Special Report

Europe Capital Markets Newsletter – 2Q25

July 2025

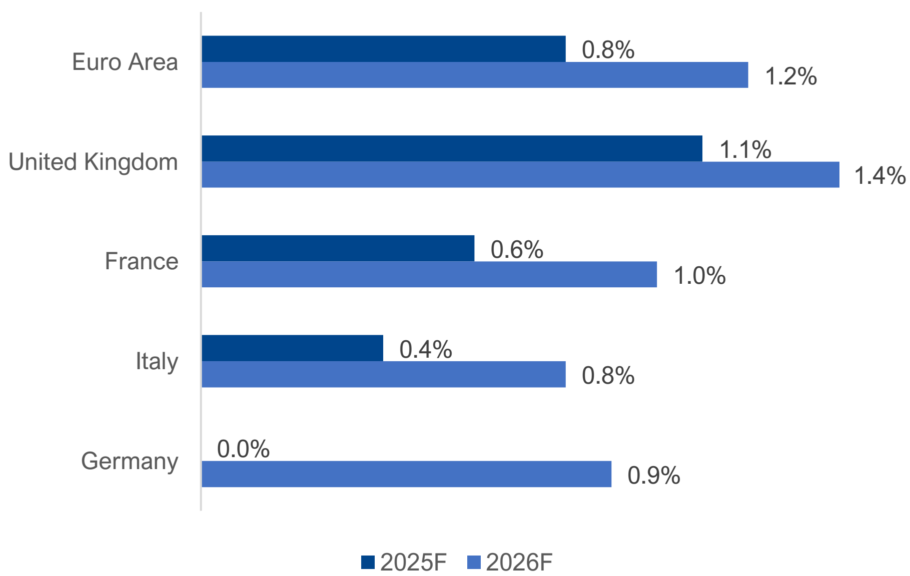
Executive Summary

Growth outlook improves	• GDP forecasts for 2026 were trimmed from Q1 2025 projections but still point to a rebound, led by easing inflation and strong consumption in Germany and France • Both the ECB and BoE have ended their rate hiking cycles and shifted to cuts; another ECB cut is expected in September 2025 • Elevated energy costs and geopolitical tensions remain the main threats to recovery
Euro and pound appreciated against dollar	• The Euro and Pound have strengthened against the US Dollar, aided by capital outflows from US assets • European and UK government bond yields have fallen from 2023 peaks, reflecting easing inflation and softer growth • The Euro's strength is at risk if ECB policy remains more cautious than the Fed, with yield differentials driving currency moves
Defense, industrials, and policy support fuel equity gains	• European equities (STOXX Europe 600 +9.3%, FTSE All Share +8.9%) closely tracked US gains (S&P 500 +10.2%) in Q2 2025, driven by rate cuts and cooling inflation • Defense stocks led, with Rolls-Royce (+32%), Airbus (+23%), and Safran (+15%) as top performers; Industrials benefited from defense and NATO spending • The S&P 500–Europe valuation gap widened again in late Q2 as US tech earnings drove US outperformance, while Europe lagged on lower tech exposure and geopolitical risk
NATO spending reset unlocks opportunities for defense majors	• NATO increased GDP defense spending target from 2% to 5% of the GDP. This shift is expected to raise NATO's total annual defense spending from ~$380 billion in 2024 to over $1 trillion by 2035. • European defense companies across high-tech and mission-critical segments are poised to benefit, though elevated valuations demand sustained earnings delivery.

