parties into the polling abyss. Ahead of state elections in eastern Germany, where the extreme right AfD is flying high, that would be fatal. The last chance saloon for reforms of Chancellor Merz' government is now. The good thing is, the coalition knows this as well. It is doomed to succeed. The coming weeks will define not only the future of the coalition, but also of Germany's near term economic future.

Now the summer of reforms must succeed!!

04 |

Economic Outlook

No luck – and then bad luck

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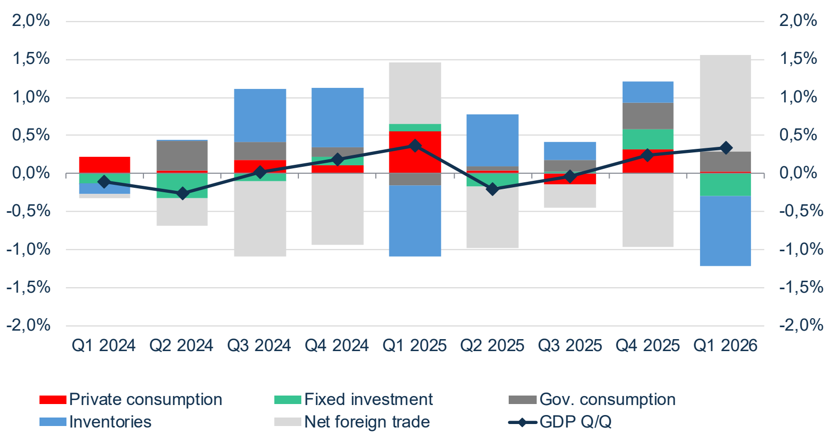
A good start to 2026

Measured against the forecasts made six months or a year ago, the German business cycle ought to be running at full steam. Evidently, it is not. What went wrong? The answer: quite a lot. Clearly external shocks include U.S. tariff policy and its negative consequences. In Germany's case, this produced pull-forward effects in exports to the U.S. as early as the opening quarter of 2025, temporarily burnishing the German trade balance. In the following three quarters of 2025, however, foreign trade weighed noticeably on GDP growth.

The Iran war is the main risk

In the first quarter of 2026, the story almost repeated itself. The Iran war again led to pull-forward effects. Apparently drawing largely on existing inventories, companies increased exports after the war began (see fig. 5). It follows that net exports are likely once again to weigh on GDP growth in the coming quarters, while companies probably rebuild inventories. This need not happen, of course, if the agreement reached between the U.S. and Iran in mid-June leads to lasting peace in the region and thus prevents another closure of the Strait of Hormuz.

Fig. 5: Quarter-on-quarter GDP growth and breakdown by sector contributions



Source: LSEG, LBBW Research

A positive scenario

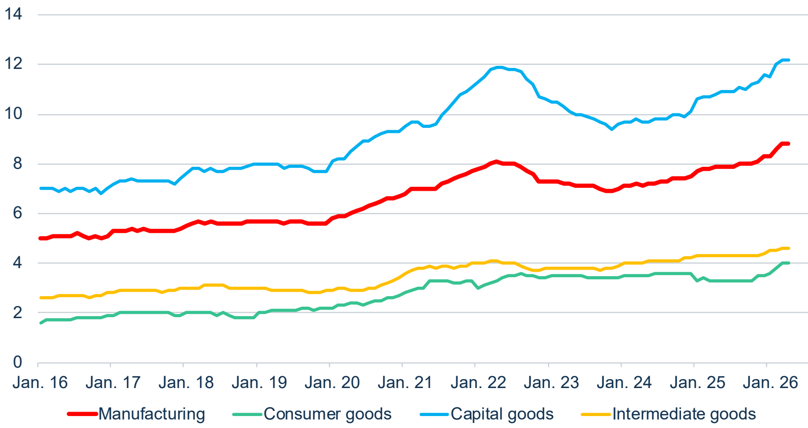
In the favorable case of a successful agreement, oil prices would probably fall further, or at least not rise again. Supply chains for other commodities and intermediate goods – by sea as well as by air – would be more stable and therefore cheaper. And the decline in uncertainty would generally be more favorable for private-sector investment. Ultimately, that would also benefit the German economy. All this, of course, is speculation: it may come to pass, but its basis could just as quickly disappear.

Stabilization at a low level

Firmer evidence on the business cycle is provided by monthly industrial data. Here the picture is mixed, but by no means uniformly bleak. Production is showing some stabilization. The data available so far suggest that in the third quarter it is likely to be roughly at the level of the previous quarter. Monthly new orders hit their low in August 2025, at 83.2 index points. Since then they have continued to recover, albeit with fluctuations. In April, the figure stood at 89.1 index points. The strongest increase in new orders most recently came from the euro area, while domestic orders lagged somewhat. Against this backdrop, the order backlog – measured as the reach of orders in months of production; see fig. 6 – has improved. On average, companies could produce for almost nine months before existing orders were worked off. The spread between sectors is considerable: in capital-goods production, the backlog would last for more than a year; in shorter-lived consumer goods, only four months. In both cases, however, this is the highest order-backlog reach since these time series began.

