

Global Mid-Year Outlook 2025

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LAZARD

Cause and Effect

In his first six months in office, President Donald Trump delivered on his campaign pledges to upend US domestic and foreign policies with significant global ramifications. To date, key macroeconomic and earnings indicators have given only early glimpses of the consequences of these policy changes—but going forward, the impacts on inflation, employment, gross domestic product (GDP), and corporate profitability are likely to become more pronounced.

- The United States entered 2025 on strong footing with decelerating inflation, a resilient economy and labor market, and a lead in artificial intelligence. Looking forward, however, the US economy is likely to drift in a stagflationary direction, with higher inflation and slower GDP growth through 2026.
- China is in the fifth year of a real estate crisis, and absent major fiscal stimulus, GDP growth is likely to decelerate further with deflation becoming more entrenched, creating longer-term systemic risks. Unfortunately, I am not optimistic regarding the likelihood of China addressing these issues.
- The Eurozone appeared poised for better growth this year but will likely suffer marginally near term from US trade policy shifts. Fortunately, US security policy changes have triggered a German fiscal inflection, while the European Central Bank (ECB) has materially eased monetary policy.
- Japan's inflation has remained above the 2% target for nearly four years, strengthening the case for a multi-year normalization process. Meanwhile, corporate strategic decision-making increasingly reflects the effects of governance reforms and a more shareholder-friendly takeover code.
- I expect increased volatility through year end across asset classes globally. Across developed markets, government borrowing is likely to increase from already-elevated levels, adding upward pressure to interest rates. With rates likely to stay higher for longer, equity investors could find it more difficult to justify elevated price-to-earnings ratios, especially in the United States.

United States

For investors, the implications of policy changes in the United States—which have been more significant under the Trump administration than under any other modern peer—are not yet fully apparent, but they likely will be in the months ahead. In the first half of 2025, the most important policy announcements were related to trade, geopolitics, and deregulation. The key decisions that will likely affect the economy and markets in the second half of the year will involve trade, immigration, fiscal deficits, and Federal Reserve leadership.

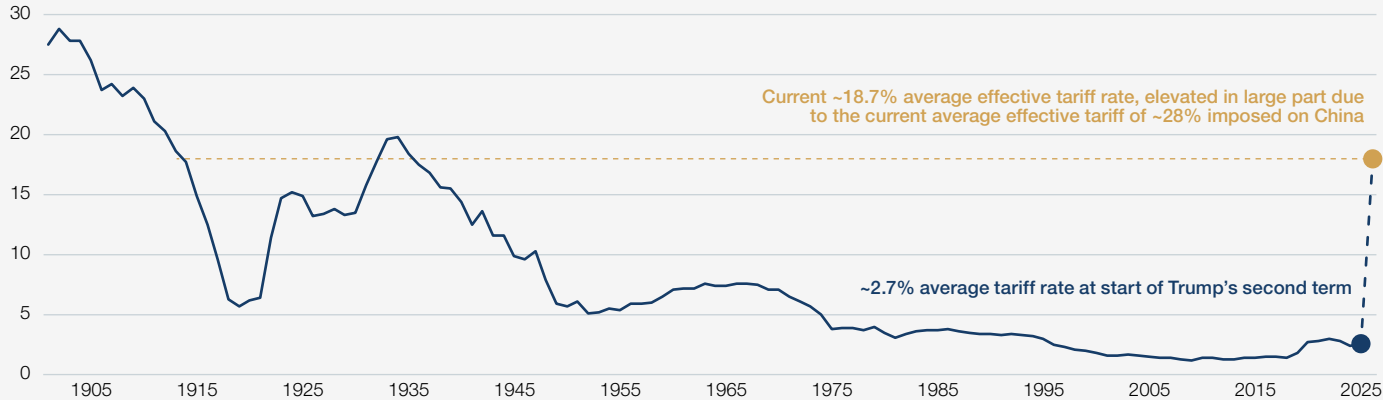
Trade Policy

Since the beginning of 2025, the weighted average tariff imposed on goods imports into the United States has increased from 2.7% to approximately 18.7% as of 11 July, according to Yale Budget Lab (Exhibit 1). Through mid-July, only the United Kingdom, China, and Vietnam have interim trade agreements with the United States, with over 70 other countries either in the queue or in the process of negotiating. The pause on “reciprocal tariffs” ended on 9 July, and the Trump administration has announced tariffs scheduled to go into effect on 1 August that are well above the 10% universal baseline level for numerous countries. Tariffs on goods imports from China are at a reduced level until 12 August. The administration continues to move toward imposing additional tariffs at a sector level including tariffs on pharmaceuticals, semiconductors, lumber, and copper and other critical minerals, with President Trump recently indicating the tariff on copper is likely to be set at 50%.

Exhibit 1.

The Weighted Average US Tariff on Goods Has Increased by ~16 Percentage Points

US Average Effective Tariff Rate on All Imports (%)



As of 11 July 2025

Source: Yale Budget Lab. Actual rates will depend on final policy implementation. The rates displayed on this chart do not factor in substitution effects.



As a rule of thumb, a one percentage point increase in the weighted average tariff typically translates to about 10 basis points (bps) of additional core inflation over time. The tariff impact is not linear: As a tariff increases, it will likely lead to substitution choices whether in terms of the product itself (e.g., if the price of chicken doubles, people might eat more pork instead) or in the source of the good (e.g., production might shift from China to India). As inflation rises, real incomes are likely to decline with negative effects on GDP, employment, and consumer spending.

Determining where tariffs will stabilize is critical for companies and investors as they make supply chain decisions and weigh the relative costs and benefits of US trade policy. In collaboration with Lazard Geopolitical Advisory (LGA), we have developed three scenarios along a continuum of outcomes that we view as most likely vis-à-vis US tariffs (Exhibit 2). In all three scenarios, we expect at minimum a 10% universal tariff to remain in force, as the US administration needs to generate revenue from tariffs to pay for tax cuts included in the recently enacted One Big Beautiful Bill Act (OBBBA).¹ We also expect sectoral tariffs imposed under national security (Section 232) and unfair competition (Section 301) auspices to persist with few exceptions. However, country-specific tariffs could vary significantly.

In the best-case scenario, the Trump administration would determine that all countries should face the 10% tariff except for China, which would endure a higher 20% tariff. In this scenario, we expect that current sectoral tariffs on items such as steel and aluminum and autos and auto parts would remain in place; we would anticipate the additional sectoral tariffs noted above on pharmaceuticals, semiconductors, etc. to be implemented as well. Taking the various tariffs into account, the weighted average tariff applied to all US imports would stabilize below the current level at ~15%. Core Consumer Price Index (CPI) inflation stabilized at ~2.8% from March to May, but we could see core inflation reaccelerate toward 4% by year end in this scenario, with unemployment stable to slightly higher in the 4.0%–4.5% range, and real GDP slowing to ~1%. This scenario

appears increasingly unlikely given the announcements through the month of July regarding country-level reciprocal tariffs.

