

An aerial photograph of a rugged coastline. The top half of the image shows a dense, vibrant green forest covering the land. Below the forest, a series of steep, grey rock formations descend towards the water. The rocks are layered and have a weathered appearance. At the bottom of the image, the deep blue water of the ocean meets the shore, with white foam from the waves visible. The overall scene is a mix of natural beauty and geological complexity.

# Global Mid-Year Outlook 2026

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LAZARD

# Executive Summary

As we reach the midpoint of 2026, the global investment landscape looks meaningfully different than at the start of the year. Iran continues to dominate headlines—but the more consequential shifts are structural.

- My outlook for the years ahead is grounded in three core convictions: the US dollar will likely weaken as investors seek to reduce their outsized exposure to US assets; steeper yield curves in developed markets will be driven by rising fiscal deficits; and stronger relative non-US equity market performance will cause investors to seek opportunities in markets with more attractive asset pricing.
- Artificial intelligence (AI) enthusiasm has continued to drive markets to new heights in 2026, but I believe the sustainability of this growth will increasingly come under question.
- While AI-driven tailwinds continue to lift US equity market performance, the underlying resiliency of the US economy seems increasingly dubious due to the fragilities created by a K-shaped economy and longer-term policy uncertainty.
- China's economy might also be more fragile than it appears. The country's challenges—including its ongoing housing crisis, stagnating domestic demand, and heavy export dependence—cannot be fixed without meaningful structural reforms, which the Chinese government appears unlikely to implement.
- Europe was poised for an economic revival in 2026, but the war in Iran hit the region harder than any other developed market. Rising defense spending remains a bright spot, however, paving the way for increased industrial activity and technological investment.
- Japan's corporate reforms continue to pay off, reflected in higher returns on capital for Japanese companies. Beyond that, investors are likely to focus their attention on fiscal stimulus, monetary policy, bond yields, and elevated geopolitical tensions with China.
- As investors find their footing in this new landscape, I expect them to diversify away from US equities, seek alternative safe-haven assets, and increase their focus on real assets—particularly infrastructure—as a hedge against sustained higher inflation.

# Three Core Convictions

## 1. Weaker Dollar

After surging in 2021 and 2022, the US dollar has given back much of its gains (Exhibit 1). I expect this depreciation to continue in the years ahead due to several factors, including increased policy volatility, concerns over Federal Reserve independence, and elevated fiscal deficits—all of which could cause global investors to question the currency's relative attractiveness.

In this highly concentrated stock market—where US equities represent over 60% of the MSCI All Country World Index and US debt accounts for over 40% of the Bloomberg Global Aggregate Bond Index—global asset owners have become increasingly concerned about the magnitude of their US exposure and the potential lack of diversification in their portfolios. At the same time, however, many worry that reducing their US equity holdings too soon could cause them to miss out on historic AI-related gains. Having been burned multiple times since 2008, they may decide to hedge more of their foreign exchange exposure before reducing their underlying asset exposure.

Exhibit 1.

### The US Dollar Gives Back Gains

US Dollar Index (%)



As of 29 May 2026

The US Dollar Index measures the US dollar's value against the euro (57.6% weight), Japanese yen (13.6%), British pound (11.9%), Canadian dollar (9.1%), Swedish krona (4.2%), and Swiss franc (3.6%). The 27.6% increase covers the period from 5 January 2021 to 27 September 2022. The 12.5% decrease covers the period from 15 January 2025 to 27 January 2026. Source: Lazard, Bloomberg, ICE

Over time, this reduced appetite for US dollars will likely bleed into lower US Treasury holdings by foreign investors—including sovereign reserve managers—given that yields on Treasuries are less attractive compared to other sovereign debt options after accounting for FX hedging costs.

## 2. Steeper Developed Market Yield Curves

In the United States, federal government deficits of 6%–8% of GDP are likely each year for the next decade. For non-US NATO members across Europe and for Canada, military and related infrastructure spending will increase over time toward 5% of GDP, funded by larger fiscal deficits. And in Japan, the Liberal Democratic Party campaigned on a platform of reducing consumption taxes, which will mean larger budget deficits. As developed economy governments demand ever increasing amounts of funding to sustain fiscal commitments, I expect investors to demand higher yields to account for greater worries over debt sustainability and increased fear that governments will at some point seek to stimulate higher inflation to devalue their accumulated debt.

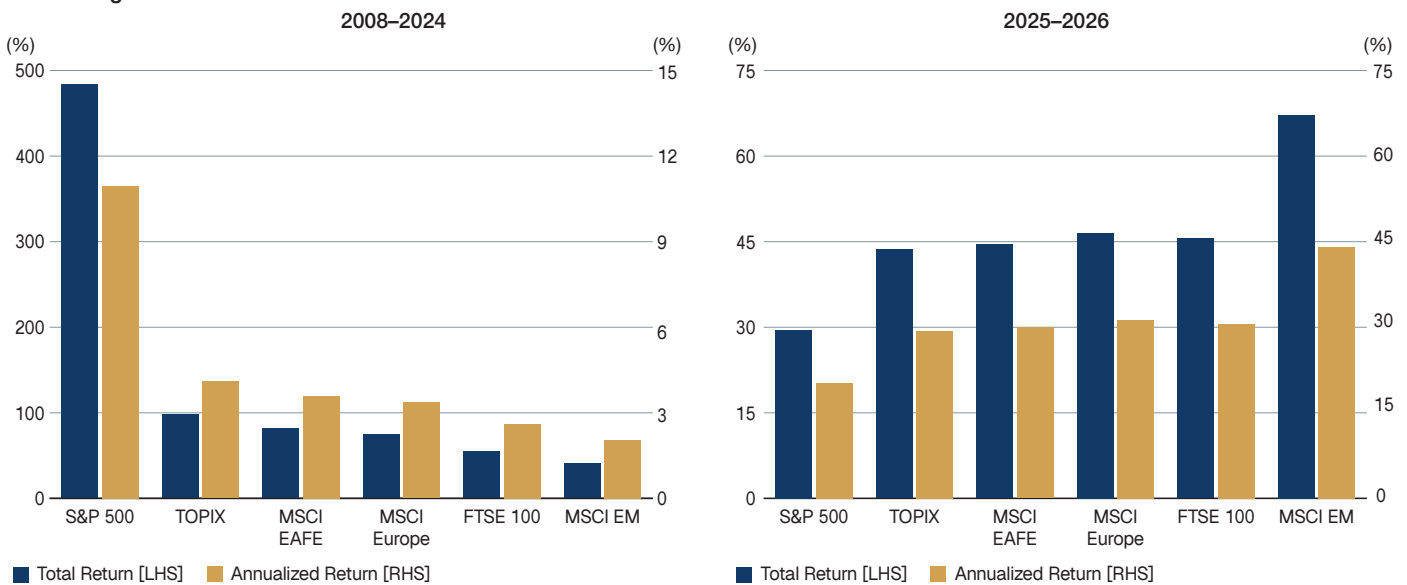
## 3. Stronger Relative Performance of Non-US Equity Markets

American exceptionalism has been the defining theme of global equity markets for nearly two decades. From 2008 to 2024, the S&P 500 Index delivered far higher returns than other key market indices globally (Exhibit 2). This outperformance was driven by multiple factors including stronger earnings growth, valuation expansion, and a strengthening US dollar. But that gap is narrowing: Total returns and annualized returns have improved across non-US markets over the past year and a half.

If I am correct about prospects for a weakening US dollar, currency translation effects will lift returns on non-US assets. At the same time, given elevated US valuation levels, higher discount rates driven by steeper developed market yield curves would have a more negative effect on US equities than those in non-US markets with less demanding valuations.

