

Special Report

Europe Capital Markets Newsletter – 1Q26



Executive Summary (1/2)

Macro & Growth Overview

- Growth in Europe and the UK is expected to remain modest through 2026–27, as weak productivity, investment frictions, and broader structural constraints continue to weigh on momentum
- The ECB and BoE kept policy rates unchanged through Q1 2026, underscoring a cautious, data-driven stance, as policy makers balanced fragile growth against renewed energy-driven inflation risks rather than signaling a decisive shift toward easing
- Inflation stayed broadly manageable early in the quarter before reaccelerating in March, while PMI readings moved above or around the 50 mark, pointing to steady but only moderate activity across major European economies

Currencies, Bond Yields, and Markets

- Currencies reversed lower in Q1 2026, with EUR/USD and GBP/USD strengthening early in the quarter before giving back gains, as renewed USD strength and persistent rate differentials weighed on European currencies
- Bond yields rose across regions in Q1 2026, with UK gilt and Eurozone yields moving higher, as energy-driven inflation risks reduced expectations for near-term rate cuts, while US Treasury yields also ended the quarter elevated, as markets reassessed the pace of Fed easing
- Q1 2026 market performance was selective, with energy leading gains, as oil prices jumped and technology, banks, and other cyclical sectors lagging amid higher yields, firmer inflation, and risk aversion

Executive Summary (2/2)

The Valuation and Earnings Perspective

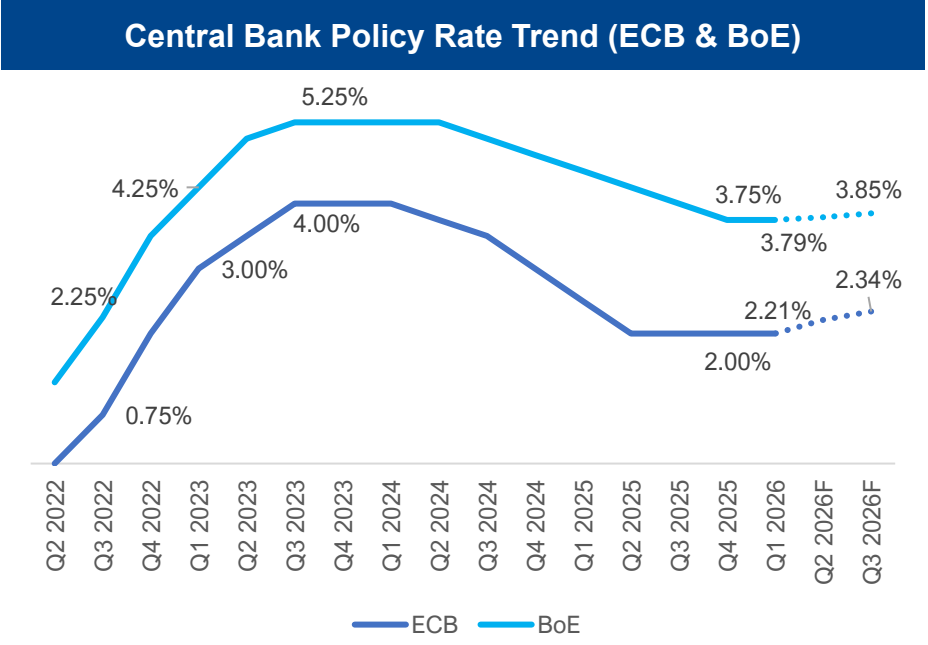
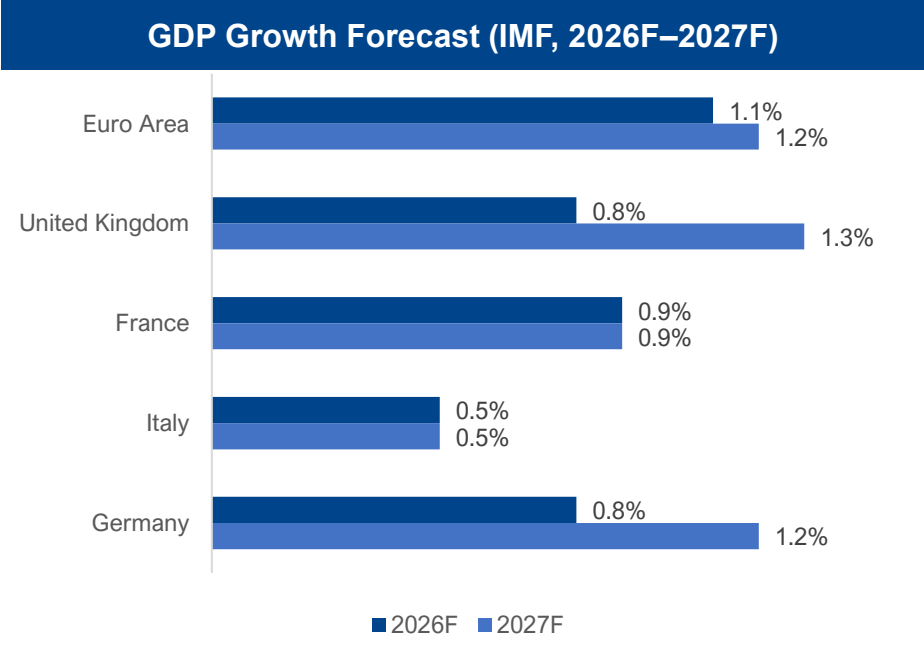
- US equities continued to command a meaningful valuation premium over Europe in Q1 2026, with the S&P 500 still trading well above the STOXX Europe 600 based on forward earnings multiples
- This premium was reinforced by a stronger US earnings backdrop, while Europe's forward growth outlook remained comparatively softer
- Differences in market composition, particularly the heavier US weighting in technology, AI, and other growth-oriented sectors, also helped preserve the valuation spread