In the middle scenario, we would anticipate more dispersion in tariff levels across countries, with the United Kingdom, Canada, Mexico, and some other allies subject to 10% tariffs, while the European Union (EU) would face a 15% tariff, and China would endure a 40% tariff. Sectoral tariffs would remain in place, and the weighted average tariff on all goods imports would stabilize at ~20%. We view this scenario as the most likely. In this case, I would expect core inflation to rise to ~4% or higher, with unemployment potentially rising to 5%, and real GDP growth falling below 1.0%.

In the worse-case scenario, negotiations regarding “reciprocal tariffs” would be derailed, leading to a more extreme dispersion from 10% tariffs on some of the United States’ closest allies; to 20% tariffs on the EU and Japan; and to 60% on Chinese goods imports. Taken together with sectoral tariffs, this would lead to a weighted average tariff in excess of 25%, which would significantly increase the risk of a US recession and a meaningful economic slowdown globally. Core inflation would likely rise above 4% before declining due to the demand-destruction caused by a recession. Unemployment could reach 6%, and real GDP could shrink marginally. Given the severe economic ramifications of the worse-case scenario, we view it as less likely than the middle scenario, but measures announced since the beginning of July suggest that the worse-case scenario might be more likely than the best-case alternative despite the clear incentives to avoid this set of outcomes.

In May, the Court of International Trade ruled that the use of the International Emergency Economic Powers Act (IEEPA) to justify the universal tariff, fentanyl-related tariffs, and other episodic levies was illegal and directed the federal government to roll back tariffs within ten days. That order was subsequently put on hold, and the United States was allowed to continue collecting tariffs. The ultimate outcome of the IEEPA litigation, however, might be

Exhibit 2.

Three Scenarios Appear Most Likely for an “End Game” Outcome

		Scenario 1	Scenario 2	Scenario 3
	US Trade Deficit (\$, bn)	“Best Case” 10% baseline tariff with one exception (%)	“Base Case” 10% baseline tariff with moderate country-level dispersion (%)	“Worse Case” 10% baseline tariff with wide variance (%)
Country/Region				
China	-295	20	40	60
European Union	-236	10	15	20
Mexico	-172	10	10	10
Vietnam	-123	10	25	35
Japan	-68	10	15	20
Canada	-63	10	10	10
United Kingdom	+12	10	10	10
All Others	–	10	10	15
US Avg. Effective Tariff Rate*		~15	~20	~25
Potential Impact		Stagflation A slump in growth is likely alongside an uptick in inflation, but the economy adjusts and avoids recession.	Recession Narrowly Averted Growth stagnates and inflation spikes, especially in China-dependent supply chains.	Recession Likely Growth declines, inflation increases, and the risk of financial stress rises, especially in the United States and China.

As of 31 December 2024

Source: Lazard

* Tariff rates reflect Lazard estimates based on 2024 trade data. Inclusive of preexisting tariffs and new 2025 rates.

less consequential than it appears, as the President has the authority under Sections 122, 232, 301, and 338 to impose tariffs. While each legal statute carries its own requirements, our expectation is that the Trump administration will ultimately impose the tariffs it desires whether under the auspices of IEEPA or other statutes.

Tariff-induced inflation is a one-time event that will “drop out” of the numbers after one year, but given the elevated inflation of recent years, there is a risk that workers will demand higher wages to compensate for increased goods prices. It is also true that the prices of domestic alternatives to imported goods tend to increase when tariffs are imposed, as the domestic producers capitalize on the opportunity to add to their profit margins. As a result, investors should not be too sanguine about the potential enduring economic effects of trade policy.

Deporting 1.3 million workers from the United States could raise inflation by 50 to 60 bps.

Immigration Reform

Under the OBBBA, funding for large-scale deportations and more stringent border enforcement could reduce the supply of labor, particularly in industries that depend on immigrants, increasing price pressures.

Though mass deportations of undocumented immigrants will likely take months to accomplish, I believe the economic implications could be material over time. On 15 June, President Trump announced a target of 3,000 arrests per day of undocumented immigrants versus the 650 daily average in the first five months of the administration. If this target is achieved, it would equate to almost 1.1 million deportations—about 200,000 short of the largest-scale deportation in US history in 1954.

In 2026, even while tariff-induced inflation begins to fade, wage pressures are likely to increase due to stricter enforcement of immigration laws. The Peterson Institute for International Economics (PIIE) has estimated that deporting 1.3 million workers from the United States could lower US GDP by over 1.2 percentage points over three years relative to growth in the absence of increased deportations,² and could raise inflation by 50 to 60 bps. The effects would be sharpest for industries that are more dependent on undocumented workers. These include agriculture (where approximately 42% of hired crop farmworkers are estimated to be undocumented), construction (where ~14% of workers are undocumented), and other commercial and retail services (Exhibit 3).

Exhibit 3.

Trump's Proposed Deportation Agenda Could Materially Disrupt Labor Forces across Numerous Sectors

Top 10 Industries for Undocumented Immigrant Workers

#	Industry Group	Approx. Number of Undocumented Immigrant Workers	Undocumented Immigrant Share of Workforce (%)
1	Agriculture*	1,000,000	42.0
2	Construction	1,544,600	13.7
3	Hospitality	1,002,200	7.1
4	General Services	500,800	6.5
5	Wholesale Trade	193,400	5.5
6	Transportation & Warehousing	460,500	5.5
7	Manufacturing	870,400	5.4
8	Professional Services	970,800	4.7
9	Retail Trade	708,500	3.9
10	Mining and Extraction	22,100	3.6

Source: American Immigration Council analysis of the 2022 1-year American Community Survey

* Represents the percentage of hired crop workers according to USDA Economic Research Service, 2021. Of total hired crop workers, 32% are US-born, 7% are immigrants with US citizenship, and 19% are other authorized immigrants.

Fiscal Policy

While trade policy has dominated the news since early February 2025, I expect fiscal policy to become an increasingly important market driver moving forward. In January 2025, the Congressional Budget Office (CBO) forecast \$21.7 trillion of deficits over the next decade assuming current laws remained in place. With the enactment of the OBBBA, deficits over the next decade are likely to rise by an additional \$3.5 to \$5.5 trillion based on estimates from the CBO and the Committee for a Responsible Federal Budget (CRFB) (Exhibit 4). Within the OBBBA, several tax cuts are scheduled to expire in 2028 while key outlay reductions only begin after the midterm elections in 2026. The CRFB estimates that if the temporary revenue reductions are made permanent without offsetting reductions of outlays, the OBBBA could add \$5.5 trillion to deficits through the next decade.