Exhibit 2.

### Broadening Out



As of 28 May 2026

Left chart covers 4 January 2008 to 30 December 2024. Right chart covers 30 December 2024 to 28 May 2026.

Source: Bloomberg

## AI Juggernaut Continues to Drive Risk-Asset Prices

Alongside these market shifts, the AI investment boom warrants closer attention—both for its scale and for the questions it leaves unanswered.

US hyperscaler capex is expected to exceed ~\$750 billion in 2026, an increase of over 80% from 2025. What concerns me most about the sustainability of the AI investment boom is the murkiness of the roadmap to an attractive return on invested capital (ROIC). With cumulative AI investment estimated at \$5 trillion–\$10 trillion between 2026 and 2030, hyperscalers' ability to achieve shareholder-friendly ROIC levels appears increasingly questionable. The suppliers to these companies also face challenges as they debate the sustainability of volume, pricing, and margins on goods they supply to the AI value chain. With share prices for some AI-related companies up 1,000% or more since the beginning of 2025, the expectations required to warrant current valuations are increasingly demanding, even if one assumes high gross margins and long, productive asset lives—both of which seem unrealistic given the pace of obsolescence in the tech industry.

As worrisome is the potential commoditization of AI over time. While some users may be willing to pay a premium for market-leading options, I expect cost and baseline dependability to drive adoption for most of the world's businesses and consumers. If that is the case, fast followers that invest a fraction of the capex of market leaders could be in a better position to win market share by offering lower cost, slightly less advanced AI tools.

This is not to say that there are no winners. Hardware suppliers in Taiwan, South Korea, Japan, and the United States are benefiting significantly from the AI arms race, enjoying explosive sales growth and expanding margins—and rewarding investors handsomely. However, my biggest concern is sustainability. With the Philadelphia Stock Exchange Semiconductor Index (SOX) up over 100% year-to-date through late June and a trailing price-to-earnings ratio exceeding 60x, according to Bloomberg, it appears the market is pricing in an excessively optimistic scenario.

The macro backdrop, the three core convictions previously outlined, and the evolving influence of AI paint a picture of a world in transition—one in which the opportunities are real but unevenly distributed. Next, we take a deeper dive into major economic regions and identify where these forces converge and diverge in ways that matter most for portfolio construction.

Hyperscalers' ability to achieve shareholder-friendly ROIC levels appears increasingly questionable.

# The United States

## Iran War Drives Inflation Higher

The Iran War replaced tariffs as the primary driver of inflation in 2026. Surging energy prices caused headline inflation to reaccelerate year-over-year (Exhibit 3), while month-on-month figures reached levels not seen since mid-2022.

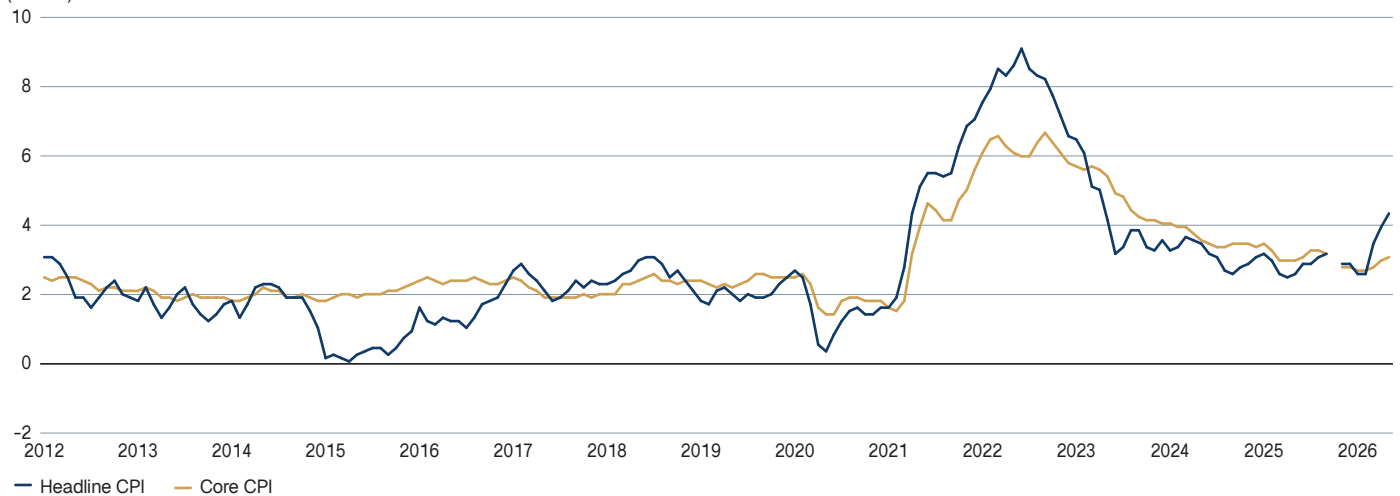
Fortunately, other than in airfares, there are few signs of energy inflation transmitting through to core inflation, which excludes food and energy prices—but I do believe discretionary spending could come under pressure as households compensate for higher energy bills.

The mid-June agreement to reopen the Strait of Hormuz—reflecting Lazard Geopolitical Advisory's base case expectation of the past few months—suggests shipping will remain below pre-war levels on average in the fourth quarter of this year. But we believe it will take more time for shipping companies to regain confidence in the safety of transiting the Strait of Hormuz and moving nearly 1,000 vessels back to their normal routes.

Exhibit 3.

### US Inflation Has Reaccelerated Due to the Iran War

(% YoY)



As of May 2026

Data for October 2025 were not reported due to a lapse in US federal government funding.

Source: Bureau of Labor Statistics, Haver Analytics

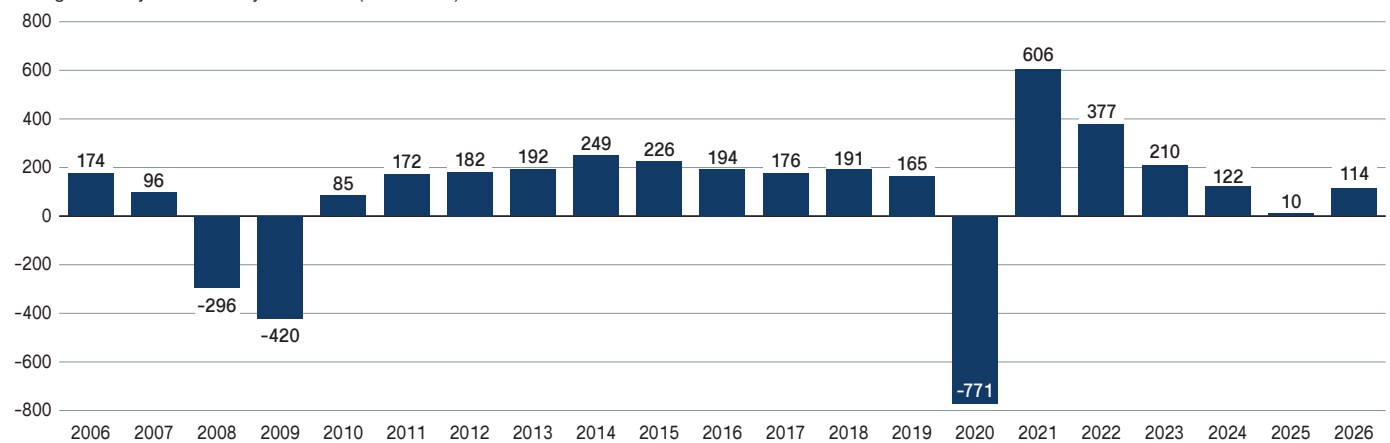
## Can the US Labor Market Stay Strong?