At least there are orders

Fig. 6: Germany – Order backlog in manufacturing in months of production

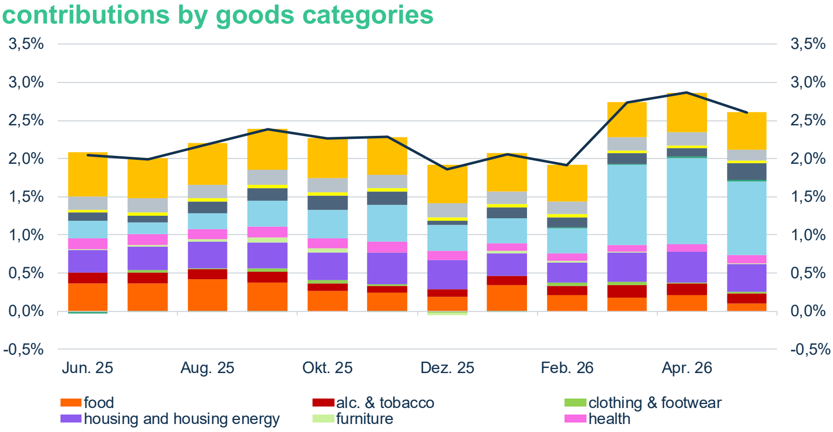


Source: LSEG, LBBW Research

With a possible end to the Iran war, inflation is also likely to recede somewhat into the background. The categories “transportation”, “household and energy” and “other” had risen more sharply of late (see fig. 7), with the so-called fuel-price discount holding back the increase in the “transportation” category for two months – it also includes fuel prices.

Keeping an eye on inflation

Fig. 7: Germany – Consumer prices year on year and contributions by goods categories



Source: LSEG, LBBW Research

In the coming months, however, some after-effects of the Iran war are still to be expected, for instance in food, since the global supply of fertilizers has also been impaired. The inflation contribution from food is therefore likely to rise in the months ahead. Companies’ scope to pass higher costs on to consumers is currently much smaller, however, than during the high-inflation phase of 2022/23. At that time, the lifting of restrictions after the Covid-19 pandemic coincided with the start of the war in Ukraine. Overall, we expect an inflation rate of 2.7% this year and 2.3% next year.

The second price wave is still to come

05 |

Energy & Environment

A missing thread

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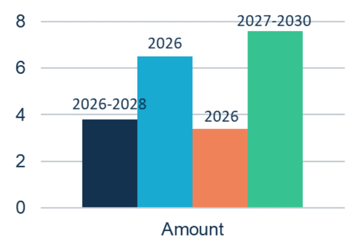
Germany's Economics Minister Katherina Reiche has stated the government's goal in energy policy: to keep the triangle of affordability, security of supply and climate protection in balance. In principle, this is a sound approach. After all, the energy transition must be economically feasible. In addition, Germany, as an industrial location, needs a reliable energy supply. And the fact that climate protection is a serious issue has once again been demonstrated in recent weeks – with extreme heat across Europe, infrastructure was pushed to its limits in many places.

The energy-policy trilemma

Environmental and energy policy lacks consistency

Berlin wants to ease the burden on companies and households with a package to lower energy prices. It includes the abolition of the gas-storage levy, a new federal subsidy for grid fees, a reduction in the electricity tax and the introduction of an industrial electricity price (fig. 8). Companies in particular will benefit from these measures, as the federal subsidy for grid fees applies only to the extra-high-voltage grid – and only the very largest electricity consumers are connected to it. Small businesses and households will receive only a small share of the subsidy, whose funds come from the Climate and Transformation Fund (KTF). Since 2026, Berlin has also been financing the gas-storage levy from the KTF – a fossil-fuel subsidy from a fund explicitly intended for climate protection. According to the Federal Ministry for Economic Affairs, the resulting relief effect will amount to EUR 3.4bn by March 2027. This leaves EUR 7.6bn in funding for the 2026 climate-protection program for the period from 2027 to 2030.

Fig. 8: Subsidies by period at a glance
In EUR bn



Source: EU-Commission, Federal Government, Bundestag, LBBW Research

The approach does have positive aspects. on the one hand, lower electricity prices are urgently needed in order to advance electrification and, above all, to make it more economically attractive. And energy-intensive industry naturally offers the greatest leverage. At present, electricity prices are still two to three times higher than gas prices – there is no incentive to electrify. On the other hand, companies that receive the industrial electricity price between 2026 and 2028 commit to investing at least half of the cost saved in their decarbonization. The subsidies provide noticeable relief for companies, but they do not solve the structural problems – high grid costs, a lack of flexibility and insufficient system efficiency.

Federal states united in opposition to Reiche's braking course

New EEG creates uncertainty

The current conflict in energy policy concerns the expansion of renewable energy. Reiche wants to gear the energy transition more strongly towards cost efficiency, market integration and system efficiency, and is putting funding mechanisms under review. The agenda includes restrictions on rooftop solar, stricter requirements in areas with grid bottlenecks, follow-up regulation for the Renewable Energy Sources Act (EEG) from 2027 onwards and a slower expansion path. The federal government expects this to make the energy transition more affordable and easier to manage. The federal states, municipalities and investors, however, fear less planning certainty and a slowdown in the expansion of wind, solar, storage and grids.

The reaction of the federal states to the plans was correspondingly clear: at the Energy Ministers' Conference, all 16 energy ministers opposed Reiche's backward step on renewables. They made it clear that, in their view, cost control must not come at the expense of expansion speed, approvals and investment certainty.