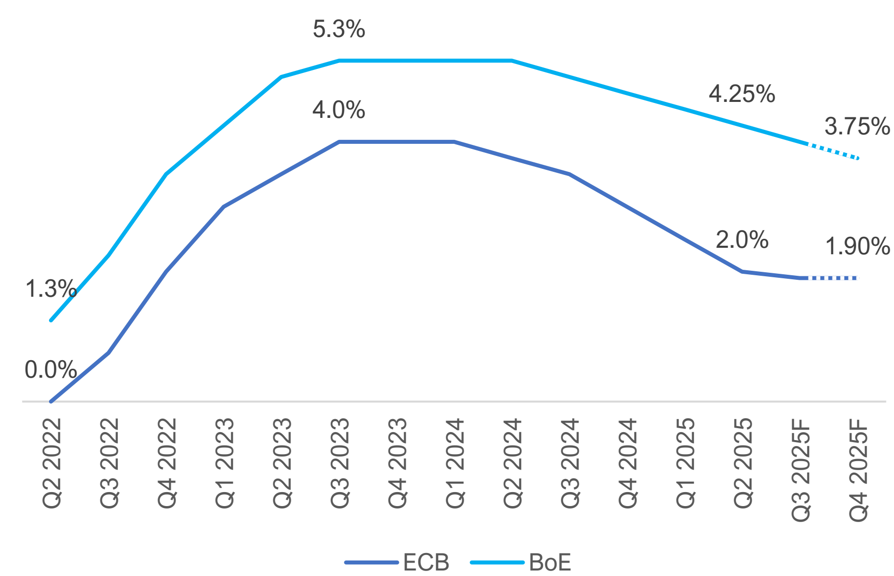
Modest Growth Recovery Amid Rate Cuts

- While GDP growth forecast reflects a slight downward revision across major European economies compared to Q1 forecast, growth is still expected to strengthen in 2026, driven by easing inflation and a rebound in household consumption, in Germany and France.
- Elevated energy costs and geopolitical tensions, particularly in the Middle East, pose key threats to the recovery, potentially dampening external demand and raising inflation pressures.
- The ECB and BoE continues to ease policy rates that peaked in 2023 at 4.0% and 5.25%, respectively.
- With a pause in July, the ECB is expected to have its next rate cut in September, followed by another potential reduction in Q4 2025-signaling a gradual easing path.

GDP Growth Forecast (IMF, 2025F–2026F)



Central Bank Policy Rate Trend (ECB & BoE)



Source: *IMF, Bloomberg, Morningstar, Aranca Research*

Eurozone and Italy outpace UK with stable inflation and stronger manufacturing momentum

Inflation

Country	2024												2025					
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
UK	4.0%	3.4%	3.2%	2.3%	2.0%	2.0%	2.2%	2.2%	1.7%	2.3%	2.6%	2.5%	3.0%	2.8%	2.6%	3.5%	3.4%	N.A
Eurozone	2.8%	2.6%	2.4%	2.4%	2.6%	2.5%	2.6%	2.2%	1.7%	2.0%	2.2%	2.4%	2.5%	2.3%	2.2%	2.2%	1.9%	2.0%
Germany	3.1%	2.7%	2.3%	2.4%	2.8%	2.5%	2.6%	2.0%	1.8%	2.4%	2.4%	2.8%	2.8%	2.6%	2.3%	2.2%	2.1%	2.0%
France	3.4%	3.2%	2.4%	2.4%	2.6%	2.5%	2.7%	2.2%	1.4%	1.6%	1.7%	1.8%	1.8%	0.9%	0.9%	0.9%	0.6%	0.8%
Italy	0.9%	0.8%	1.2%	0.9%	0.8%	0.9%	1.6%	1.2%	0.7%	1.0%	1.5%	1.4%	1.7%	1.7%	2.1%	2.0%	1.7%	1.7%

Manufacturing PMI

Country	2024												2025					
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Eurozone	46.6	46.5	46.1	45.7	47.3	45.8	45.8	45.8	45.0	46.0	45.2	45.1	46.6	47.6	48.6	49.0	49.4	49.5
UK	47.0	47.5	50.3	49.1	51.2	50.9	52.1	52.5	51.5	49.9	48.0	47.0	48.3	46.9	44.9	45.4	46.4	47.7
Germany	45.5	42.5	41.9	42.5	45.4	43.5	43.2	42.4	40.6	43.0	43.0	42.5	45.0	46.5	48.3	48.4	48.3	49.0
France	43.1	47.1	46.2	45.3	46.4	45.4	44.0	43.9	44.6	44.5	43.1	41.9	45.0	45.8	48.5	48.7	49.8	48.1
Italy	48.5	48.7	50.4	47.3	45.6	45.7	47.4	49.4	48.3	46.9	44.5	46.2	46.3	47.4	46.6	49.3	49.2	48.4