The US labor market has stabilized, but the outlook remains uncertain. Nonfarm payroll growth has recovered from 2025 post-pandemic lows (Exhibit 4) and the unemployment rate has edged down to 4.3% in May from 4.4% in December. What is unclear is where the breakeven rate for nonfarm payroll growth relative to the unemployment rate will settle. The breakeven rate is the pace of employment growth necessary to keep pace with the growth of the labor force, such that the unemployment rate remains stable. It is a cornerstone metric that helps the Fed determine whether it is achieving its full employment mandate alongside price stability. In 2025, it appeared to have declined to ~50,000 jobs per month from the pre-pandemic level of ~140,000, largely reflecting reduced immigration, but the 2026 job growth figures and stable unemployment suggest a higher breakeven rate.

Exhibit 4.

### Job Growth in 2026 Has Improved Significantly Relative to 2025

Average Monthly Nonfarm Payroll Growth (Thousands)



As of May 2026

Source: Bureau of Labor Statistics, Haver Analytics

For the last two years, companies have slowed the pace of hiring without meaningfully cutting headcount. This is consistent with post-pandemic “labor hoarding,” as companies may now be rightsizing their workforces through attrition. At the same time, AI-driven automation expectations and tariff-related cost uncertainty are contributing to companies’ reluctance to hire. Adding to worker anxiety, Challenger, Gray & Christmas reported that from March to May 2026, the most important driver of job cuts was AI.

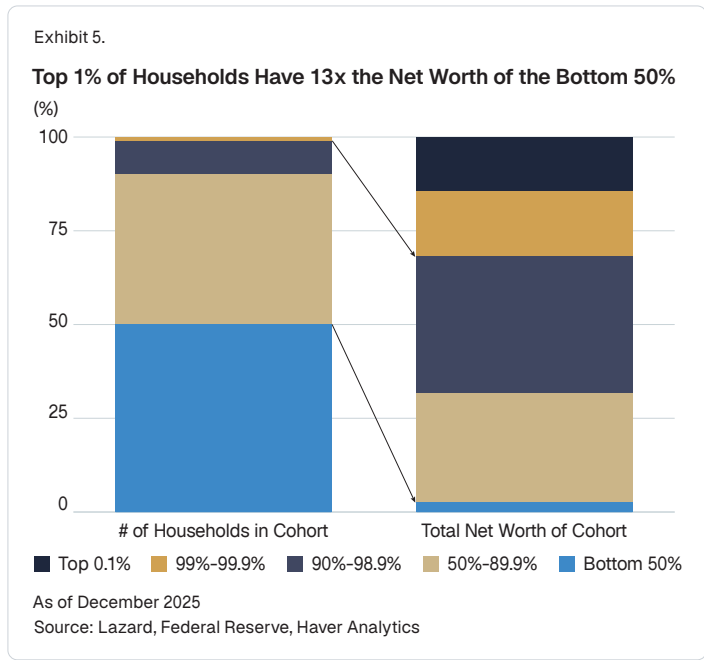
In an environment where AI appears poised to disrupt most of the service industry, workers are unlikely to demand large wage gains (despite the inflationary backdrop) or switch jobs. With real wages under pressure, consumers are unlikely to increase discretionary spending, which then feeds back to weaker labor demand.

## The Fragility of a K-Shaped Economy

With sustained elevated inflation and a soft labor market, the K-shaped economy—in which higher income households thrive while lower income households struggle—is likely to worsen.

In general, the US population can be divided into two camps. The first is the ~42% of the US population that does not have any direct or indirect ownership of equities. Many of these people also do not own their homes, and their consumption is driven primarily, if not exclusively, by wage income. The second group is the portion of the population for whom accumulated wealth and the profits generated from that capital are relatively more important than labor market conditions and wages.

Of course, the reality is more complex: There are about 340 million individuals in the United States, each with their own circumstances, not just two simple groups. But overall, the divergent experiences of American households raise questions about the quality and sustainability of resilient macroeconomic performance. While US income inequality has long been a concern, Exhibit 5 illustrates the financial polarization facing US households. At the end of 2025, total US household net worth was \$175 trillion. The bottom 50% of US households had total net worth of ~\$4.3 trillion or 2.5% of the total, while the top 1% controlled \$55.9 trillion, or 31.9%. The fact that ~1.4 million households have 13x the net worth of the bottom ~67.7 million highlights the extreme divergence in economic circumstances facing US consumers and their ability to withstand periods of high inflation and declining real wages.

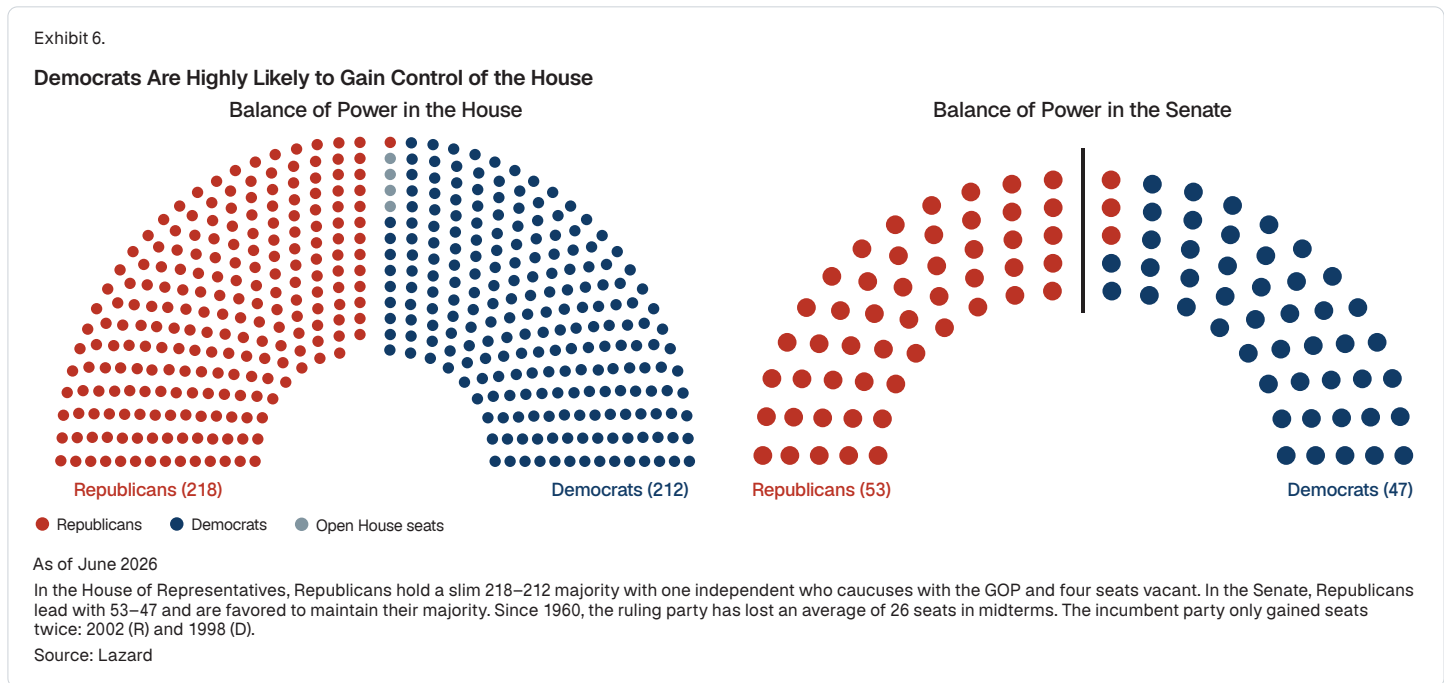


Research from the Federal Reserve Bank of New York highlights the economic implications. High-net-worth households have driven a disproportionate share of retail spending in recent years,<sup>1</sup> while Americans on the lower part of the “K” continue to lose spending power. For this cohort, the accumulated shocks of the past several years have been severe: multi-decade-high inflation from 2021–2023 depleted pandemic savings; tariff-driven inflation arrived alongside a weakening job market in 2025; and the Iran War triggered another surge in energy and food prices in 2026. Add to these factors the fear of AI-driven job losses, and you have a recipe for consumer retrenchment.