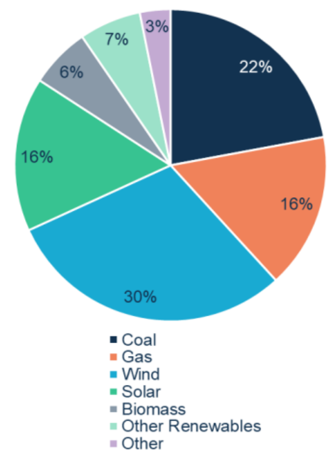
No clear course, no consensus

The new instrument of energy sharing illustrates this conflict. After tenant electricity, it is one of the most important further developments for a decentralized energy transition. Since June 2026, plant operators have been able to supply renewable electricity via the public grid to contractually bound customers at freely negotiable prices. This makes installations more attractive, can improve grid utilisation efficiency and enables households that cannot install their own solar panels to purchase low-cost renewable electricity. The contradiction is this: the federal government is creating an attractive instrument for more citizen energy and regional participation. However, it only makes sense if the expansion of renewables continues reliably.

Security of supply and building modernization

Yet one thing is also clear: renewables alone will not be able to secure the electricity supply at all times in the future either. Controllable capacity is needed that can step in flexibly, stabilize the grid and bridge periods of low wind and solar generation. Looking ahead, electricity demand will rise. At the same time, around 22 GW of coal-fired power capacity will leave the grid by 2038 (see fig. 9). The power-plant strategy is therefore intended to incentivise the expansion of hydrogen-ready gas-fired power plants. Since these facilities will in future run for only a few hours a year, operators will receive remuneration for the capacity they keep available – rather than, as usually the case, for the electricity produced. This could increase system costs and make electricity more expensive in longer term. It is therefore all the more important to carefully weigh up the expansion of such long-term capacity. Allthough the strategy does take storage into account, with a tender volume of a maximum of 2 GW out of a total of 11 GW of controllable capacity this year, storage remains more of a footnote. Yet storage facilities support the grid every day: they absorb electricity surpluses and feed them back into the grid when supply is tight – without expensive fuels. A supposed technology-neutral approach that in practice primarily favours new gas-fired power plants could prove costly for electricity customers in the long run.

Fig. 9: Net electricity generation in 2025, in %



Source: Destatis, LBBW Research

Efficiency should determine use

There is also a conflict with the Building Modernization Act. It opens up new ways of using gas and oil heating systems, provided the fuels can gradually be replaced by biogenic energy sources. This creates a conflict of objectives. Biogas, biomethane and e-fuels are scarce resources that may be particularly valuable elsewhere – especially as a flexible alternatives to conventional gas-fired power plants or for industrial use. At present, biogas and biomethane account for about 6 % of the electricity mix. If they are increasingly tied up in the buildings sector, they will be missing where they could contribute to security of supply. The central question is therefore: do the proposed measures really create incentives for biogas, e-fuels, storage, flexibility and efficiency where they deliver the greatest systemic benefit?

Conclusion

The federal government's strategy does not look consistently coherent. The basic idea is right: the energy transition must remain economically viable in order to secure public acceptance. Yet Berlin also appears to lack the courage, or the will, to turn decisively away from fossil fuels such as gas and oil. At the same time, the task is demanding. Securing supply over the next 20 years is difficult to plan when there is little robust experience with a new energy system. With their decisive intervention, the 16 state energy ministers have for now recalculated the route.

06 |
Rates

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The ECB moves first

The Iran war threw the monetary-policy plans of the major central banks into disarray in the first half of 2026. The U.S. Federal Reserve has paused its rate-cutting cycle. Nor is it showing any sign of resuming it any time soon. At the start of the year, monetary policymakers in the euro area had still been heading for an extended period of unchanged policy rates. The energy-price shock caused by the months-long closure of the Strait of Hormuz, however, prompted the ECB to raise its deposit rate by 25 basis points to 2.25% in June.

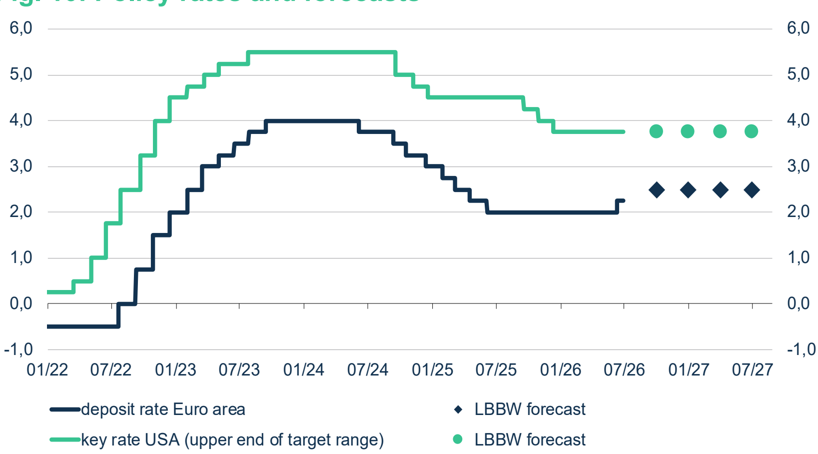
Change at the top of the Fed creates uncertainty

