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**Ben Lambert**  
Portfolio Manager



**Adam Child**  
Portfolio Manager

# Europe is finally positioned for growth

## What were the key events and surprises in 2025 for European equities?

The seeds of 2025's key events were sown the previous September, when Mario Draghi issued a fresh blueprint for the EU's industrial strategy, identifying €845 billion of critical infrastructure investment needed by 2040 to modernise Europe's outdated grids, transport links, and industrial backbone. As the new year began, growing geopolitical instability forced a widespread rethink of defence policy, with pressure coming from the new Trump administration for NATO members to meet their 2% of GDP commitment, which directly benefitted Europe's globally competitive defence sector. There appeared to be a recognition among EU powerbrokers that a pro-growth agenda had become essential.

April's tariff announcements clearly proved to be a negative headwind, with a 20% headline reciprocal tariff on EU goods prompting a sharp selloff, though the 90-day pause announced a week later helped reverse this. Policy support in Europe began to mobilise, and the European Central Bank (ECB) adopted a more dovish stance, with multiple rate cuts over the year. Germany is central to whether the shift materialises into a persistent one. It is uniquely positioned with a lower-than-average debt-to-GDP of c.60%, and its proposed €500 billion infrastructure fund, equivalent to 11.6% of GDP over 12 years, alongside reforms to its debt brake and sharply increased defence spending, could deliver a fiscal impulse of 3-4% of GDP by 2027. In a US\$4.7 trillion economy, that's around US\$140 billion incremental annual spend.

## How is this policy shift expected to impact 2026?

The asset class is trading on about 14x forward earnings, a 40% discount to the US, which represents recessionary lows. However, this doesn't match up with the forward-looking view of earnings. European earnings have grown at less than half the rate of the US, but on a two-year forward view, they're growing close to parity with the US. So, there's clearly something that's being lost between that forward-looking view of earnings strength and where the stocks are trading relative to US peers. Perhaps there is a degree of embedded scepticism given the lethargic growth of the past decade, but we regard that as an opportunity.

We believe that for the first time in about 15 years, it is plausible to make an upside case for economic growth expectations in Europe. Germany's fiscal framework points to c. US\$140 billion annualised extra spending into the 2030s. That figure is bigger than the Marshall Plan and reunification spend combined, and it comes as the ECB is cutting rates. This highly unusual alignment should help to counter some recent economic softness, support domestic demand, and more broadly, improve the perception of growth prospects.

## Do you expect market leadership to continue to broaden?

Evidence already points to wider participation. Banks in select periphery markets such as Ireland, Portugal and Greece offer double-digit all-in yields, defence remains structurally supported by localisation and equipment investment, and power equipment suppliers have recently tracked US tech benchmarks. That mix suggests leadership beyond the mega-cap US AI beneficiaries. Europe's role in AI infrastructure looks more tied to power and electricals. Data centres cite power availability as the top constraint, and AI training sites are roughly 500 times more power-intensive than traditional enterprise facilities. European electrical equipment providers have kept pace with the Nasdaq recently, and we expect continued capex into grids, substations, and cabling in 2026.

European equities are trading close to the steepest relative discount to US peers in 35 years, and it's important to note the flow dynamics at play from a starting point of historically extreme crowding in US equities (which are close to an all-time high % of global market cap). European investors hold approximately US\$9 trillion of US stocks. Repatriating just 5% of that holding would equate to ~12x the inflow we have seen into the asset class in 2025.

## What are the main opportunities and headwinds facing European equity markets in 2026?

For the first time in years, Europe can position itself as not just looking cheap, but investable. With more reforms than we have seen in decades and bolder political decision-making, we believe Europe now has a clear line of sight to accelerating GDP and earnings growth into 2026 and beyond. In addition to the headline structural tailwinds which are falling into place, there are supportive cyclical factors in the background.

Corporate balance sheets are healthier than at any time in the past decade. Banks, long the problem child, are now over-capitalised, regulators are more permissive, and shareholder distributions via buybacks and dividends are rising. Monetary policy is also supportive, with eight rate cuts since June 2024 – a pace not seen since the GFC – yet this time, not in response to a crisis. Consumer strength adds another layer; unlike their US peers, European households have preserved pandemic-era savings and are benefitting from rising real incomes, creating potential upside to domestic demand and a positive credit impulse.

However, there are potential risks to be mindful of, including shorter-term tariff risks to earnings, a return to higher inflation, any escalation in the Ukraine conflict, disruptions to European energy security, or disruptive geopolitics. That said, Europe has been dealing with these issues for some time. A sudden retrenchment in German fiscal policy could certainly be disruptive for wider European growth prospects, but momentum is currently very much expansionary and pro-growth. Further trade policy uncertainty is a potentially significant headwind that could constrain earnings growth, although Europe's deal with the US should bring more clarity for investors.

We believe Europe is at the beginning of a structural re-rating that should underpin positive performance in 2026, with a new regime of more frequent style volatility that favours selective stock picking.

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### Australia

Level 28 Suite 3, Chifley Tower  
2 Chifley Square  
Sydney, NSW 2000  
Telephone: +61 2 9160 8400  
australia@ninetyone.com

### Botswana

Plot 64289, First floor  
Tlokweng Road, Fairgrounds  
Gaborone  
PO Box 49  
Botswana  
Telephone: +267 318 0112  
botswanaclientservice@ninetyone.com

### Channel Islands

PO Box 250, St Peter Port  
Guernsey, GY1 3QH  
Telephone: +44 (0)1481 710 404  
enquiries@ninetyone.com

### Germany

Bockenheimer Landstraße 23  
60325 Frankfurt am Main  
Telephone: +49 (0)69 7158 5900  
deutschland@ninetyone.com

### Hong Kong

Suites 1201-1206, 12/F  
One Pacific Place  
88 Queensway, Admiralty  
Telephone: +852 2861 6888  
hongkong@ninetyone.com

### Luxembourg

2-4, Avenue Marie-Thérèse  
L-2132 Luxembourg  
Telephone: +352 28 12 77 20  
enquiries@ninetyone.com

### Namibia

Am Weinberg Estate  
Winterhoek Building  
1st Floor, West Office  
13 Jan Jonker Avenue  
Windhoek  
Telephone: +264 (61) 389 500  
namibia@ninetyone.com

### Netherlands

Johan de Wittlaan 7  
2517 JR Den Haag  
Netherlands  
Telephone: +31 70 701 3652  
enquiries@ninetyone.com

### Singapore

138 Market Street  
CapitaGreen #27-02  
Singapore 048946  
Telephone: +65 6653 5550  
singapore@ninetyone.com

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### South Africa

36 Hans Strijdom Avenue  
Foreshore, Cape Town 8001  
Telephone: +27 (0)21 901 1000  
enquiries@ninetyone.com

### Sweden

Västra Trädgårdsgatan 15,  
111 53 Stockholm  
Telephone: +46 8 502 438 20  
enquiries@ninetyone.com

### Switzerland

Dufourstrasse 49  
8008 Zurich  
Telephone: +41 44 262 00 44  
enquiries@ninetyone.com

### United Kingdom

55 Gresham Street  
London, EC2V 7EL  
Telephone: +44 (0)20 3938 1900  
enquiries@ninetyone.com

### United States

Park Avenue Tower, 65 East 55th Street  
New York, 10022  
US Toll Free: +1 800 434 5623  
usa@ninetyone.com