Making matters worse, the January deficit forecast is likely to prove too optimistic. The CBO's estimates assumed the federal funds rate and 3-month Treasury bill rate would average 4.0% and 3.8%, respectively, through 2025, while the 10-year Treasury note yield would average 4.1%. In both cases, actual yields have been higher than expected. At the same time, the CBO assumed real GDP would grow by 2.1% in 2025 versus the current consensus expectation for only 1.5% growth. In total, these divergences will add to deficits as slower economic growth translates to less tax revenue and as higher interest rates lead to larger interest expense. The economic forecast errors could result in deficits being over \$100 billion higher each year if sustained into the future.

While the deficit outlook is disturbing, tariff revenue could reduce these imbalances. Treasury Secretary Scott Bessent has indicated that tariff revenue could exceed \$300 billion per year. After accounting for slower economic growth, higher interest expenses, and tariff revenue, deficits over the next decade could be 50 –75 bps lower than indicated in Exhibit 4. With

the United States moving in a negative direction from a fiscal sustainability perspective, markets are likely to respond. Other developed market governments, including most NATO members, are also likely to run larger deficits in the near- to intermediate-term, increasing the demand for capital in debt markets to fund sovereign deficits.

Federal Reserve Leadership

Against this somewhat downbeat economic backdrop, I expect tensions between the White House and the Fed to escalate. The friction could lead President Trump to nominate a successor to chair the Fed earlier than usual relative to the May 2026 expiration date for Jay Powell's tenure in that role. Trump has verbalized this possibility, setting markets abuzz with speculation regarding potential front-runners to replace Powell.

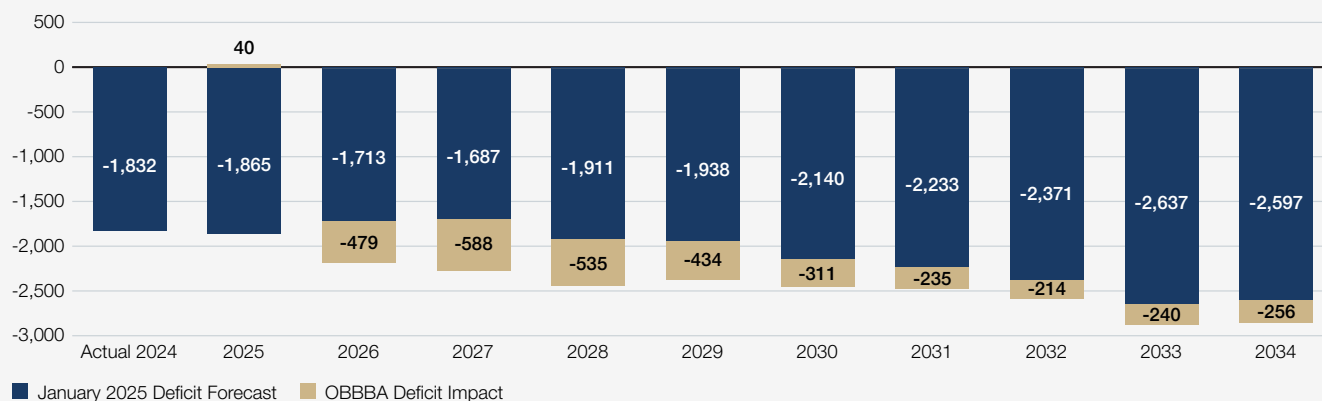
In a world with inflation reaccelerating, growth slowing, and fiscal deficits exceeding 6% of GDP, maintaining confidence in the Fed's independence will be critical to smooth market functioning. While the risk of an extreme shift in Fed policy doctrine appears low, any material shift toward politically influenced Fed decision-making could negatively affect the US dollar and Treasuries.

It is notable that in President Trump's first term, he attempted to reshape Fed decision-making with unorthodox choices, but in each case, his attempts were derailed by Senate opposition. In this term, I suspect the Senate will be much more permissive when it comes to Fed appointments and I worry that a more politically malleable candidate could be confirmed, leading to decreased investor confidence in the Fed's inflation-fighting credibility and accelerating reallocation of capital away from US dollar-denominated assets to other safe alternatives. Arguably, there could already be early signs of such a shift in investor allocations in part due to concerns over US policy changes more broadly, including concerns regarding diminution of Fed independence.

Exhibit 4.

Deficits Are Likely to Exceed 6.5% of GDP Each Year from FY2026 to FY2034 Due to the OBBBA

CBO Budget Deficit Projections (\$B)



Deficit as % of GDP	6.4%	6.1%	7.0%	7.0%	7.2%	6.8%	6.7%	6.5%	6.6%	7.1%	6.7%
Debt held by the public	97.8%	99.8%	103.1%	106.5%	110.1%	112.9%	115.6%	117.8%	120.1%	122.6%	124.8%

As of July 2025

Source: Lazard, Congressional Budget Office, US Treasury Department. Data presented is in fiscal years which end 30 September, e.g., FY2024 ended 30 September 2024.

China's economy is at an important juncture. Policy interventions to date have failed to cement a floor for housing prices and consumer confidence, and excessive reliance on goods exports appears to be threatened due to US trade policy shifts. Companies have been de-risking their supply chains and reducing capital commitments to China, seeking better options in other low-cost production locations. Investors continue waiting for a large fiscal stimulus package and structural reforms, but neither appears to be likely in the immediate future.

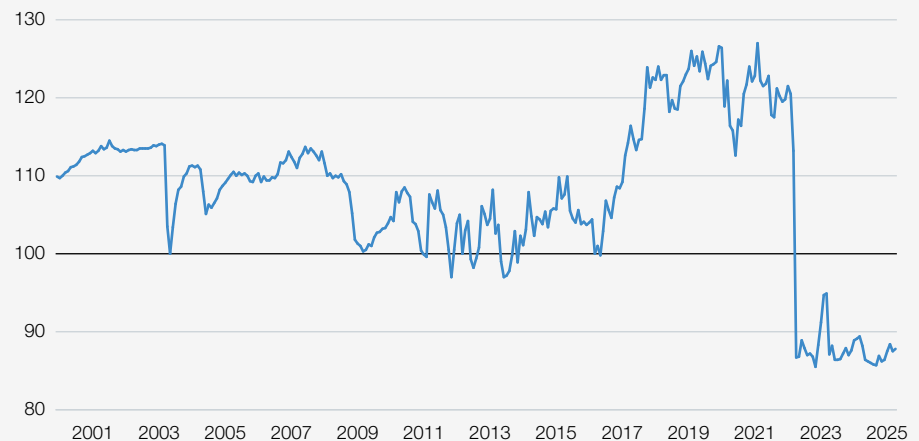
Consumer Confidence and Housing

Consumer confidence remains near record-low levels as the housing crisis is now in its fifth year (Exhibit 5). Previously occupied home prices are down by more than 26% from peak levels in Tier 1 cities, 31% in Tier 2 cities, and 36% in Tier 3 cities according to Beike, a housing data provider in China.³ With the median Chinese household having ~60% of its assets in residential real estate, these price declines are devastating. Chinese consumers have responded rationally by trying to rebuild their assets by saving more of their discretionary income. A higher savings rate is the opposite of what China's economy needs, as excess supplies of manufactured goods continue driving deflation and increasing the country's reliance on exports to sustain current economic activity levels.