Policy-rate gap between the U.S. and the euro area is narrowing

The policy-rate differential between the U.S. and the euro area has thus narrowed since the start of the year. We expect this trend to continue in the second half. Under its new chairman, Kevin Warsh, the Fed is likely to keep resisting President Trump's vehement demands for more rate cuts. In view of the growing risk of persistently high inflation, policymakers will probably point for now to the fact that monetary policy is already mildly restrictive – in other words, that it is slowing the economy. We therefore expect the Fed's target range to remain unchanged at 3.50% to 3.75% until the end of 2026 (see fig. 10). At this point, a rate increase is more likely than a cut, as the U.S. labor market has recently sent unexpectedly positive signals. One source of uncertainty is how strongly Warsh will put his stamp on the Fed's course. He has announced "reforms" without becoming more specific, and he is regarded as an advocate of a leaner Fed balance sheet. For the time being, however, we consider a major program to reduce the still-vast bond holdings to be unlikely.

Fed policy rate to remain unchanged

Fig. 10: Policy rates and forecasts



Source: Bloomberg, LBBW Research

ECB set for one more rate hike

ECB faces more pressure

We attribute the ECB's decision to move ahead with monetary tightening to two factors. First, Europe's central bankers are under pressure to bolster their inflation-fighting credentials, having initially acted with marked hesitation during the inflation crisis of 2022/23. Second, Europe is more vulnerable than the U.S. to the consequences of the Iran war – including the risk of disruptions in global supply chains. The number of further ECB rate moves will depend above all on the extent to which second-round effects from the energy-price shock become visible in the coming months. We currently expect policymakers to raise the deposit rate by another 25 basis points by the end of 2026. At 2.50%, the rate is likely to reach its peak, as growing economic risks argue against a stronger or faster tightening cycle (see fig. 10).

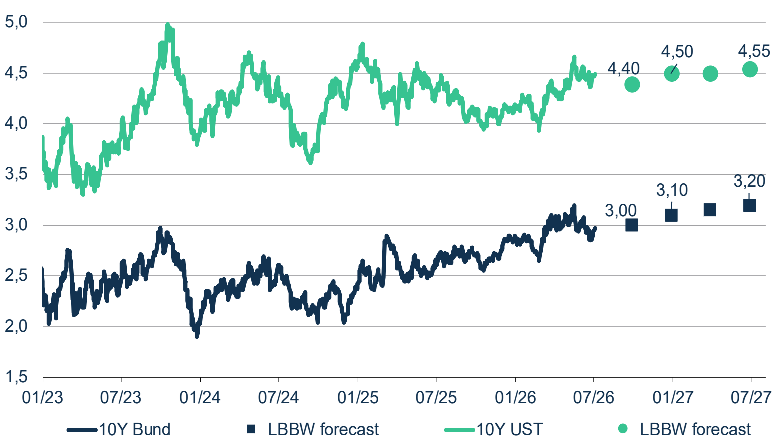
Deposit rate to peak at 2.50%

Long-term rates: mind the debt

Bond-market participants on both sides of the Atlantic lifted their policy-rate expectations significantly in the first half of the year. Bond yields rose sharply, especially at the short end of the curve, before the provisional U.S.-Iran agreement triggered a countermove. The potential for a price recovery in the second half depends heavily on whether the situation in the Strait of Hormuz normalizes durably. If the ECB's rate increases remain in line with our expectations, we see the risk of another price shock in the EUR bond market as limited.

Consequences of the Middle East conflict remain in focus

Fig. 11: Government-bond yields and forecasts



Source: Bloomberg, LBBW Research

With regard to longer-dated bonds, however, we continue to recommend caution. The pressing issue of the continuing global rise in public debt has recently faded somewhat from view, as geopolitical factors have dominated the debate. Yet the negative economic consequences of the Iran war, on the one hand, and the direct costs of the war, on the other, threaten to widen the holes in government budgets further. We therefore consider it likely that term premia on long-dated government bonds will rise again over the medium term to compensate for the growing debt risk.

In the U.S. Treasury market, there is also the uncertainty already mentioned in connection with the change at the top of the Fed. Against this backdrop, we currently consider it plausible that the yield on 10-year Bunds will move in a range between 3% and 3.5% over the medium term. For 10-year U.S. Treasuries, we expect a range between 4.5% and 5%. In case yields advance into the upper half of these corridors, opportunistic buying may well become worthwhile from an investor's perspective (see fig. 11).

Debt concerns could rise again

07 | Currencies

The U.S. dollar's old shine endures

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The U.S. federal government's net interest payments now exceed its defense spending. Some historians therefore see America's great-power status – and with it the role of the U.S. dollar as the world's leading currency – at risk. Making matters worse, the country's social divisions are impairing its ability to correct its fiscal course. The U.S. dollar's share of global reserves has fallen. Strikingly, other major currencies such as the euro or the yen have not benefited from this – but gold has.

No alternative to the U.S. dollar

The U.S. dollar's position as the dominant currency in global trade remains intact. There is no real alternative. The euro area is a currency union without a historically grown community of solidarity. The Chinese renminbi is not fully convertible, and the rule of law is not assured in its currency area. The U.S. dollar therefore continues to act as a safe haven in times of crisis, as was shown once again after the outbreak of the Iran war. The U.S. currency appreciated, even though the U.S. yield advantage temporarily declined (see fig. 12).