Europe's LNG Shock Reprices Gas and Power Markets

- Europe remains structurally reliant on imported LNG after the reduction in Russian pipeline gas, making regional gas and power prices highly sensitive to global supply disruptions
- Middle East supply disruption, reduced LNG trade flexibility, and cargo rerouting have renewed Europe's gas risk premium, keeping TTF and power prices elevated and volatile
- The equity impact is uneven: LNG/trading-exposed companies, low-cost generators, and regulated networks are better positioned, while gas-exposed names with delayed pass-through face margin pressure

Europe Faces Soft Growth as ECB and BoE Hold Rates Steady

- Euro area growth is expected to remain subdued through 2026–27 amid persistent structural and cyclical pressures. Higher energy prices, weak manufacturing activity, softer external demand, and elevated uncertainty have driven downward revisions to regional growth forecasts, particularly for Germany. While higher public and defense spending may provide partial support, consumer demand and private investment remain constrained. Other major European economies, including France, Italy, and the United Kingdom, are also expected to record modest growth amid tight financial conditions.
- The ECB kept policy rates unchanged at 2.0% through Q1 2026, maintaining a cautious stance, as higher energy prices and geopolitical uncertainty created fresh upside risks to inflation and downside risks to growth.
- The Bank of England also held rates at 3.75% through the quarter, balancing subdued growth and easing domestic price pressures against the renewed inflation risks from higher global energy costs.



Sources: IMF, Bloomberg, Aranca Research

Reaccelerating Inflation and PMI Recovery Across Major European Economies

Inflation

Country	2024			2025									2026					
	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar
UK	2.3%	2.6%	2.5%	3.0%	2.8%	2.6%	3.5%	3.4%	3.6%	3.8%	3.8%	3.8%	3.6%	3.2%	3.4%	3.0%	3.0%	NA
Eurozone	2.0%	2.2%	2.4%	2.5%	2.3%	2.2%	2.2%	1.9%	2.0%	2.0%	2.1%	2.2%	2.1%	2.1%	2.0%	1.7%	1.9%	2.5%
Germany	2.4%	2.4%	2.8%	2.8%	2.6%	2.3%	2.2%	2.1%	2.0%	2.0%	2.2%	2.4%	2.3%	2.6%	2.0%	2.1%	1.9%	2.7%
France	1.6%	1.7%	1.8%	1.8%	0.9%	0.9%	0.9%	0.6%	1.0%	1.0%	0.9%	1.1%	0.8%	0.8%	0.7%	0.3%	0.9%	1.7%
Italy	1.0%	1.5%	1.4%	1.7%	1.7%	2.1%	2.0%	1.7%	1.7%	1.7%	1.6%	1.8%	1.3%	1.1%	1.2%	1.0%	1.5%	1.7%

Manufacturing PMI

Country	2025												2026					
	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar
Eurozone	46.0	45.2	45.1	46.6	47.6	48.6	49.0	49.4	49.5	49.8	50.7	49.8	50.0	49.6	48.8	49.5	50.8	51.6
UK	49.9	48.0	47.0	48.3	46.9	44.9	45.4	46.4	47.7	48.0	47.0	46.2	49.7	50.2	50.6	51.8	51.7	51.0
Germany	43.0	43.0	42.5	45.0	46.5	48.3	48.4	48.3	49.0	49.1	49.8	49.5	49.6	48.2	47.0	49.1	50.9	52.2
France	44.5	43.1	41.9	45.0	45.8	48.5	48.7	49.8	48.1	48.2	50.4	48.2	48.8	47.8	50.7	51.2	50.1	50.0
Italy	46.9	44.5	46.2	46.3	47.4	46.6	49.3	49.2	48.4	49.8	50.4	49.0	49.9	50.6	47.9	48.1	50.6	51.3