Source: *Eurostat, S&P Global, Aranca Research*

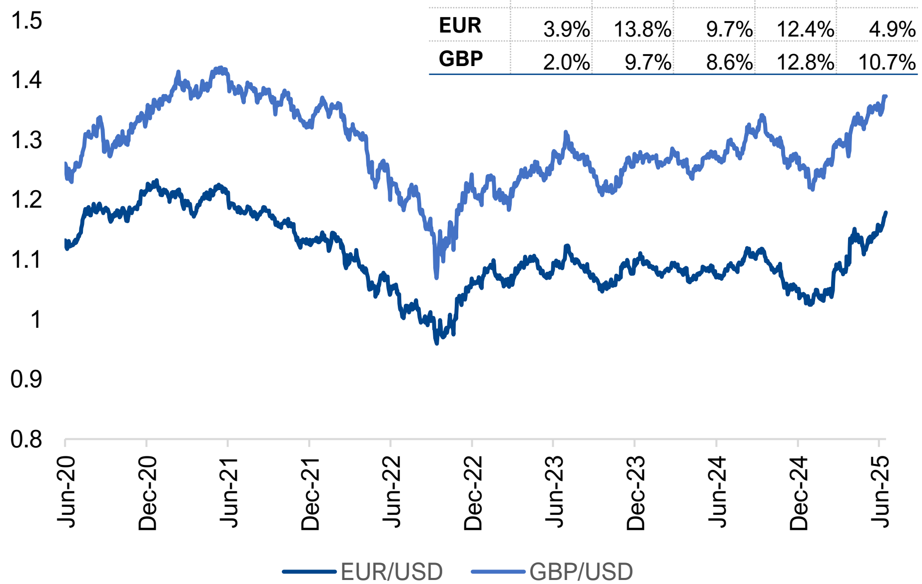
Euro Strength at Risk Amid Widening Policy Divergence

- The Euro has strengthened significantly against the US Dollar due to the capital outflows from US assets amid ongoing trade tensions and shifting investor sentiment towards European markets. The British Pound has also performed strongly supported by improving UK Economic fundamentals and relative monetary policy stability.
- Government bond yields in both the Eurozone and the UK have declined from their 2023 peaks, reflecting easing inflationary pressures and softer growth expectations. This persistent yield differential highlights a key driver of currency dynamics: weak inflation and growth outlooks in Europe. If the ECB maintains a cautious policy stance, this gap is likely to persist potentially eroding Euro strength through the rest of 2025.

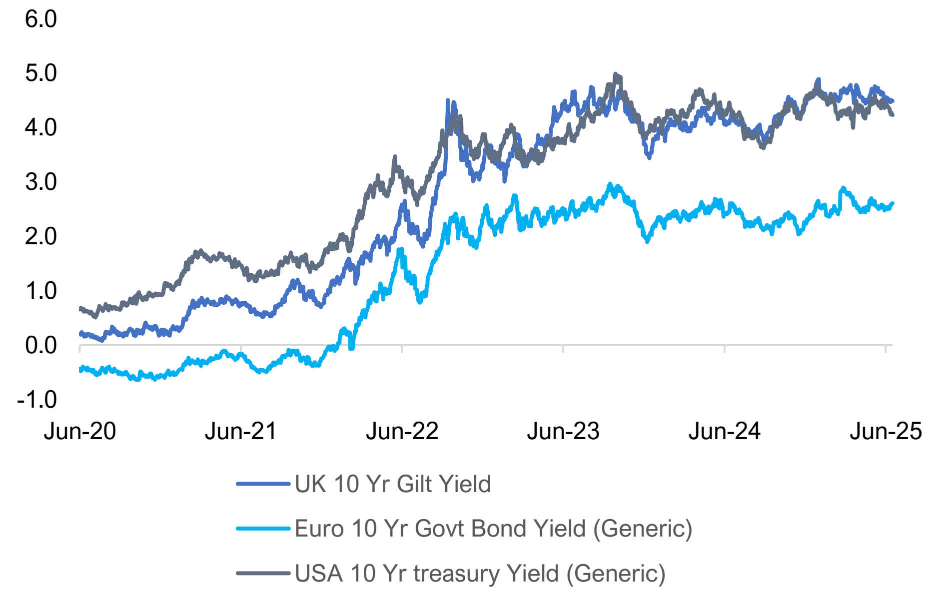
Currency Performance vs. the USD

Spot Returns vs USD (%)