Two arguments now point to a recovery in the euro. First, we expect the Strait of Hormuz to become passable again on a larger scale by late summer at the latest, which should reverse the shifts into the U.S. dollar triggered by the Iran war.

Fig. 12: Transatlantic spread – yield differential between government bonds of the U.S. and the euro area

Source: LSEG, LBBW Research

Second, according to our forecast, the ECB will raise its deposit rate by a quarter of a percentage point in September 2026, while the Federal Reserve should leave its policy rate unchanged until mid-2027 (see chapter 6). In view of this, we expect the euro to appreciate to USD 1.18 by the end of 2026.

Fed on hold until mid-2027

Pound sterling: weakness on both sides of the Channel

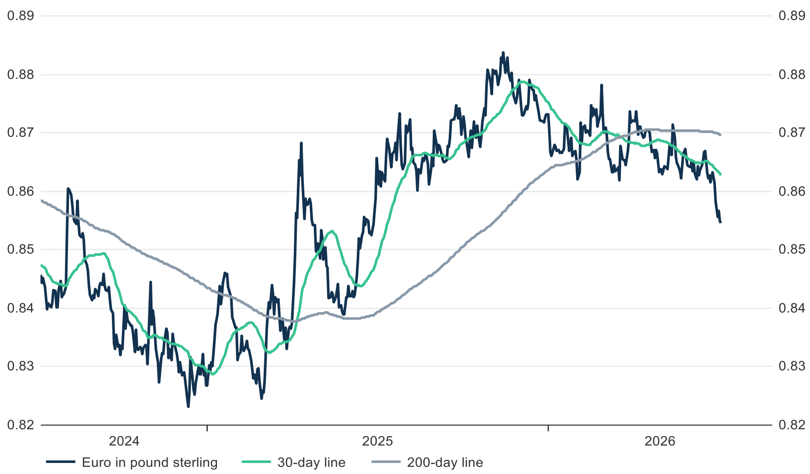
Since Brexit, Britain has often been perceived in the rest of Europe as an economic and political problem case. Debates about crumbling infrastructure, weak productivity growth, long waiting times in the health-care system, migration and social polarization shape the country's image. Yet many of these debates are now taking place just as much in Germany and other euro-area countries.

British Prime Minister Keir Starmer fought in vain for his political survival after a heavy defeat for his Labour Party in regional and local elections. But Emmanuel Macron and Friedrich Merz are also currently recording very low approval ratings. In Britain, as in France and Germany, right-wing populist parties are gaining support. Growth prospects for both currency areas are similarly lackluster. According to our forecast, both Britain and the euro area will grow next year at a rate of only slightly above 1%.

Weak growth on both sides

We expect the yield advantage of British government bonds over their German counterparts to decline. Set against this, however, is the fact that, by our purchasing-power-parity calculations, the euro is significantly overvalued against sterling. On balance, we expect the euro to move sideways against the pound.

Fig. 13: Euro in pound sterling, with moving averages



Source: LSEG, LBBW Research

Franc likely to weaken over the longer term

Franc currently sought as safe haven

For now, the Swiss franc's safe-haven status is likely to remain the dominant factor amid global uncertainty, and franc strength should therefore persist. Over the longer term, we expect other factors to come back to the fore, especially as the Swiss currency is trading at historically strong levels. Its interest-rate disadvantage versus the single currency should continue to widen. That points to a weaker franc against the euro. Over a longer horizon, we therefore expect the franc to depreciate. Parity, however, is likely to remain out of reach for the foreseeable future.

Bank of Japan supports the yen

BoJ seeks a firmer yen

At present, expectations that U.S. policy rates may even rise again are weighing on the Japanese currency. They have led to sustained yen weakness. After the latest foreign-exchange interventions to support the yen against the U.S. dollar failed to have an effect, the Bank of Japan has now finally raised its policy rate by 25 basis points to 1.00% and announced that it will raise rates further. After the long period of weakness, this should give the yen some renewed support over the medium term against both the U.S. dollar and the euro.

08 | Equities

AI hopes trump geopolitics

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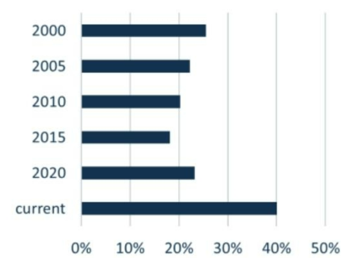
Geostrategically, the United States have suffered a debacle in the Persian Gulf and are now struggling to restore the status quo ante. In artificial intelligence, however, America remains at the forefront. And in the first half of the year, that theme allowed stock markets to look past the burdens imposed by the war. In the second quarter, the AI rally pulled ever more stocks upward in its wake – companies that benefit, or might benefit, directly or indirectly from the construction and equipping of vast data centers: semiconductors and their production, power supply, networking, specialty materials and more.