Exhibit 5.

Chinese Consumer Confidence Remains Near Record-Low Levels

Survey of Chinese Consumer Confidence (Greater than 100 = Optimistic)



As of April 2025

Source: Bloomberg, Chinese National Bureau of Statistics

Solving the Crisis

To resolve this dilemma, I believe China needs a combination of a large-scale fiscal stimulus program and major structural reforms that appear unlikely to be delivered. In recent years, the central government has announced dozens of stimulus measures, but most have focused on monetary policies aimed at stimulating more borrowing. However, I believe fiscal stimulus focused on incentivizing consumption is needed. The only effective demand-stimulating measures in recent years have been subsidies for consumer durables and for electric vehicle purchases, but these subsidies pull forward demand rather than sustainably increasing it. Instead of one-off temporary incentives to spend, the central government needs to implement enduring policies that encourage households to consume more and save less on a sustained basis. That can likely only be achieved through structural reforms.

The structural reforms needed to accelerate sustainable growth relate to both the social safety net and government funding sources. The social safety net is a glaring issue, with 180 million rural and urban elderly people receiving an average basic pension payment of only RMB240 (~\$33) per month. Many of these people receive even less, as the minimum



payment is only RMB143 per month. Such a miserly payment leaves workers in China struggling to save during their working years to reduce the risk of outliving their savings. China made one step in the right direction late in 2024 by increasing the retirement age for workers, but it should follow this measure by initiating a multi-year, significant increase in pension payments to reduce consumer fears of ending up destitute in retirement.

In 2020, the central government introduced the Three Red Lines policy in part to shrink the bloated property development sector. Unfortunately, local and provincial governments depend heavily on revenue from land sales to property developers for funding. In 2021, revenue from land sales and land-use rights sales accounted for almost 40% of local government revenue. By 2024, property-related revenue had declined to just over 20% of revenue. This level remains too high and volatile to be a reliable funding source for local governments. Property-related revenue peaked at over 30% of income for provincial governments in 2021 but remains high at approximately 20% of receipts today.⁴ For well over a decade, provincial and local governments in China have contemplated shifting to property taxes to fund part of their budgets, but this shift has not occurred on a widespread basis and is unlikely during

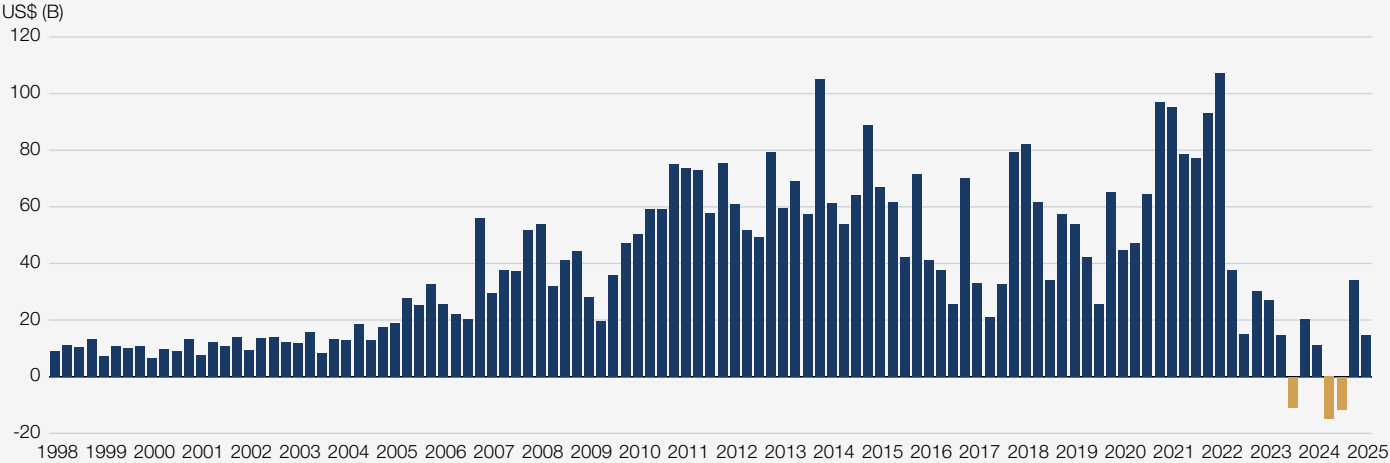
a property crisis. Alternative sources of tax revenue need to be developed to further rebalance the Chinese economy away from excessive dependence on residential real estate development.

On top of the domestic issues emanating from housing, China also faces trade-related headwinds from the US trade war and broadening corporate efforts to de-risk their exposure to China. With a weighted average tariff of 28% now imposed by the United States on exports from China, 15% of Chinese exports have now become less competitive relative to alternative sources.⁵ While some portion of China’s exports to the United States do not have readily available substitutes, e.g., critical minerals, the tariffs are a meaningful headwind to growth.

In part due to the US tensions, and in part due to the difficulty of competing against favored domestic peers, companies have been reallocating capital to other countries. For the twenty years ending in 2021, nearly all foreign direct investment (FDI) into emerging markets went to China. But in three of the last seven quarters, China’s FDI was negative, as companies withdrew more capital than they invested into China (Exhibit 6). I expect this trend to be sustained as companies seek more attractive opportunities elsewhere.

Exhibit 6.

Foreign Direct Investment into China Has Been Negative for Three of the Last Seven Quarters



As of March 2025
Source: Chinese State Administration of Foreign Exchange, Haver Analytics

China has proven to have the upper hand in trade negotiations.

Signs of Potential Stabilization

While I remain negative on China's outlook, there are some recent signs of potential stabilization. After two years of monetary policy easing, total social financing (system-wide credit) has begun to accelerate marginally, with total credit outstanding growing by ~9% in June 2025 versus ~8% in November 2024 according to the People's Bank of China. Chinese consumers are not eager to add to their debt balances, and much of the increase in credit growth has been government-oriented—but to the extent these funds are used to purchase goods and services, it could boost China's lethargic economy.

The sharp escalation in US tariffs on imports from China appeared set to cut China's GDP growth in half in early April, but subsequent negotiations in Geneva and London have reduced the average effective tariff on Chinese goods from a peak of 110%–115% to ~28% according to Yale Budget Lab. Importantly, a material portion of China's exports to the United States are exempt from the country-level tariff as they are instead subject to sectoral tariffs related to steel, aluminum, autos, and auto parts. As the United States rolls out tariffs on semiconductors, pharmaceuticals, copper, and lumber, the weighted tariff applied to US imports from China is likely to rise.