With equities, housing, and other asset prices at or near all-time highs, I expect the United States to sustain solid real GDP growth—but I believe the quality of the growth will be suspect given the narrowing breadth of the drivers.

## Midterm Elections and Economic Consequences

Since 1960, the party controlling the White House has lost an average of 26 House seats in midterm elections. Given the unpopularity of the Iran War and President Trump’s near-record-low favorability ratings, Democrats are optimistic about the November elections and the prospects for even bigger gains. However, Democrats face their own favorability challenges, and mid-cycle redistricting efforts could deliver a net Republican gain of as many as ten House seats. Democrats face more of an uphill climb in the US Senate, where they would need to gain four net seats to win control, as many of the seats currently held by Republicans are in solidly red states. Taking the factors into account, Lazard Geopolitical Advisory currently sees the Democrats as having an approximately 80% chance of winning control of the House versus an approximately 40% chance of winning a majority of the Senate (Exhibit 6), but these odds could change materially between now and November.



From a policy perspective, a Democratic House would likely prioritize restoring Medicaid funding and Affordable Care Act premium subsidies that were cut from the federal budget in 2025 and could threaten government shutdowns to obtain the funding. Meanwhile, both parties would likely support replenishing Pentagon munitions and increased national security spending. Tax increases would almost certainly be dead on arrival given Republican opposition, and I am skeptical that Congress will agree on offsetting spending cuts elsewhere. All of this could cause fiscal deficits to widen further.

Updating the most recent Congressional Budget Office deficit forecasts to reflect changes in tariff revenue assumptions and likely fiscal changes after the midterm election, I expect US deficits to range from 6%–8% of GDP each year for the next decade. With rising deficits across developed markets, debt investors may demand a higher term premium for US Treasuries, leading to a steeper yield curve with higher long-term rates. We already began to see evidence of this dynamic in historically “risk-free” Treasuries in 2025, where significant fiscal expansion alongside dollar depreciation led to outflows from long-duration US Treasuries.

## Federal Reserve Independence

With fiscal deficits widening further, Fed credibility will become even more important after the midterm elections in November. Unfortunately for new Fed Chair Kevin Warsh, investors will be looking for him to prove his independence where his predecessors were typically given the benefit of the doubt and assumed to operate independently of the White House. Against a backdrop of elevated inflation, a full-employment economy, and presidential admonitions for lower short-term interest rates, Warsh is in a tough spot.

Fortunately, the Federal Reserve Board and the Federal Open Market Committee (FOMC) are structured to avoid being excessively influenced by any single member. The 12 FOMC voters have equally weighted votes, and the majority rules. It is unclear what policies Warsh will advocate in his new seat, but he has argued in the past for a smaller Fed balance sheet and for rate cuts. Warsh also might seek to reduce the frequency of Fed press conferences or to eliminate some current communication tools such as the Summary of Economic Projections or the “dot plot” within it, which could add to market uncertainty around the direction of monetary policy.

Market anxiety regarding Fed independence has decreased recently as the case for policy easing has weakened, making the risk of unwarranted rate cuts less likely. The Fed Funds futures market has shifted from suggesting at least two rate cuts in 2026 as recently as February to now forecasting one or two 25-basis point (bps) rate hikes. But once the Iran War has conclusively ended, I expect markets to become more highly sensitized to any signs of Fed independence being weakened.

With fiscal deficits widening further, Fed credibility will become even more important after the midterm elections in November.



# China

## Housing and Consumer Confidence

China's economy might also be more fragile than it appears. Real GDP is growing, but a closer look reveals an ongoing housing crisis that continues to depress consumer confidence.

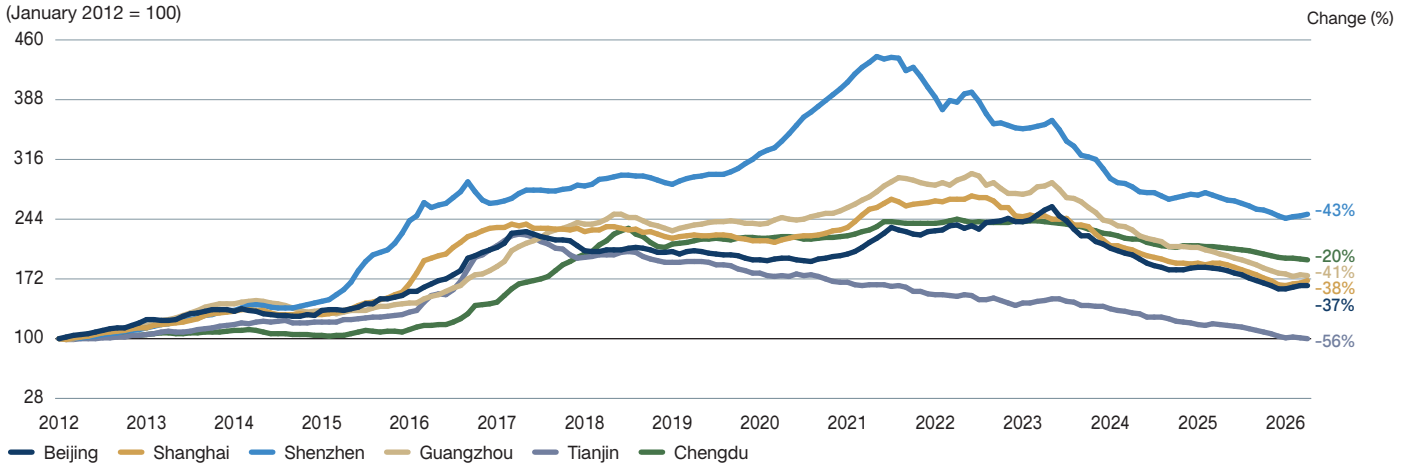
Assessing the state of the Chinese housing market can be challenging given very different readings from different data providers,<sup>2</sup> but the latest data suggest that prices for previously occupied homes have declined anywhere from 20% to 56% across China's top six cities (Exhibit 7). Given that the median household in China has about 60% of its assets invested in housing, these declines weigh heavily on the typical consumer's balance sheet and spending appetite.

Unsurprisingly, consumer confidence remains near record-low levels (Exhibit 8). From early 2025, there were signs of a slight uptrend in confidence, but more recent data have raised questions regarding the sustainability of the improvement.

Exhibit 7.