AI rally keeps broadening

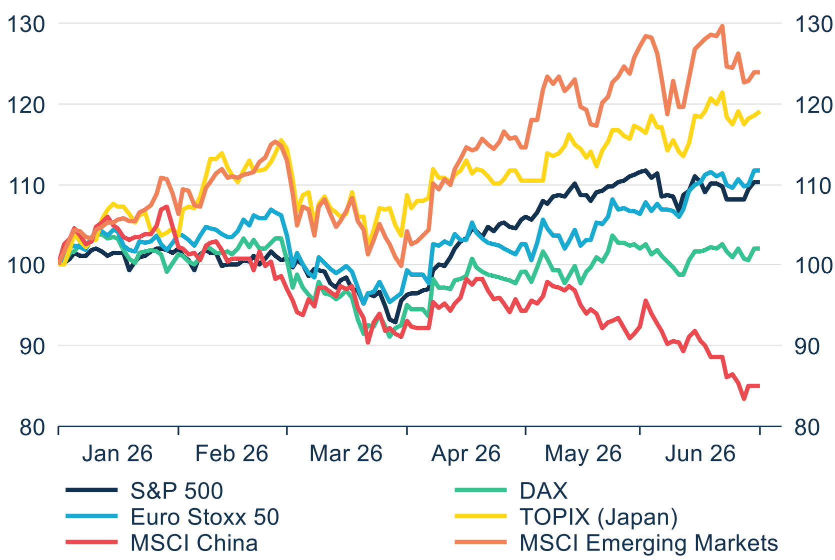
To us, this looks like the closing fireworks of the AI boom. The parallels with developments around 2000 are hard to miss. Back then, half of Europe's market capitalization was tied up in mobile-communications stocks, while on Wall Street investors piled into anything to do with computers and the internet. Such one-sidedness was a clear warning sign. Yet today the concentration of market value in a small number of stocks has reached another dimension altogether: 40% of the S&P 500 is accounted for by its ten largest constituents (see fig. 15). Even if artificial intelligence is beginning to permeate economic life, this has little left to do with the stock market as a mirror of the economy.

Fig. 15: Share of the top ten stocks in the S&P 500
in %



Source: LSEG, LBBW Research

Fig. 14: Equity markets since the start of the year
indexed to 100, in local currency



Source: LSEG, LBBW Research

AI investments as a big bet on the future

Profitability of AI investments in question

So far, the protagonists of the AI boom have broadly met market expectations in terms of earnings. The IT giants even account for the lion's share of profit growth among U.S. companies. Yet only a smaller part of their profits comes from AI applications. Most of their earnings are generated in areas such as internet advertising and digital services. The massive build-out of capacity is therefore a bet on the future, one that will pay off only if computing power remains scarce. From a business perspective, the immense investments will have to be depreciated relatively quickly, which will weigh on balance sheets. And with their extreme demand, the big operators have driven up prices for chips and processors, a development reflected in the strong performance of emerging-market indices. In the MSCI Emerging Markets index, the stock markets of South Korea and Taiwan, with their semiconductor industries, carry heavy weights.

Consolidation ahead

During the Iran war, investors regained their confidence fairly quickly. Prices were already rising after the ceasefire, and once the U.S. and Iranian leaderships agreed on their memorandum, markets ticked off the war as an issue. From this direction, however, there can now be no more positive surprises. The same applies to the economy, the geopolitical constellation and the interest-rate backdrop. The signals no longer point to cuts, but to increases. As companies increasingly finance AI investments with debt rather than from cash flows, tighter capital conditions pose a risk to the boom. And on the equity side, too, the balance between demand and supply is deteriorating. With SpaceX, the first mega-issuance has been successfully completed; next in line are the AI companies Anthropic and OpenAI. Placing these multibillion-dollar amounts will require fresh capital. And once lock-up periods expire, further share blocks, in even larger volumes, are likely to come to market.

Liquidity is now becoming scarcer

Take profits selectively

The risk-reward profile on stock markets has therefore deteriorated markedly. Trying to predict the timing and scale of a correction precisely, however, would be presumptuous. We would therefore take profits selectively and tend to underweight equities. There are early signs on stock markets of a rotation in leadership: capital is flowing out of the heavily weighted stars and more broadly back into the market. The polarization described above is likely to level out again.

Market leadership is starting to shift

Selectivity remains the key. We see opportunities in financials and in defensive sectors such as telecommunications and health care. High-earning oil and gas stocks can serve as a hedge against a renewed flare-up of the Iran conflict.

A correction in the AI rally would hit the U.S. harder than Europe, which is why we prefer the Old World. Domestic markets are also valued far more modestly. We would also take profits in the sharply risen Japanese market, which has likewise benefited from the chip-industry boom. By contrast, we would hold on to emerging markets outside China. After years of underperformance (see fig. 14), they offer the chance of a fundamental re-rating, including from a geopolitical perspective. The economies in this group continue to show above-average growth. Only the stock markets of South Korea and Taiwan have already performed strongly; other markets, such as India, have lagged behind.