As the US market becomes less hospitable to Chinese exports, goods trade has been redirected to other countries. Some of these exports are likely then shipped to the United States to avoid tariffs, but the ability of other economies to absorb excess supplies of goods produced in China is limited, both economically and politically.

Perhaps most importantly, as it relates to trade, China has proven to have the upper hand in trade negotiations with the United States due in part to its dominance in critical minerals. The United States has been more anxious to reach a deal than China has, as US companies faced the prospect of idling manufacturing facilities in the absence of key inputs from China. As Adam Posen, the President of the Peterson Institute for International Economics, has noted in his article in *Foreign Affairs* in April,⁶ China appears to have “escalation dominance” because of US dependency on a wide array of products only produced in China. This dependency is most evident in the very trade deficit that the Trump administration wishes to narrow.

Through year end, I expect China's growth to remain sluggish. Most economists from major financial institutions have been assuming that a substantial fiscal stimulus package would be introduced to offset the pain of a US trade war, but that package is nowhere to be found. Hence, expectations for 4.5% real GDP growth, the Bloomberg consensus as of 30 June, appear overly optimistic. That said, the prospects of China's economy derailing and entering recession also appear less likely given the US capitulation on trade.

The EU could be on the cusp of a watershed moment. The initial steps are very encouraging, but the metamorphosis from a bureaucratic, risk-averse political union to a dynamic, growth-oriented one will take years. The process gained significant momentum with constitutional changes enacted by Germany in the first half of 2025 which should begin to lift economic activity before year end. In the interim, ECB monetary policy easing should help to mitigate the impact of US tariffs while also reducing financing costs across the region.

German Inflection

The initial German election results in February were disappointing as the new governing coalition fell just short of the majority required to enact major constitutional changes. However, the events that followed were a positive surprise. The fiscal reversal embraced by the new government was unexpected and bold, and it could be transformative for the Eurozone’s prospects.

The new coalition under Chancellor Friedrich Merz enacted a plan to spend €1 trillion on infrastructure and defense over the next 12 years. The agreement adjusted the rules of the German “debt brake” to only count defense spending of up to 1% of GDP against fiscal deficit limits while exempting any additional spending (Exhibit 7). Merz has since indicated an intention to target defense spending of 5% of GDP by 2029 versus the 2.1% in 2024. Within this 5% target, 3.5% of GDP is targeted at narrowly defined defense spending while an additional 1.5% is earmarked for defense-related infrastructure and border security. The reforms also include €500 billion for infrastructure investments, of which €100 billion is dedicated to climate change. The federal government also adjusted the rules to allow states to run deficits of up to 0.35% of GDP versus the prior zero allowance, which will lead to incremental stimulus on top of federal spending. The changes agreed in Germany could lead to an increase in borrowing and spending of over €115 billion per year (~2.6% of GDP). Even with this additional borrowing, the debt-to-GDP ratio would likely only rise from 63% in 2024 to 70%–75% by 2030.

Exhibit 7.

The Magnitude of Germany's Fiscal Reversal Appears Underappreciated

Measure	Details
Reform Debt Brake Calculation	<ul style="list-style-type: none">• New calculation excludes defense spending > 1% of GDP from debt brake calculation• New German defense spending commitments could equate to between €60–€120 billion per year above current levels
Create €500 Billion Infrastructure Fund	<ul style="list-style-type: none">• Fund to be spent over 12 years (~€42 billion per year of additional infrastructure spending)• €100 billion targeted toward energy transition and €100 billion for Länder (German federal states) and municipalities
Länder Debt Limit	<ul style="list-style-type: none">• Länder now allowed to take on debt of up to 0.35% of GDP per year (~€15 billion)

As of July 2025
Source: Kiel Institute for the World Economy, PIIE

The effects could be far-reaching, as Europe seeks to develop defense capabilities independent of the United States. Taken alongside the ReArm Europe Initiative, which will allow for common debt issuance of up to €150 billion and use of a fiscal escape clause to allow more defense spending across the EU, these measures could lead to sizable increases in European military spending.

Increased government spending on its own does not increase my economic optimism, but in this case, I believe markets might underappreciate the multiplier effects that can result from higher defense spending if, and only if, it is implemented properly. To the extent European defense spending is focused on technological innovation and capabilities, it can lead to other economic advances. In the United States, the Defense Advanced Research Projects Agency (DARPA) has provided critical funding that led to the invention of the internet, Global Positioning System (GPS), semiconductors, voice recognition, autonomous vehicles, and more. In many areas where the United States is a technological leader, DARPA was involved in early-stage, high-risk funding. To the extent Europe can unify across national borders and create a peer to DARPA, higher defense spending could help narrow the innovation gap with the United States.

Defense spending will not only lead to potential innovation breakthroughs. It could also absorb excess manufacturing capacity. For example, media have reported that Rheinmetall has contemplated acquiring Volkswagen's Osnabrück car factory to produce armored personnel carriers. While no agreement has been finalized, examples such as this could help accommodate workers at risk of being idled due to decreased demand for European vehicles while also reducing the cost and time to begin producing needed military equipment.

A Multi-Year Metamorphosis

But this task will require many more steps beyond higher German deficits, fiscal escape clauses, and joint debt issuance. Europe will have to overcome nationalistic inertia to act as a single economic unit. Capital markets union will be a key element of increasing the availability of funding to companies while joint procurement will also be important to ensure the most efficient use of government money. As one example, Europe currently is developing two sixth-generation fighter jets to reduce dependence on the United States. One is being

developed by France, Germany, and Spain, while the other is being developed by the United Kingdom, Italy, and Japan. Such duplication makes little sense when economies of scale are critical to reducing per-unit costs. In the same vein, Bruegel has analyzed the cost of developing a modern tank and found that Germany spends €29 million for each Leopard 2A8 tank versus €17.6 million for each US M1A2 Abrams tank, and €4.2 million for each Russian T-90 tank.

To state the obvious, the goal is to maximize defensive capabilities, not to maximize defense spending. If Europe is going to build a credible defense capability, it will need to put aside nationalistic sentiments and collaborate to accelerate production at the lowest cost.