### Private Sector Housing Data Suggest Sharp Home Price Declines

(January 2012 = 100)



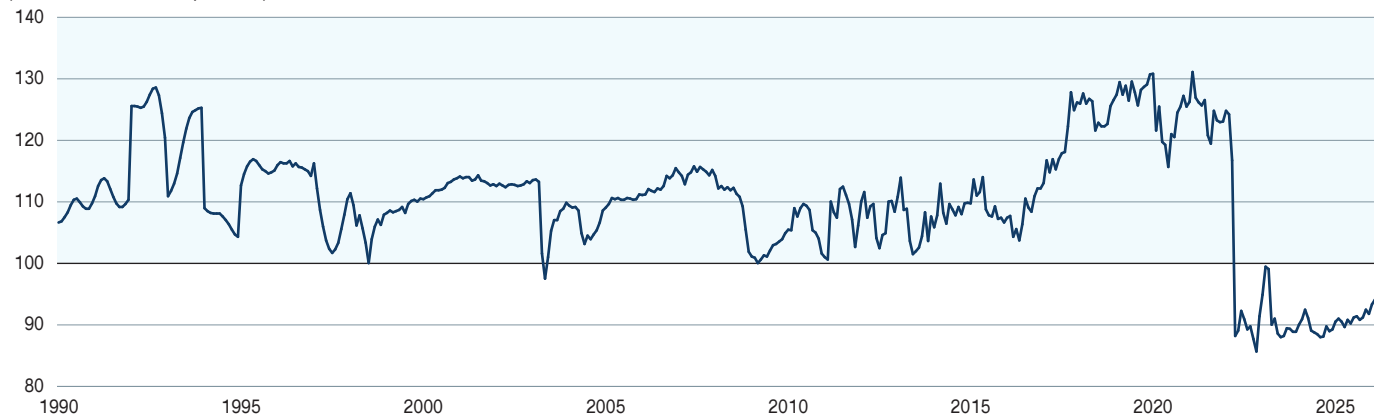
As of April 2026

Source: Centaline, Morgan Stanley

Exhibit 8.

### Chinese Consumer Confidence Remains Near Record-Low Levels

(Greater Than 100 = Optimistic)



As of April 2026

Source: Chinese National Bureau of Statistics, Haver Analytics

## China’s K-Shaped Economy and the Need for Structural Reforms

China continues to report real GDP of ~5% per annum, as “new economy” sectors such as electric vehicles and energy transition products grow rapidly and gain market share globally. But the quality of China’s economic growth has deteriorated as domestic drivers weaken and the country becomes more dependent on exports.

In recent months, industrial production has grown by 4%–6% year-over-year while retail sales fell year-over-year in May for the first time since the COVID pandemic, as manufacturers produced more goods than domestic consumers could buy. Rather than pursuing the structural reforms needed to strengthen consumption, however, the government appears to be doubling down on central planning and industrial policy—a model built on suppressed domestic wages, elevated savings rates, and export dependence that looks increasingly unsustainable.

In my view, the top priority should be addressing structural inequality. This would mean significantly improving the social safety net for rural workers, who typically earn the lowest wages and receive minimal government benefits in retirement. Approximately 180 million Chinese citizens receive an average benefit of RMB246 per month, which equates to \$34 per month.<sup>3</sup> By contrast, about 120 million urban retirees receive a much more generous benefit of RMB3,498 (\$485) per month, while the roughly 20 million government retirees receive RMB6,243 (\$867) per month. While some differentiation in retirement payments is warranted due to the cost of living in cities versus rural areas, this level of rural deprivation is extreme and could easily be alleviated without significant adverse consequences.

Encouragingly, some National People’s Congress members called for higher farmers’ pension payments in the 2026 Two Sessions. If the Chinese government were to enact such reforms, I believe the growth outlook for China would be brighter over a considerably longer time horizon than it is today, as consumer spending would increase while fears of outliving savings would decrease.

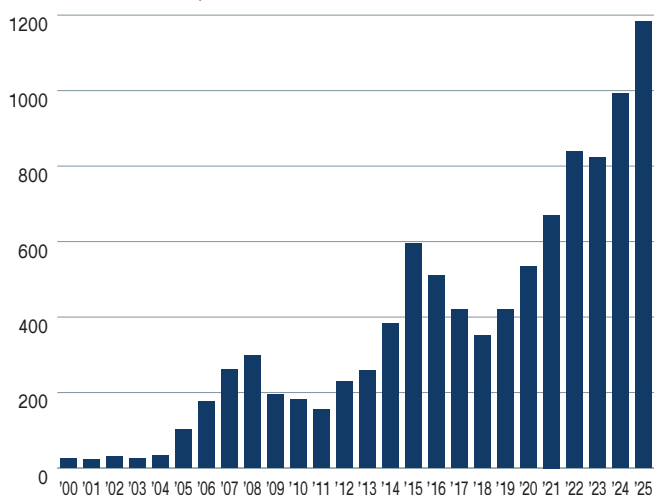
## China’s Export Engine

In the absence of the historical tailwinds from infrastructure and real estate construction, China’s export engine has become increasingly important to driving growth. In 2025, ~33% of China’s real GDP growth was driven by net exports—the highest level since 1997—and the trade surplus reached \$1.18 trillion or ~6% of GDP (Exhibit 9). Despite the US-initiated trade war in 2025, China’s exports rose to a new record of over \$370 billion in May 2026, a 19% increase from the comparable periods in 2025. Not all of the increase, however, has been due to market share gains. China has also been a beneficiary of the AI-related capex boom with demand for legacy semiconductors and other technology equipment rising sharply, leading to price increases versus historical price erosion.

Exhibit 9.

### China’s Trade Surplus Reached \$1.18 Trillion in 2025

China Annual Trade Surplus (\$B)



As of December 2025

Source: China Customs General Administration, Haver Analytics



# Eurozone

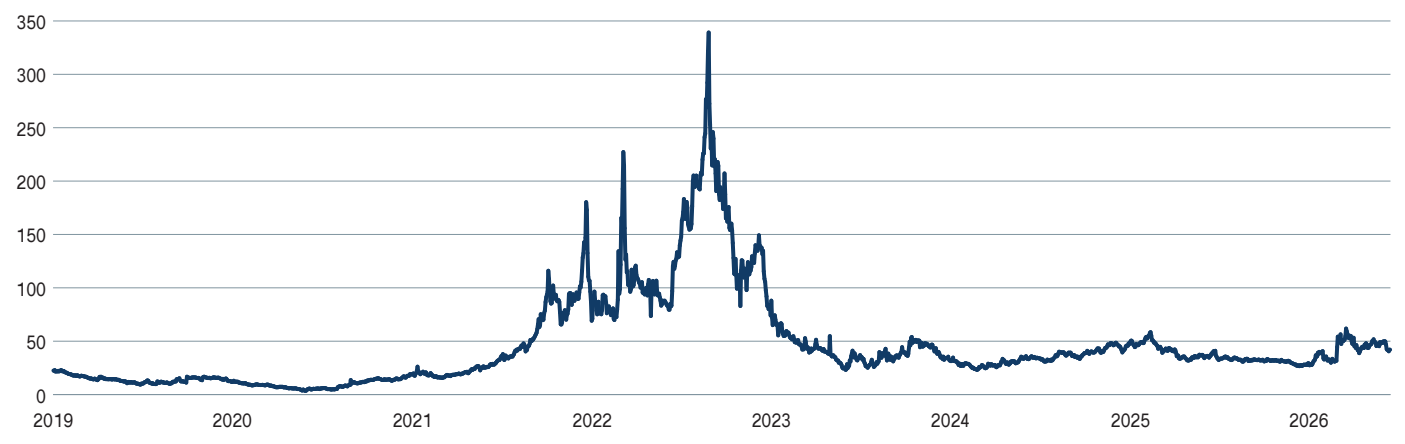
## Iran War Impacts Energy Prices and Consumer Confidence

2026 was poised to be the year when the Eurozone would narrow the real GDP growth gap with the United States, thanks to rising real wages, normalized energy markets, and fiscal stimulus. Then the United States and Israel attacked Iran, unleashing a global surge in energy prices that is likely to hit Europe harder than any other major developed economy.