Emerging markets still offer opportunities

09 |

Real Estate

Recovery with reservations

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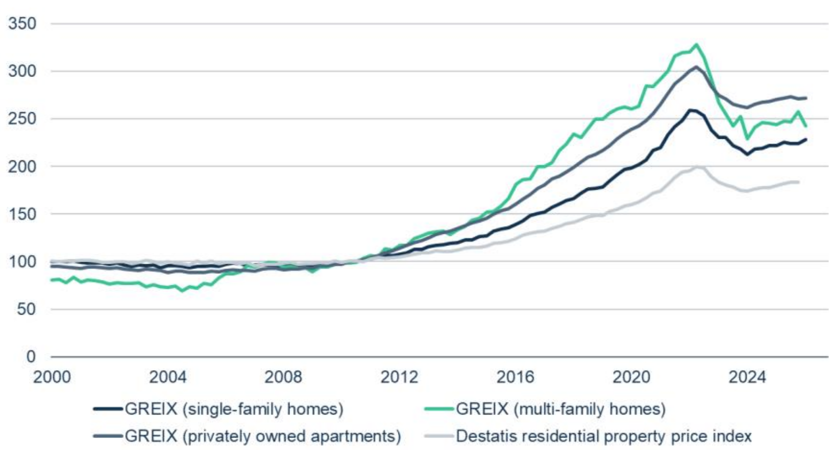
Prices in the residential real-estate market continued to rise at the start of this year. Recently, however, momentum has weakened markedly. Overall, the market remains in an upswing, but is once again struggling with less favorable conditions.

According to the German Real Estate Index (GREIX, see fig. 16), house-price trends have differed substantially by segment in recent years. One thing unites all residential-property sectors: their respective cyclical highs from the beginning of the decade remain a long way off (fig. x). Condominiums and single-family homes are still 11% and 12%, respectively, below their peaks. For apartment buildings, the gap is as much as 26%. In a short-term view, however, this segment is less informative because the sample size is relatively small. Overall, single-family homes have recently been the main driver of price developments. For condominiums, momentum has slowed significantly. We are maintaining our forecast of a 3% to 4% price increase for this year. Yet the current dynamics point more to a development at the lower end of that range.

Real-estate prices keep rising

Fig. 16: German Real Estate Index (GREIX)
(2010 = 100)



Source: Destatis, ECONtribute, IfW, LBBW Research

Residential-property prices: decline from the respective cyclical peak to the first quarter of 2026

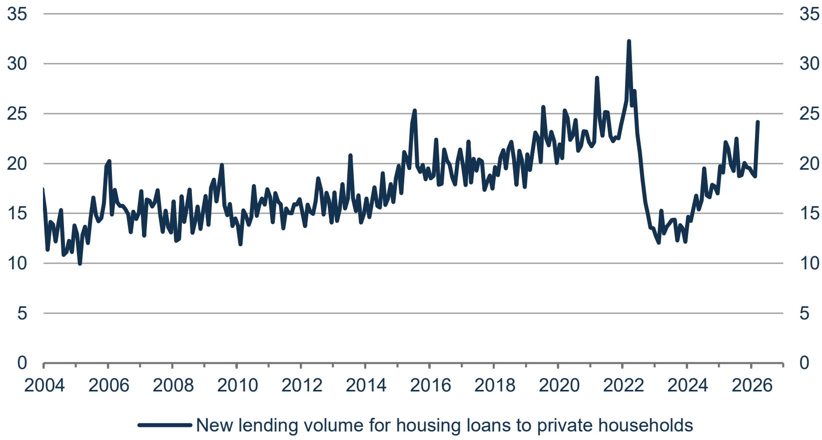
SFH	MFB	Condo
-12 %	-26 %	-11 %

Housing shortage persists

On the financing side in particular, there is currently little hope of a rapid return to pre-crisis levels. In the first three months of this year, the volume of new residential construction loans rose by just 1.5% compared with the same period last year. The fact that there was any increase at all was due to an unusually strong rise in March. At more than EUR 24bn, it marked the highest monthly figure in almost four years (fig. 17). It seems likely that many private households were gripped by a last-call panic: the outbreak of the Iran war drove up the prices of many goods and services. Against this backdrop, securing what were still perceived as low interest rates became the order of the day.

Little growth in new residential construction loans

Fig. 17: Residential construction loans to private households
(New business in EUR bn per month)



Source: Deutsche Bundesbank, LBBW Research

2026: Strong March saves the first quarter

Interest rates continue to rise

Interest rates: No turnaround in sight for now

The difficulties on the refinancing side are becoming more acute. Already over the course of last year, many became convinced that mortgage rates would not return to their low pre-Covid levels any time soon. By now, it would count as a success if rates merely held at their current level. In the wake of expansionary fiscal policy in the euro area – not least in Germany – coupons on government bonds rose sharply year on year. Experience shows that mortgage rates track Bund yields very closely (see fig. 18). We expect rates not to fall below their current level for the foreseeable future. For now, a mortgage rate above 4% remains the norm.

Fig. 18: Effective interest rates on residential construction loans compared with the yield on ten-year Bunds
(in %, volume-weighted average rate)

Source: Bundesbank, LSEG, LBBW Research

Bund yields drive mortgage rates

Commercial real estate remains badly bruised

German commercial real estate stuck in crisis

Germany's commercial real-estate market has been struggling for some time to stabilize. It has not done so convincingly. Rents in the commercial segment and prices for buildings and properties are no longer falling across the board; on the surface, some upward tendencies can even be discerned. Yet the picture is shaped by developments in selected subsegments and narrowly defined regions. Moreover, the clouds have darkened in recent weeks: the Iran war has further clouded the economic outlook, especially for the logistics sector.

More on this in the latest LBBW Real Estate Quarterly.