The ECB Can Help Ease the Way

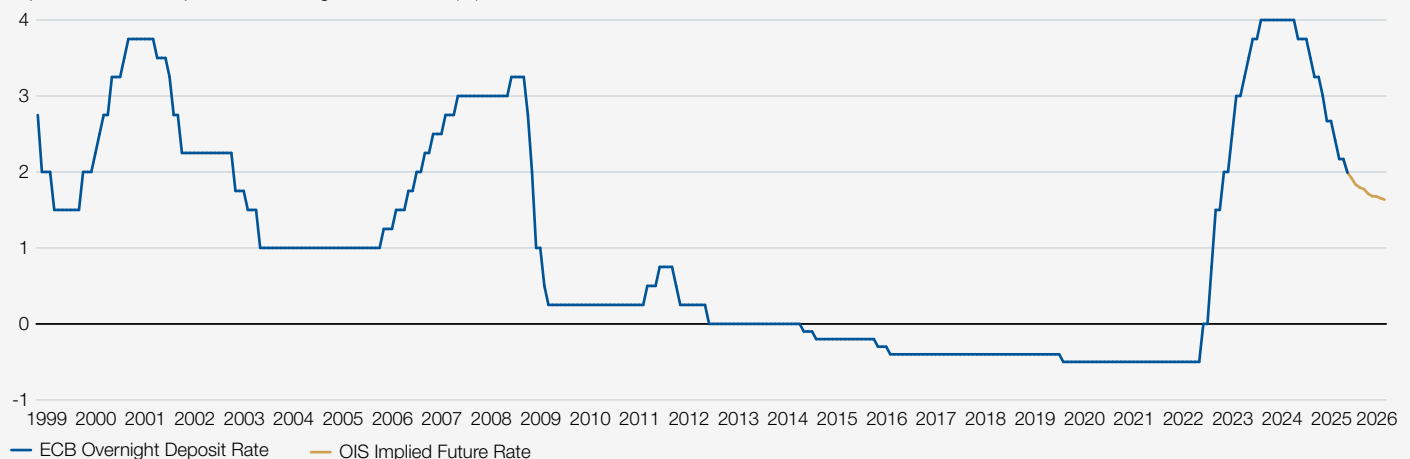
Fortunately, defense and infrastructure spending are not the only positive catalysts for Eurozone growth. The ECB has now cut interest rates by 200 bps, reducing financing rates for corporate and mortgage borrowers and leading to an upturn in lending volumes. At the same time, inflation has receded to levels approximating the ECB's 2% target while wage growth is sustainably exceeding price increases to deliver real compensation growth. I expect one more rate cut by the ECB, versus market expectations for only 16 bps of easing by year end (Exhibit 8). My more dovish outlook is premised on my expectation for above-consensus US tariffs on goods from the EU with a more negative near-term impact on growth. Slower growth combined with lower inflation (due to falling energy prices and a stronger euro) should give the ECB more latitude to ease rates further.

The improving economic backdrop was becoming more evident before the US election in November with consumer confidence rebounding sharply from post-Ukraine invasion lows. After a brief dip, confidence has begun to recover again, and I expect to see ongoing economic acceleration moving into 2026.

Exhibit 8.

Markets Appear to Be Underestimating the Magnitude of ECB Rate Cuts

Implied Eurozone Deposit Rate through March 2026 (%)



As of 30 June 2025

Source: Bloomberg. Markets imply a 4% chance of a 25-bps rate cut at the July meeting and a 47% chance of an additional 25-bps cut at the September meeting.

The Japanese economy might also be at an inflection point. Inflation has normalized over the last four years, leading to a major shift in consumer psychology. Corporate governance and takeover code changes have forced companies to think of shareholders among their top priorities. Households, in response to inflation, are reallocating their assets away from non-interest-bearing assets like currency and deposits toward riskier options like equities. Taken together, this could be the beginning of a long-term improvement story for Japanese companies and their investors.

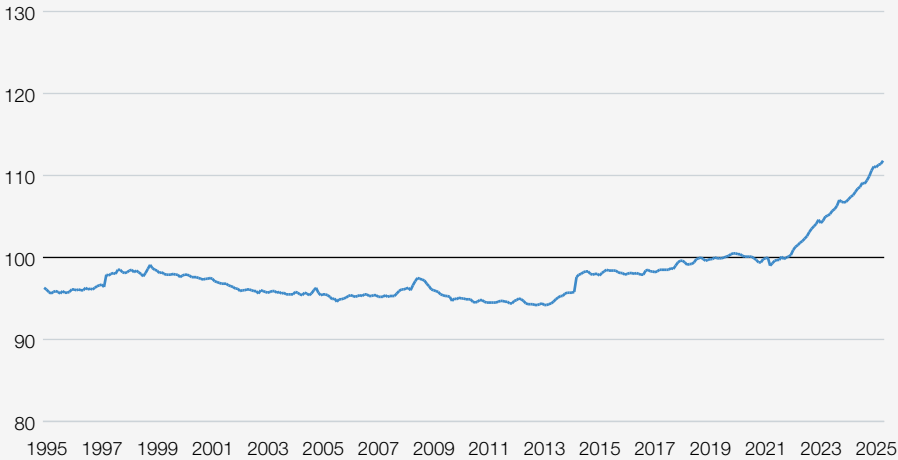
Inflation Normalization

Over the 22 years ending in 2021, inflation in Japan increased by a total of 1% (Exhibit 9). Since the end of 2021, prices are up 11.9% or a 3.3% compounded annual rate. The abrupt shift in the inflationary backdrop has upended Japanese price assumptions and wage demands. Inflation drivers have varied—from imported inflation due to a weakening Japanese yen to price increases for rice in the last year—but regardless of the source, for consumers, the world has changed.

Exhibit 9.

After Decades of Price Stability, Inflation Took Off since Late 2021

Japan General Consumer Price Index (SA, 2020 = 100)



As of May 2025

Source: Haver Analytics, Japan Ministry of Internal Affairs and Communications



As a result of accelerating inflation, workers have demanded much higher compensation increases, with the most recent *shunto* negotiations—the negotiations that take place each spring between labor unions and employers—delivering the largest wage gains for workers since the early 1990s. As wages increase, these cost pressures are leading companies to increase prices on goods and services while incentivizing them to invest more in productivity-enhancing capital expenditures. Over time, despite abysmal demographics and high government debt burdens, I believe Japan can sustain inflation and definitively break the deflation mindset.

Corporate Governance and Takeover Code Reforms

Meanwhile, Japan’s corporate governance evolution continues to gain momentum. Admittedly, I want to say “revolution,” but this is still Japan, and change can occur slowly. That said, enduring progress is often best achieved through incremental reforms that allow society to acclimate to the changed environment. I see that process as being well underway in Japan.