	1-Mo	YTD	1Y	3Y	5Y
EUR	3.9%	13.8%	9.7%	12.4%	4.9%
GBP	2.0%	9.7%	8.6%	12.8%	10.7%



10-Year Government Bond Yields

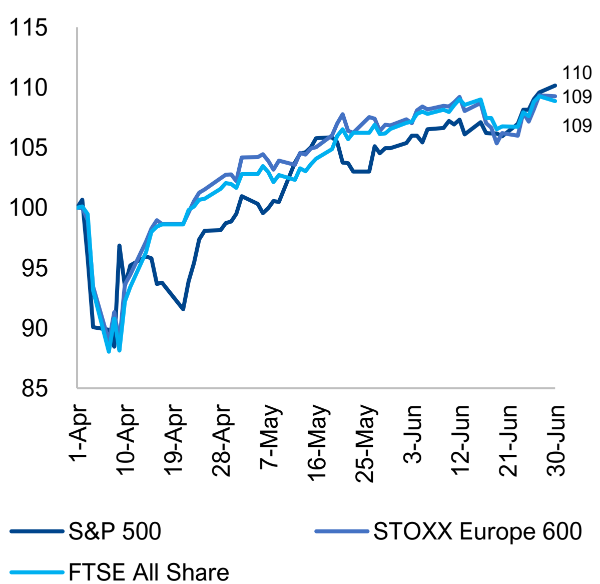


Source: *Bloomberg, Aranca Research*

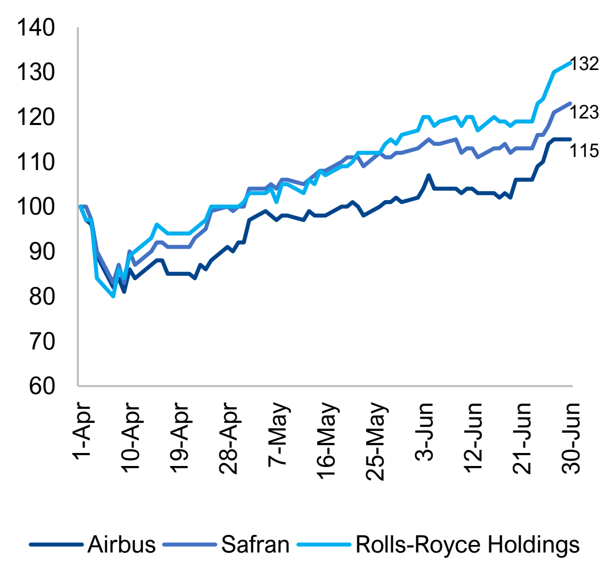
Narrowing the Gap: European Equities Nearly Match U.S. Q2 Gains

- European equities maintained strong momentum in 2Q25, with the STOXX Europe 600 and FTSE All Share rising 9.3% and 8.9%, respectively, slightly trailing the S&P 500's 10.2% gain. The rally was supported by easing inflation and a shift in monetary policy stance, as the ECB delivered a rate cut in June.
- Defense stocks led the charge, extending their 1Q25 gains amid expectations of prolonged rearmament in Europe. Rolls-Royce (+32%), Airbus (+23%), and Safran (+15%) were among the top performers in the STOXX Europe 600 Defense index, reflecting investor confidence in long-term defense and aerospace spending.

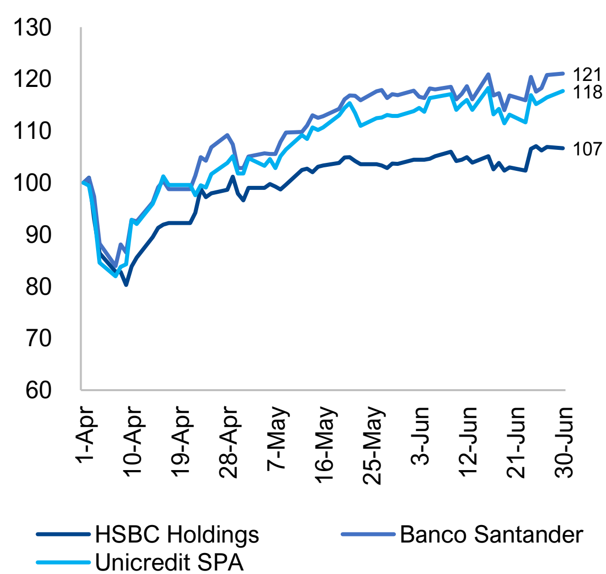
European Index Performance (2Q25)



STOXX Europe 600 Defense (Top 3)



STOXX Europe 600 Banks (Top 3)