10 | Commodities

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Oil prices highly volatile

The Iran war triggered a sharp rally in oil prices from late February. The closure of the Strait of Hormuz caused substantial disruption to oil supply. Accordingly, the price of Brent climbed by around USD 50 within a few weeks, reaching its highest level since mid-2022. But as the warring parties moved closer together and hopes grew for an imminent normalization of oil trade, the price fell back just as quickly in June (Fig. 19).

Fig. 19: Iran war temporarily triggers oil rally

Source: LSEG, LBBW Research

Brent climbed to almost USD 120 in March

Large supply deficit in the second quarter

From late February to late May, oil supply fell by around 13.5m barrels per day (mbpd). Although roughly 20 mbpd of oil and oil products normally pass through the Strait of Hormuz, several effects helped limit the supply shortfall. Some Gulf states began using alternative export routes. Oil exports also rose from countries such as the U.S., Kazakhstan, Russia and Brazil. Finally, the release of strategic reserves – 400m barrels – by IEA member states in March eased conditions in the oil market somewhat. On balance, oil supply in the second quarter is likely to have been around 94.5 mbpd. However, oil demand has also fallen significantly since the outbreak of the war. In the second quarter of 2026, oil consumption is likely to have declined by around 5 mbpd versus 2025, to just under 99 mbpd. This implies an oil-market supply deficit of a little over 4 mbpd in the second quarter.

Oil supply falls to its lowest level in five years

Outlook: Supply surplus from the fourth quarter

As a result of conservation measures introduced in response to the Iran war and the weak global economy, oil demand in 2026 is expected to fall by an average of 0.9 mbpd from the previous year, to about 103.5 mbpd. Supply, however, will decline by almost 4 mbpd to a little over 102 mbpd because of the months-long closure of the Strait of Hormuz. In the second half of 2026, oil demand should recover and rise by around

A relatively large supply surplus is likely in 2027

4 mbpd compared with the first half. Supply, however, is expected to increase even more strongly, by 6.5 mbpd versus the first half of the year. For the final quarter of 2026, we again expect a supply surplus in the oil market, which is likely to widen further in 2027. Against this backdrop, Brent has little upside potential. By mid-2027, the price is likely to be around USD 70 per barrel.

Iran war halts gold rally

The gold price set a new record of almost USD 5,600 in January 2026. After that, the Iran war created strong headwinds for the precious metal (Fig. 20). For one thing, the war drove energy prices sharply higher, lifting inflation expectations and making future U.S. rate cuts less likely. For another, market participants' risk aversion increased, prompting them to unwind gold investments in favor of greater liquidity. Finally, the U.S. dollar has appreciated since the war began, making gold purchases more expensive outside the U.S. currency area.

Fig. 20: Gold reaches all-time high in January

Source: LSEG, LBBW Research

Gold is now more than 25% below its all-time high

Outlook: Upward trend not yet over

The lifting of the blockade of the Strait of Hormuz is the precondition for gold to return to an upward trend. As energy prices fall and inflation concerns recede, sentiment toward gold should improve markedly again. Rising gold prices are also supported by solid demand for coins and bars, a sluggish supply side in the gold market, a likely depreciation of the U.S. dollar and, last but not least, rising gold demand from cryptocurrencies. However, chronically weak jewelry demand and central banks' relative restraint in adding to their gold reserves are likely to curb the momentum of any gold rise in the coming months. U.S. policy remains a source of uncertainty and will probably continue to spring the occasional surprise on markets – meaning the precious metal should remain in demand as a safe haven. Against this backdrop, gold should again have upside potential from current levels.

Mid-2027 forecast: USD 4,600 per ounce of gold

11 |

Research Forecasts

Economy					
		2024	2025	2026e	2027e
Germany	GDP	-0.5	0.4	0.5	0.8
	Inflation	2.3	2.2	2.7	2.3
Euro Area	GDP	0.9	1.5	0.8	1.0
	Inflation	2.4	2.1	2.9	2.4
USA	GDP	2.8	2.1	2.2	1.6
	Inflation	3.0	2.7	3.6	2.2
China	GDP	5.0	3.7	3.5	3.2
	Inflation	0.2	0.0	1.2	1.5
World	GDP	3.2	3.3	2.7	2.8
	Inflation	3.5	3.4	3.8	3.0

Interest Rates and Spreads				
	Spot	09/30/26	12/31/26	06/30/27
ECB Deposit Rate	2.25	2.50	2.50	2.50
Bund 10 Years	2.99	3.00	3.10	3.20
Fed Funds	3.75	3.75	3.75	3.75
Treasury 10 Years	4.54	4.40	4.50	4.55
BBB Bundspread (bps)	89	100	110	120

Equity Markets				
	Spot	09/30/26	12/31/26	06/30/27
DAX	25 465	25 000	25 500	26 500
Euro Stoxx 50	6 320	6 200	6 300	6 400
S&P 500	7 504	7 300	7 500	7 800
Nikkei	68 257	65 000	66 000	67 000

Currencies and Commodities				
	Spot	09/30/26	12/31/26	06/30/27
US-Dollar per Euro	1.14	1.17	1.18	1.19
Swiss Franc per Euro	0.92	0.92	0.93	0.94
Pound per Euro	0.85	0.85	0.85	0.85
Gold (USD/Troy Ounce)	4 149	4 200	4 400	4 600
Oil (Brent - USD/Barrel)	72	80	75	70

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