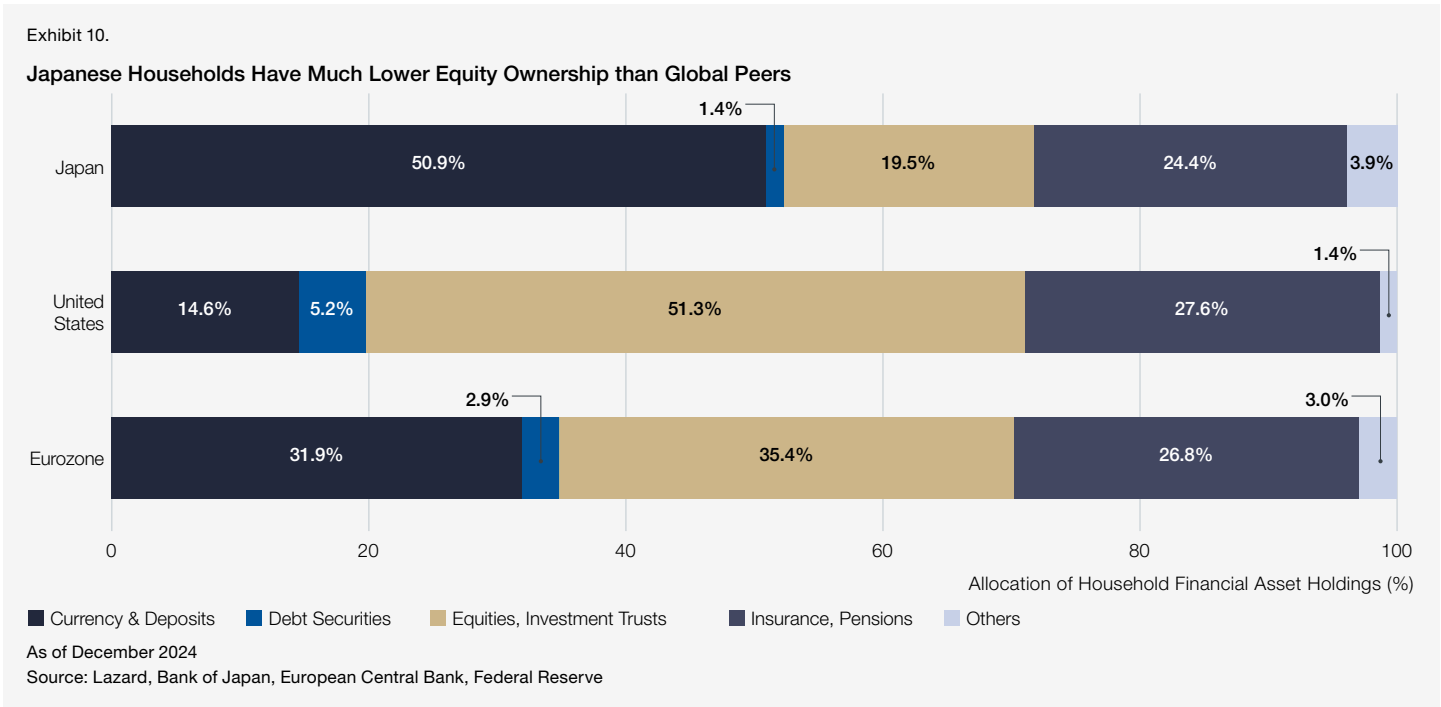
The capital optimization story in Japan began in 2012 but did not gain meaningful momentum until 2023, when the Tokyo Stock Exchange (TSE) issued a policy called “Action on Cost of Capital-Conscious Management and Other Requests.” The TSE guideline required companies whose share prices traded at or below book value for a sustained period to develop capital allocation plans to remedy the situation. By early 2025, over 90% of Prime-listed companies—that is, the major Japanese companies listed on TSE’s Prime Market—had complied with this new guideline and share buybacks and dividends had reached record levels.

In August 2023, the Ministry of Economy, Trade, and Industry released new corporate governance rules requiring companies to better align with global standards when assessing takeover bids. The new policy, “Guidelines for Corporate Takeovers—Enhancing Corporate Value and Securing Shareholders’ Interests,” required companies that receive unsolicited bids to disclose them, be transparent about the bid evaluation process, and fully consider shareholder interests when considering an offer.

These measures, in my view, could represent a positive turning point for Japanese companies’ returns on capital and the broader equity market. Make no mistake: Not every company will embrace good governance principles or manage capital effectively. But for investors, the new rules are likely to present opportunities to identify companies with management teams that are focused on improving returns on capital that then lead to improved share price performance.

Household Financial Asset Allocation

Even while Japanese companies are being pressured to improve their capital management and governance, sustained high inflation is leading to shifts in household financial asset allocation. As of August 2022, 55.2% of Japanese household financial assets were allocated to currency and bank deposit holdings while only 14.2% was invested in equities and investment trusts. As of the end of 2024, these allocations had shifted to 50.9% in currency and bank deposits and 19.5% to equities and investment trusts (Exhibit 10). I expect this reallocation of assets to continue as Japanese consumers recognize that the era of zero inflation has ended. Despite the progress in increasing capital allocations to riskier assets, Japanese households still fall far short of other developed market peers in terms of ownership of equities which suggests significant additional runway for further additions to ownership of higher risk and return assets.



Geopolitical Considerations

Policy decisions are a key source of uncertainty globally, with the potential impact of aggressive US trade policies representing the biggest divergence between my expectations and those of the market. However, geopolitical issues also pose threats (but few opportunities) to the outlook.

As of the date of publication, the world remains focused on two geopolitical hot spots. The Russia-Ukraine conflict is now in its third year, with growing casualty figures on both sides amid a grinding war of attrition. At the same time, Israel and Iran have agreed to a fragile ceasefire that falls well short of a peace agreement, and Israeli operations in Gaza remain underway. While movement in the Ukraine crisis remains at a glacial pace, both this conflict and the Middle East conflict could easily expand and escalate quickly.

While navigating a perilous geopolitical landscape, the United States has also introduced uncertainty into global relations with allies and adversaries. As a positive result, US pressure on NATO allies appears to have culminated in a commitment to increase defense spending to 5% of GDP from 2% across the non-US members of NATO. Higher defense spending is likely to deliver growth benefits to non-US NATO members, but it also likely means larger fiscal deficits.

A more negative shift relates to the United States' commitment to defending its allies. Partly as a result of US commentary regarding NATO treaty obligations, I would argue that other non-NATO countries are likely to increasingly question their ability to rely on the United States for a defense umbrella in the event of a crisis. For example, in the case of Taiwan, President Joseph Biden, indicated a clear commitment to defending Taiwan, leaving little doubt in Beijing about US intentions. Under President Trump, on the other hand, the messaging is not so clear. Key cabinet members are aggressively pro-Taiwan and would likely advocate defending its independence, but President Trump has openly questioned why the United States would defend Taiwan and whether it could possibly succeed.

If the goal of deterrence is to avoid conflict by convincing your adversary of your absolute willingness to fight, the power of US deterrence has almost certainly faded recently. This means the risk of conflict has likely increased as adversaries question US commitment and recalibrate their assessments of risk and reward related to territorial or other conquests.