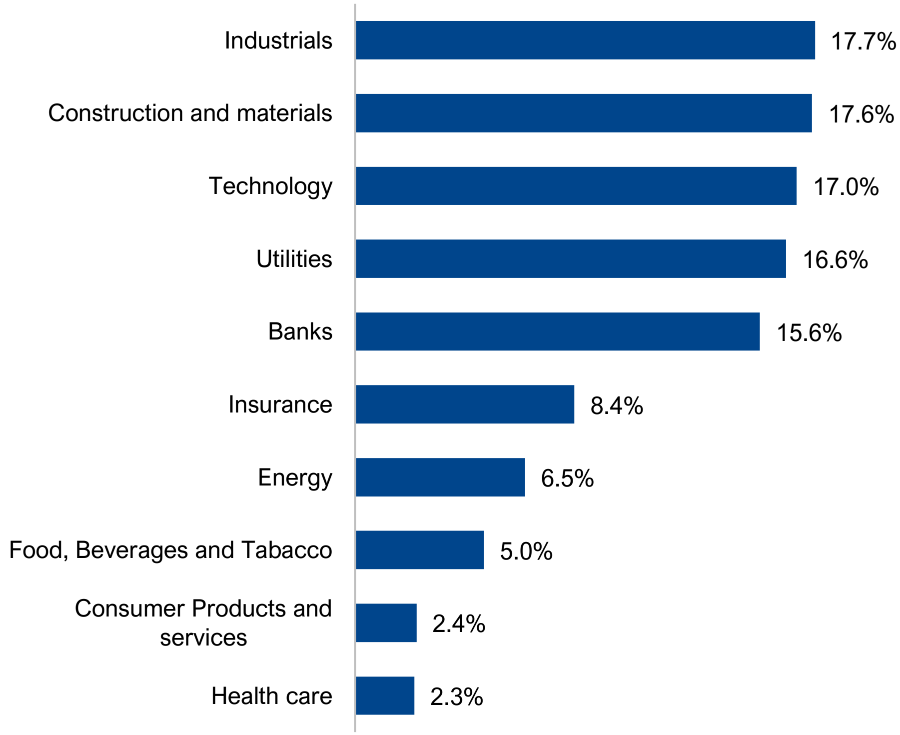


Source: *Bloomberg, Aranca Research; all charts rebased starting from April 1, 2025*

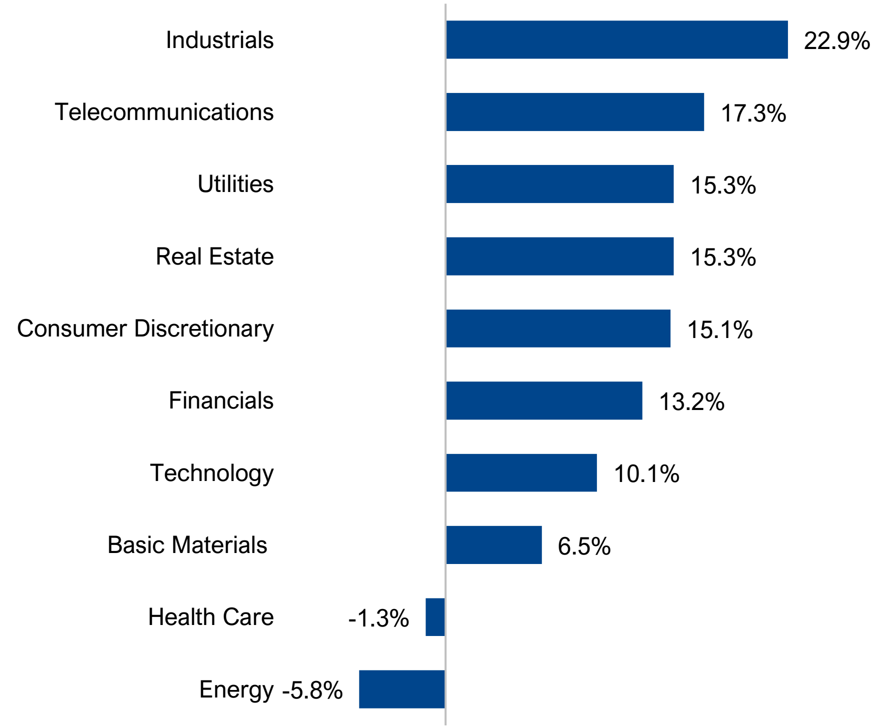
Industrials lead on defense boost, while rate-sensitive sectors rally on ECB cuts

- Industrials outperformed, driven mainly by defense stocks, as rising geopolitical tensions and increased NATO spending boosted investor interest in aerospace and defense segments.
- Real Estate and Infrastructure rebounded due to falling ECB rates and Germany's €500bn infrastructure boost.
- Utilities gained, supported by the ECB's rate cut to 2%, which made their stable dividends more attractive in a low-yield environment amid cooling inflation.