Entering 2026, benchmark natural gas prices had declined from a peak of over €300/MWh after Russia invaded Ukraine to under €30/MWh. While a majority of Eurozone economic activity is in the service sector, the decline in energy prices would have boosted industrial activity and helped ease the cost of living for households. After the attack on Iran, however, prices more than doubled before returning to ~€42/MWh by late June (Exhibit 10). The energy price surge had global implications—but Europe is feeling these challenges more acutely due to its dependence on imported energy.

Exhibit 10.

### Natural Gas Front-Month Futures Prices Have Risen ~33% since the US and Israel Attacked Iran (Price per MWh, Euros)



As of 22 June 2026  
Benchmark natural gas refers to the Virtual Trading Point Netherlands Title Transfer Facility.  
Source: Bloomberg

Consumer confidence had also been recovering slowly before the Iran War, as unemployment fell to the lowest level since the creation of the euro in 1999, inflation returned to the ECB's 2% target, and real wages grew moderately. But in the two months after the initiation of the Iran War, consumer confidence fell by the fourth-largest amount since the inception of the survey (Exhibit 11). Until the Iran War ends, I expect Eurozone consumer confidence to remain weak given energy supply vulnerabilities and the price shock being felt by European households.

Exhibit 11.

**European Consumer Confidence Fell Sharply since the Iran War Began**

(Seasonally Adjusted, % Balance/Diffusion Index)



As of May 2026

Source: Bloomberg, European Commission

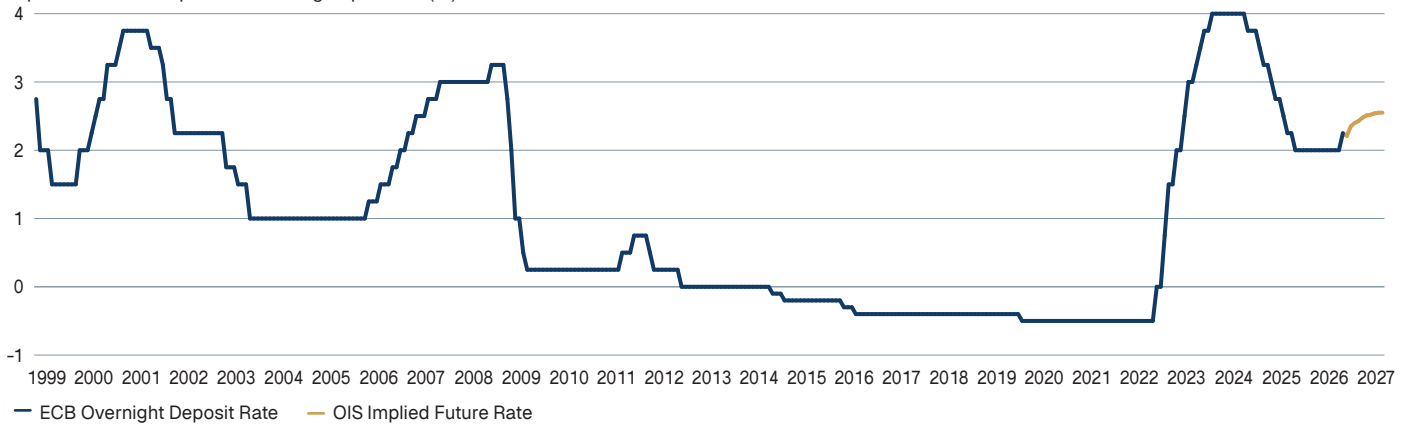
**ECB Expectations**

Adding insult to injury, the ECB hiked rates by 25 bps on 11 June, and markets suggest at least one additional 25-bps hike by year end (Exhibit 12). Hiking interest rates will not increase the flow of crude oil or liquified natural gas through the Strait of Hormuz, but it will depress economic activity in a region that has seen lethargic activity levels for years.

Exhibit 12.

**Markets Suggest ~32 bps of Additional ECB Rate Hikes through December 2026**

Implied Eurozone Deposit Rate through April 2027 (%)



As of 22 June 2026

Markets imply a 10% chance of a 25-bps rate hike at the 23 July policy meeting and a 78% chance of one 25-bps rate hike through the 10 September policy meeting.

Source: Bloomberg

## Trade Tensions

The July 2025 Turnberry agreement capped US tariffs on European goods at 15%, though steel and aluminum remained subject to a 50% tariff. The European Union subsequently ratified the deal with conditions, but both sides were critical of the other's compliance with the letter and spirit of the agreement. In early May, President Trump threatened to raise tariffs on European autos to 25%; if imposed, the agreement could unravel—reigniting a trade conflict between two blocs that exchange over \$1 trillion in goods annually. I expect trade tensions between the United States and European Union to persist.

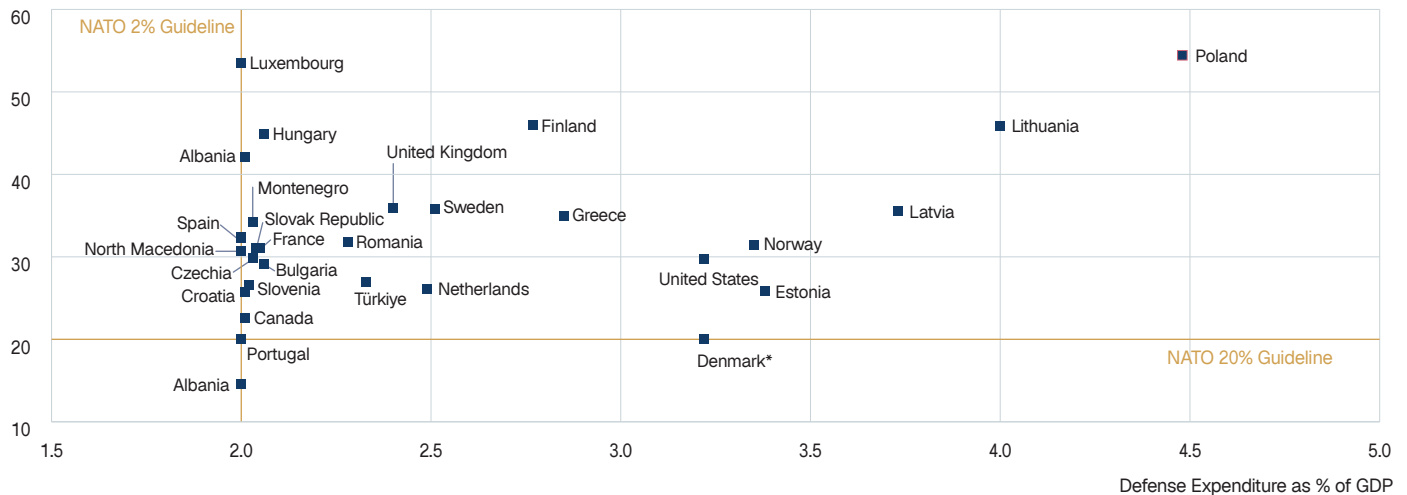
## Defense Ramp

A bright spot for Eurozone growth is the increase in defense spending (Exhibit 13). While the ramp in German defense spending is most notable, the increase in non-US NATO defense spending has already been impressive with a 37% real increase from 2023 to 2025. Going forward, spending on the military will more than double to over \$1 trillion over time if non-US NATO members comply with the commitments they made in 2025 to spend 5% of GDP on defense and related infrastructure. This could lead to significant increases in industrial activity and technology investment, but also larger fiscal deficits.

Exhibit 13.