Investment Implications

Since 2025 began, global GDP growth expectations have been downgraded, US inflation forecasts have increased, and rate curves have steepened. Making matters worse, geopolitical instability has worsened with another kinetic Middle Eastern conflict. For investors, the backdrop of uncertainty is likely to persist. Not only will they have to juggle concerns about US trade, immigration, fiscal, and Fed leadership decisions; they will also have to contemplate an increasingly dangerous geopolitical backdrop whether it relates to active wars or the potential for much more economically consequential potential future conflicts.

Exhibit 11.

Despite a Deteriorating Economic and Geopolitical Backdrop, Global Equities Have Been Resilient YTD

Index Performance (1 January 2025 = 100)



As of 30 June 2025
Source: Bloomberg

Remarkable Resilience So Far

Despite the significant policy shifts so far this year, equity markets have reached new all-time highs. An investor who slept through the first half would be forgiven for thinking the world became a more peaceful, predictable place with many markets such as the KOSPI in Korea and the DAX in Germany delivering double-digit percentage gains while the US, Japan, and China largely treaded water on a point-to-point basis (Exhibit 11).

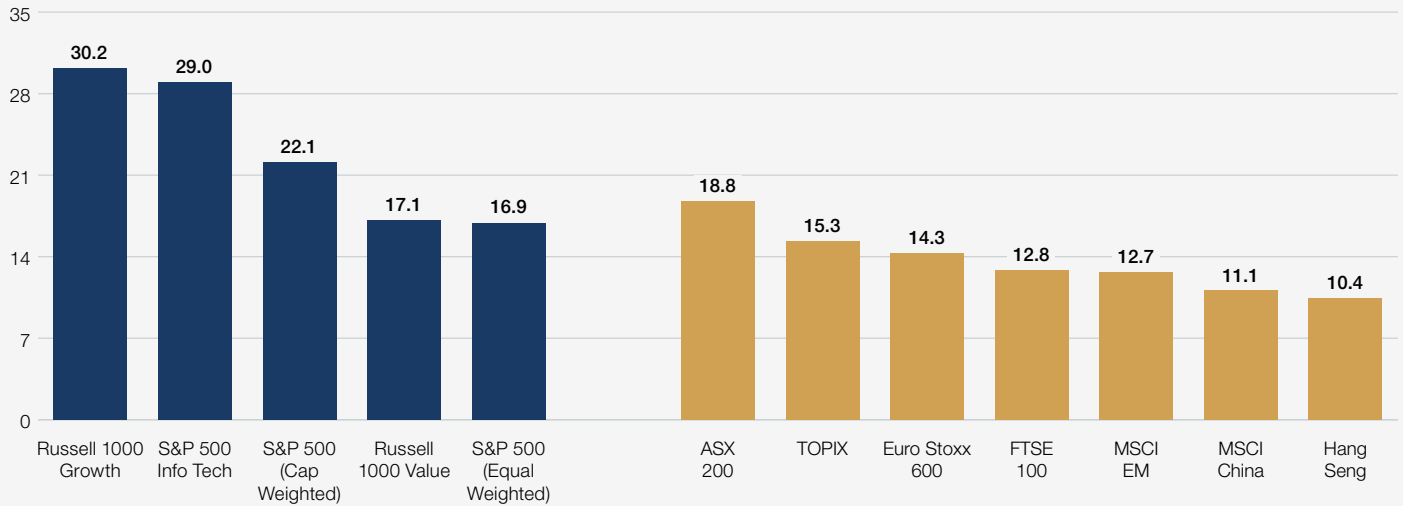
Policy Changes Should Soon Be Reflected in Data

Looking forward, I expect the consequences of US policy changes to become more apparent in US economic and corporate profit data. Higher inflation, slower growth, and weaker consumption are likely to lead to reduced earnings estimates in more directly affected sectors while sustained high interest rates could pressure stretched US valuation multiples. Outside of the United States, valuations are less demanding, and in many cases, the economic direction of travel is positive. This could lead to sustained outperformance of non-US equities after over a decade of significant underperformance (Exhibit 12). Indeed, many investors globally are rightfully questioning if now is when American exceptionalism reaches an end point and contemplating whether and how much capital to reallocate to other options. Although timing tops and bottoms is extremely difficult, it is wise to assess when a trend might be nearing an end.

Exhibit 12.

US Equities' Premium Valuations Leave Little Room for Error

Forward US and non-US P/E multiples listed from highest to lowest



As of 30 June 2025

Source: Bloomberg

This is not to say that I am bearish on US equities. Instead, my point is that the drivers of US outperformance are waning while other markets are beginning to offer more reasons for optimism. Successful investing often requires the ability to recognize whether a country or company is moving in a positive or negative direction in terms of growth. I would argue that the United States started from a clearly superior position but has become less predictable

and in some cases has enacted policies that are negative for its competitiveness and future returns. At the same time, the Eurozone and Japan, in very different ways, appear to be beginning to address some—but by no means all—of the challenges that have limited growth and shareholder returns in the past. If this positive shift is sustained, we could be at the very early stages of better economic and market outcomes in these regions.

Conclusion

As the United States becomes less predictable, Europe is becoming invigorated to make important structural changes that could lead to a more dynamic economy. While China muddles through a multi-year housing and confidence crisis, we could potentially see significant fiscal stimulus and structural reforms at some point change the trajectory of the economy—though in the interim, the market appears destined to tread water. Meanwhile, Japan appears to be in the early stages of an idiosyncratic improvement story that could positively impact returns over the long term.

Despite the policy turmoil of the first half of 2025, markets have remained remarkably resilient. I expect some of the accumulated complacency to be shaken out of investors in the months ahead as the macroeconomic consequences of major policy shifts become more evident, and as geopolitical risks introduce difficult-to-quantify tail risks. Investors would be well-advised to objectively reassess whether the key drivers of asset returns in the last decade can be sustained in the years ahead, as many of the bedrock assumptions underlying investing and corporate decision-making are now being called into question.

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Ronald Temple is the Chief Market Strategist for Lazard's Financial Advisory and Asset Management businesses. In this role, Ron provides macroeconomic and market perspectives to Lazard's investment teams on a firmwide basis and works closely with Lazard's Geopolitical Advisory group to assess economic and market implications of key geopolitical issues globally. Ron also advises clients of Lazard's Asset Management businesses regarding macroeconomic and market considerations that are important to achieving their objectives.



Important Information

Notes

- 1 [United States House Committee on Ways & Means](#) (January 2025)
- 2 [Mass deportations would harm the US economy](#) (PIIE, September 2024)
- 3 [CEIC Data, China Property Price Index](#) (January 2025)
- 4 [Chinese local governments' reliance on land revenue drops as the property downturn drags on](#), PIIE (July 2024)
- 5 [UN Comtrade Database](#)
- 6 [Trade Wars Are Easy to Lose](#) (Foreign Affairs, April 2025)

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