STOXX Europe 600

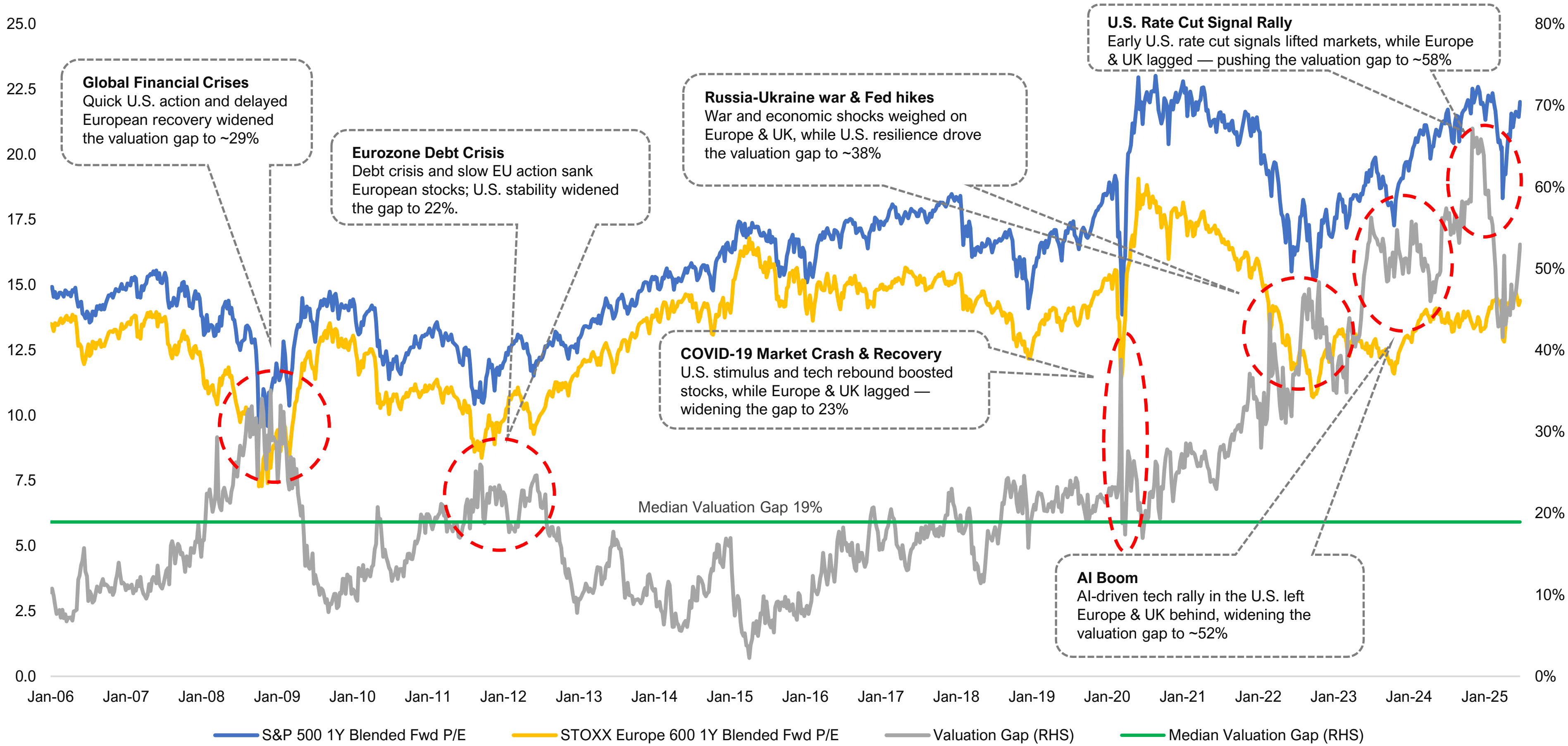


FTSE All-Share



Source: *Bloomberg, Aranca Research*

Valuation Divergence Extends into Q2 as ECB Eases and U.S. Tech Gains



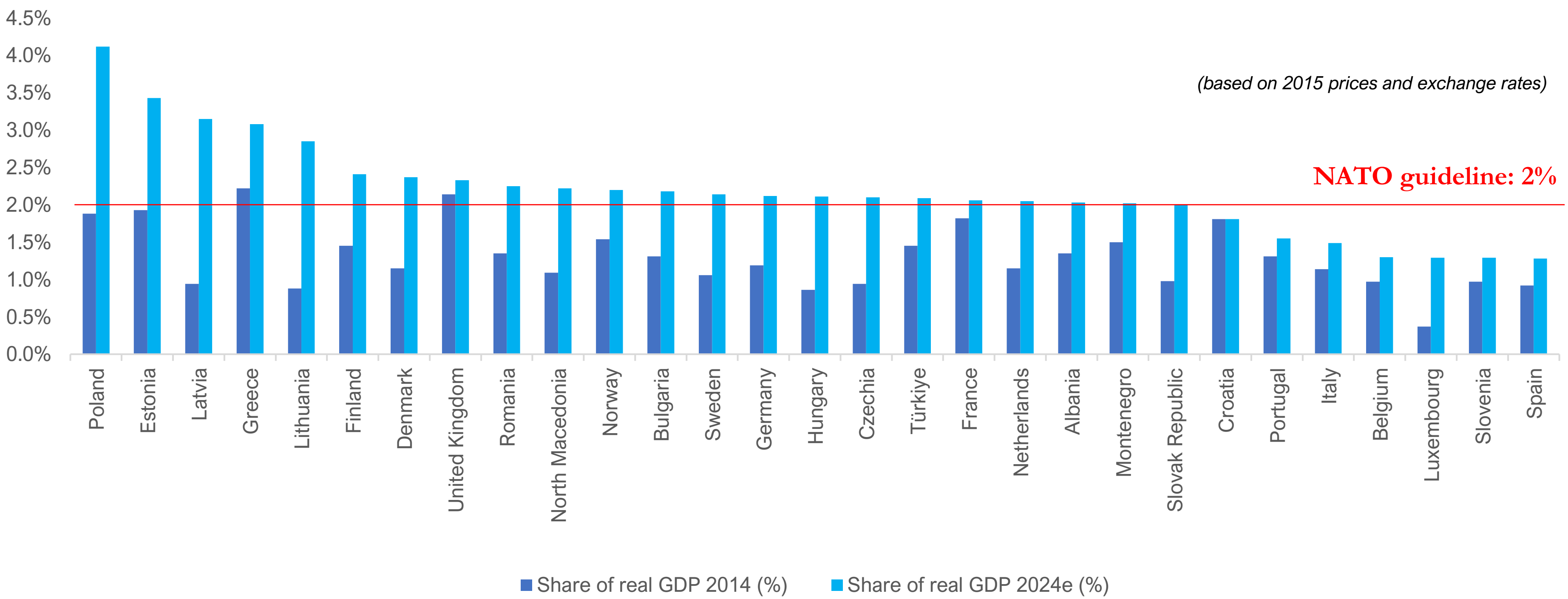
The valuation gap between the S&P 500 and Stoxx Europe 600 narrowed in Q1 2025 but widened sharply in late Q2, as strong US tech earnings and resilient economic data drove US outperformance, while European equities lagged amid weak growth, low tech exposure, and persistent geopolitical risks.

Source: *Bloomberg, Aranca Research*

NATO Spending Surge Sets the Stage for Long-Term Sector Growth

- **NATO raises defense spending target from 2% to 5% of GDP:** Since 2014, NATO member states have operated under a 2% of GDP defense spending guideline. In June 2025, this target was significantly increased to 5% by 2035 (3.5% for core budgets, 1.5% for infrastructure and cybersecurity). This spending increase will result in a total annual defense outlay from ~$380 billion in 2024 to over $1 trillion by 2035, with Europe assuming a greater share as US support recedes.
- **Clear tailwind for European defense companies:** Long-term spending visibility enhances growth prospects and valuation support for EU-listed defense firms, with inflows expected to rise amid structural budget expansions.

NATO Defense expenditure as a share of GDP (%)



Source: *NATO, Aranca Research*

Several Companies Across Defense Segments will be Key Beneficiaries

Key Beneficiaries of Europe's Rearmament Plan

1 Defense Platforms & Systems

Focus: Military aircraft, naval vessels, armored vehicles, and integrated defense platforms.

RHEINMETALL, SAAB, BAE SYSTEMS, THALES, ROLLS ROYCE, DASSAULT AVIATION, FINCANTIERI, LEONARDO, Otokar, AIRBUS

2 Defense Electronics & Subsystems

Focus: Radar, sensors, cybersecurity, surveillance

KONGSBERG, QINETIQ, aselsan 50 years, Chemring – Innovating to protect, Kitron, MILDEF, indra, COHORT PLC – THE INDEPENDENT TECHNOLOGY GROUP