### Total Defense Spending Is One Metric, but Equipment Spending Is Also Important

Equipment Expenditure as % of Defense Expenditure



As of 3 June 2025

Figures are based on 2021 prices and exchange rates. Figures for 2025 are estimates. For those Allies that have national laws or political agreements that call for 2% of GDP or more to be spent on defense annually, but that did not declare figures for 2025, it has been assumed that they spent 2% of GDP on defense.

\* Denmark has declared that it has allocated more than 20% of defense expenditure to major equipment.

Source: Lazard Geopolitical Advisory

Initially, I expect the traditional industrial sector to benefit from the military spending boost. Excess capacity in the auto industry can be repurposed in a matter of months to produce military equipment, such as armored personnel carriers and tanks, while retaining many of the original workers. Longer term, I expect higher military and related infrastructure investment to improve Europe's competitive position in technology, with defense-tech innovation helping to raise the region's productivity growth rate. Some benefits of this spending will only be evident years from now, but I expect the payoff will be material.



# Japan

## Takaichi-Era Stimulus

In the second half of 2026, investors are likely to focus on fiscal stimulus and monetary policy. The Liberal Democratic Party, led by Prime Minister Sanae Takaichi, won a landslide election in February based in part on an affordability platform calling for consumption tax reductions for food. Since then, Takaichi has tempered expectations for sizable fiscal stimulus, in part to reassure jittery bond markets that her government will not materially increase deficits. The Iran War complicated the government's path, as energy subsidies to insulate consumers and companies from Iran-related price surges have come at a considerable cost.

In the Diet session that concludes in mid-July, the Takaichi administration is likely to propose extensions of fuel subsidies and price controls for electricity and gas rates to limit the inflationary shock for consumers. Including reductions to the consumption tax for food could be politically popular as well and could boost consumption marginally at the expense of larger fiscal deficits.

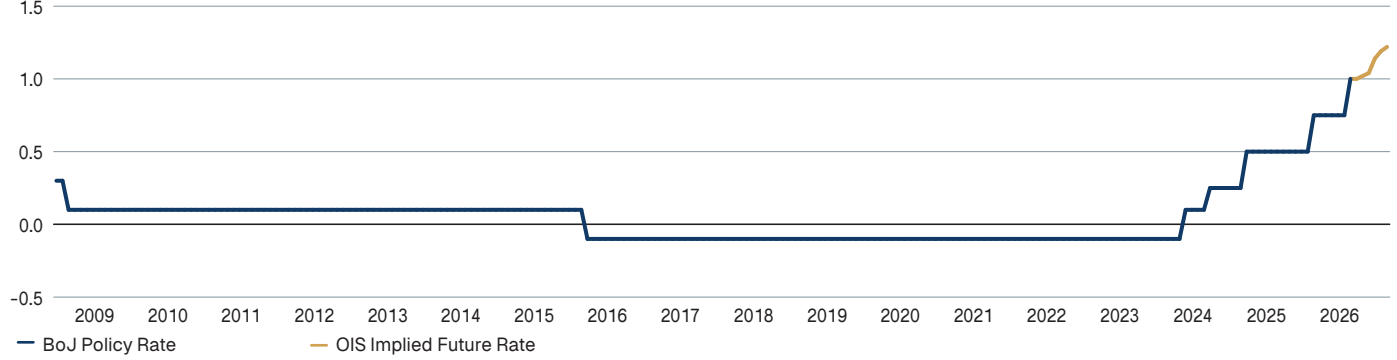
## More Rate Hikes on the Way?

The Bank of Japan (BoJ) appears on course to further raise interest rates in the second half of 2026 (Exhibit 14), taking the uncollateralized call rate to 1.25% by year end. The rationale is clear: Japan's CPI inflation exceeded 2% in 45 of the 49 months ended April 2026, and core-core inflation (ex-fresh food and energy) has been at or above 2% for 41 of the last 43 months. The Iran War has added upside risk to prices, reinforcing the BoJ's tightening bias.

Exhibit 14.

### Markets Suggest an ~97% Chance of a 1.25% BoJ Target Rate at the End of 2026

Implied Bank of Japan Target Rate through December 2026 (%)



As of 22 June 2026

Markets imply a 3% chance of a 25-bps hike through the 31 July meeting and a 27% chance of an additional 25-bps hike through the 18 September meeting.

Source: Bloomberg

I anticipate that rising rates in Japan could contribute to strengthening of the Japanese yen against the US dollar and other currencies as expectations for monetary policy outside of Japan become more dovish in the second half of this year.

## Why Japanese Bonds Matter

The TOPIX has been a standout performer since the beginning of 2025, rising 48.2% in US dollar terms through late June versus the S&P 500 Index, which has returned 28.8%. However, Japanese Government Bonds (JGBs) have been a different story, with the 10-year JGB yield rising to 2.7% from 1.1% and the 30-year yield up to 3.9% from 2.3% over the same period (Exhibit 15).

The implications for global capital flows are significant. For decades, JGBs offered one of the lowest yields globally due to Japan's low inflation and low short-term interest rates. Over time, Japanese investors allocated more capital to overseas bond markets to capture higher yields. Typically, these investors bought foreign bonds on a currency unhedged basis, hoping to benefit from any yield weakening above and beyond the extra carry from higher interest rates.

As of the first quarter of 2026, Japanese investors were the largest owners of US Treasuries, holding \$1.19 trillion out of \$9.35 trillion held by non-US investors. If my expectations are correct, rising short-term interest rates combined with a strengthening Japanese yen could turn years of investing logic upside down for Japanese investors. Rather than benefiting from higher interest rates and a weakening yen, investors could find that they are getting a smaller yield pick-up from owning US Treasuries, and they could see the value of their holdings decline when translated back to their home currency.

If this happens for a sustained period, we could see a substantial repatriation of capital from the United States, and potentially other markets, back to Japan. Given the scale of fiscal deficits and the level of debt-to-GDP in other developed economies, rising JGB yields and term premia could raise debt sustainability concerns, fueling further curve steepening.

## Elevated Tensions with China

Since November 2025, when Takaichi said that a Chinese attack on Taiwan could represent a "survival-threatening situation," the relationship between Japan and China has deteriorated. The Chinese response was swift and sharp and included a range of diplomatic, trade, and cultural policy changes.

One example of the economic damage inflicted on Japan has been the decline in Chinese visitors. In August 2025, just over one million Chinese arrivals were recorded in Japan, with ~90% being tourists. March arrivals fell below 300,000, the lowest since October 2023 and well below typical seasonal levels. Over the same period, Beijing has imposed a seafood import ban on Japanese goods, halted agricultural trade talks, and limited cultural and academic exchanges.

While the China-Japan friction is unlikely to become dangerous, it is a reminder that Japan faces geopolitical and national security risks from its much larger neighbor. The threats are also more pressing given a less predictable partnership with the United States, which has been less supportive of Japan in this situation than in the past. All of this could lead to further significant increases in Japanese military spending in the years ahead.

Exhibit 15.

### Japanese Government Bond Yields Could Be a Catalyst for Developed Markets Curve Steepening

10-Year Japanese Government Bond Yield (%)



As of 22 June 2026

Source: Lazard, Bloomberg

# Investment Implications

## Global Opportunities

As noted at the start of this outlook, I believe the drivers of US outperformance in global markets are fading—but this is not a call to short the US equity market. US equities remain expensive relative to global peers, but they also offer higher returns on capital than other markets, which justifies a premium valuation to peers (Exhibit 16).

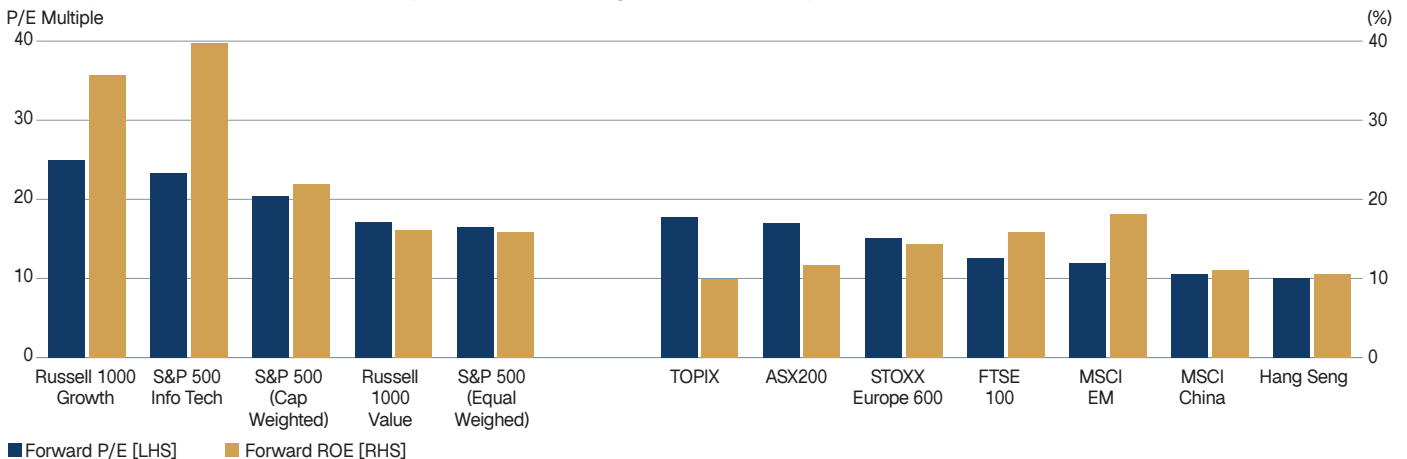
What I am making is a bullish relative call on non-US markets—especially emerging markets and Japan, where I see a better risk-reward trade-off than in US equities. In my opinion, investors that have been overweight US equities should consider reallocating capital to markets poised to benefit from attractive earnings growth, a weaker US dollar, and more attractive relative valuations.

Outside of the United States, valuations start at materially lower levels, which means earnings growth expectations are much less demanding. Emerging markets are particularly appealing, and they can offer AI exposure at far lower valuations alongside multiple other uncorrelated growth drivers. Risks from geopolitical intervention remain, but no country offers complete refuge from that.

Japanese equities look attractive as well. Even if GDP growth remains modest, Japan offers strong prospects for rising ROIC due to ongoing governance improvements, changes in the corporate takeover code, and policy support for domestic consumption.

Exhibit 16.

### While Expensive Relative to Peers, US Equities Still Deliver Higher Returns on Capital than Other Markets



As of 22 June 2026

Source: Bloomberg

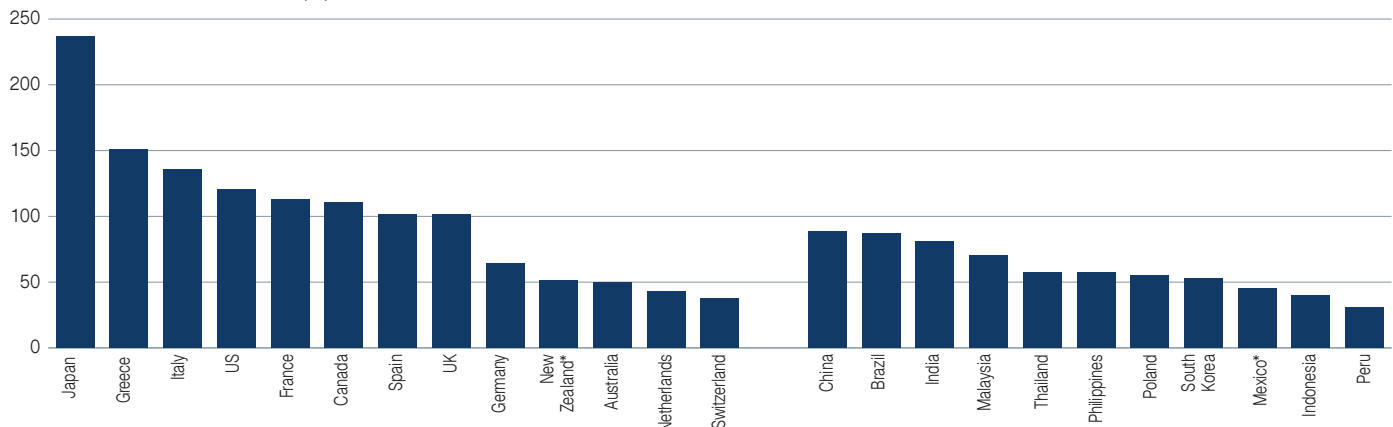
## Fixed Income and Currencies

Across developed markets, the outlook for fiscal discipline is bleak. US federal deficits are likely to range between 6%–8% of GDP each year for the foreseeable future, while European deficits are likely to expand due to higher defense and infrastructure spending commitments. Japan could also experience larger deficits due to the fiscal measures previously outlined. All told, I believe investors will increasingly demand higher term premia for long-duration government bonds while questioning whether other safe havens might be preferable. Within the sovereign debt arena, I expect EM debt to be a beneficiary of this trend, as many offer lower debt-to-GDP ratios (Exhibit 17), more orthodox monetary policies, and FX appreciation potential.

Exhibit 17.

### The Most Leveraged EMs Have Less Debt than the United States

General Government Debt-to-GDP (%)



As of 2024

\*Debt for Mexico and New Zealand is Central Government Debt. All other nations are General Government Debt.

Source: Haver Analytics, IMF Global Debt Database

## Alternative Assets

With traditional safe havens in question, real assets are also likely to gain more attention as investors seek pricing power in the event of sustained higher inflation and asset price appreciation as replacement costs rise. Infrastructure is a particularly appealing asset class, but security selection is critical. I believe investors should focus on infrastructure assets with contractual pricing power that provide inflation-fighting characteristics. I also would caution against grouping all infrastructure assets into the same bucket, as assets such as data centers may not be as reliable as toll roads, railroads, or other utilities with stronger pricing power and limited obsolescence risk.

Convertible arbitrage strategies are another strong contender as they can monetize volatility. A tumultuous geopolitical backdrop combined with the potential for AI-driven disruption will likely fuel more volatility over time, creating opportunities for investors with extensive experience in the arena.

## Conclusion

Investors are facing a different investment landscape from that of the last two decades. Non-US opportunities can increasingly deliver on the promise of technological innovation and earnings growth across a diverse array of countries and sectors, while also offering currency appreciation potential and lower valuations. Against a backdrop of a weakening US dollar, steepening developed market yield curves, and strengthening non-US relative performance, now could be an opportune time for shifts in asset allocation, taking into account a comprehensive assessment of risk and reward.

# About the Author

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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. [Explaining the K-Shaped Economy: What's Behind the Divide?](#) and [Tracking the K-Shaped Economy: Who's Driving Spending?](#) (Liberty Street Economics, part of the Federal Reserve Bank of New York)
2. This analysis relies on Centaline's home price data, published by Centaline Property Agency Limited. Even though Centaline only capture homes listed on its platform in six major Chinese cities, it better captures price volatility as housing sentiment shifts than the National Bureau of Statistics data, which tends to understate price volatility and largely excludes discounting from reported prices.
3. Data as of 2024.

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