3 Components & Equipment Suppliers

Focus: Propulsion systems, subsystems, and critical hardware integration

Melrose, smiths, AVON TECHNOLOGIES PLC, SAFRAN

4 Small Arms, Ammunition & Niche Defense

Focus: Light weapons, tactical gear, mission-specific services

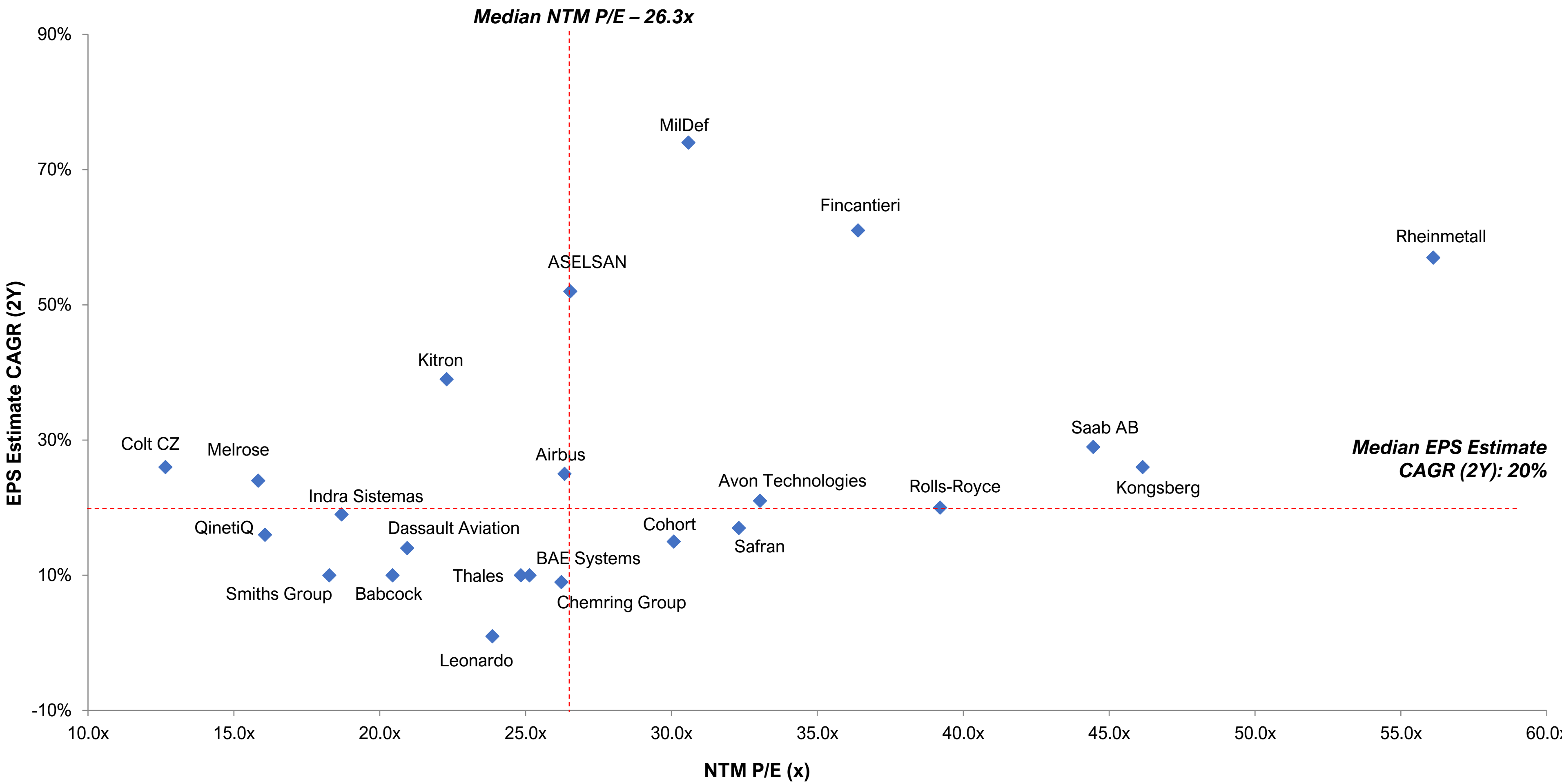
DASSAULT AVIATION, MILDEF, COHORT PLC – THE INDEPENDENT TECHNOLOGY GROUP, COLT CZ GROUP, Babcock

Sustained defense budgets will favor companies positioned in high-tech platforms and mission-critical systems, driving long-term value across select segments.

Source: *BlackRock Europe Defense UCITS ETF, S&P Capital IQ, Aranca Research*

High Valuations Demand Strong Earnings Growth Sustainability

The recent valuation surge reflects market optimism amid rising European defense expenditure. However, current lofty P/E multiples necessitate consistent EPS growth to justify continued valuation premiums.



Source: *S&P Capital IQ, Aranca Research*

2500+
Global clients

500+
Strong, professional team across multi-disciplinary domains

120+
Sectors and sub-sectors researched by our analysis

80+
Countries where we have delivered projects

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