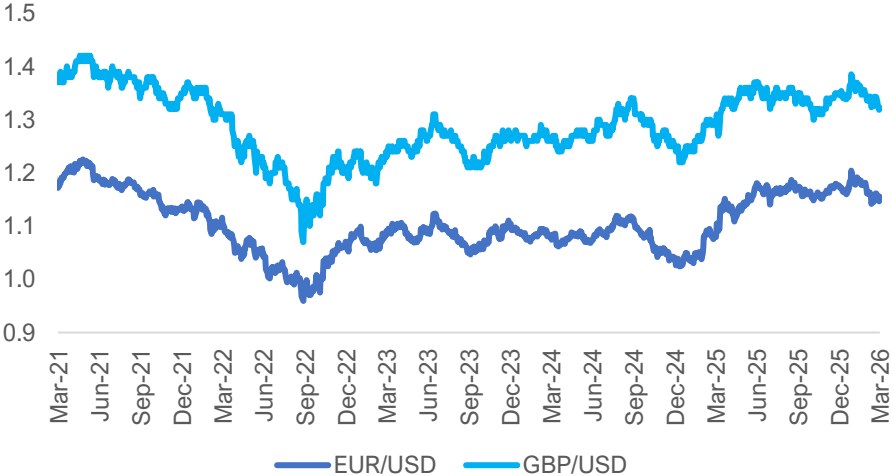
Sources: Eurostat, S&P Global, Aranca Research

Currencies Weaken in Q1 2026, While Government Bond Yields Rise Across Regions

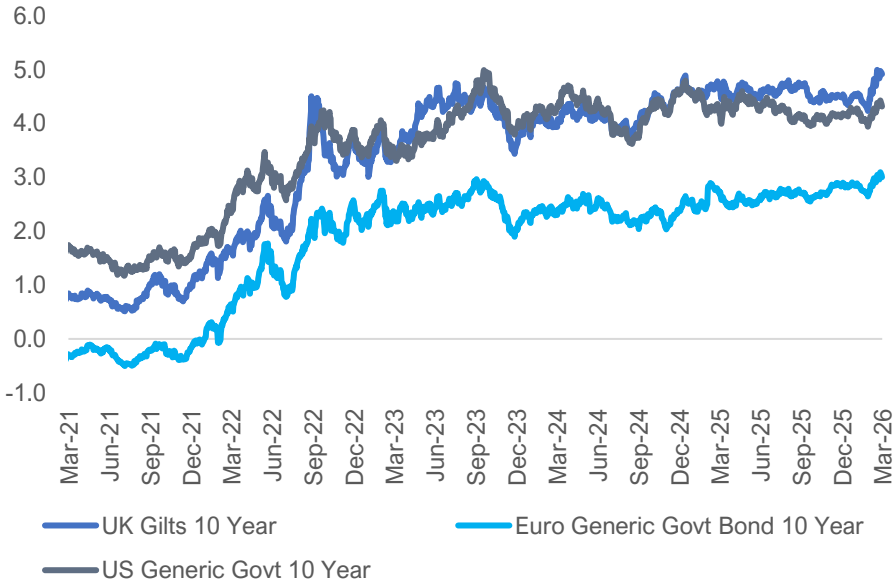
- EUR/USD and GBP/USD strengthened early in Q1 2026 before reversing and trending lower through the remainder of the quarter. Both pairs peaked in late January and declined thereafter, driven by renewed USD strength amid persistent rate differentials, as the Federal Reserve remained more hawkish than the European Central Bank and Bank of England. Despite the pullback, movements remained within a relatively narrow range, indicating a gradual shift rather than a sharp move.
- In 1Q 2026, 10-year government bond yields rose across regions. UK gilt yields increased the most, as inflation and fiscal concerns tempered expectations for rate cuts. Moreover, Euro area yields were higher, as the ECB kept rates unchanged and flagged greater inflation risks from the Middle East conflict. US Treasury yields stayed elevated and volatile, ending the quarter higher, as firmer inflation and higher energy prices led markets to reassess the path of monetary easing.

Currency Performance vs. the USD

Spot Returns vs. USD (%)				
	1-Mo	1Y	3Y	5Y
EUR	-2.2%	6.8%	6.6%	-1.5%
GBP	-1.9%	2.5%	7.5%	-4.2%



10-Year Government Bond Yields

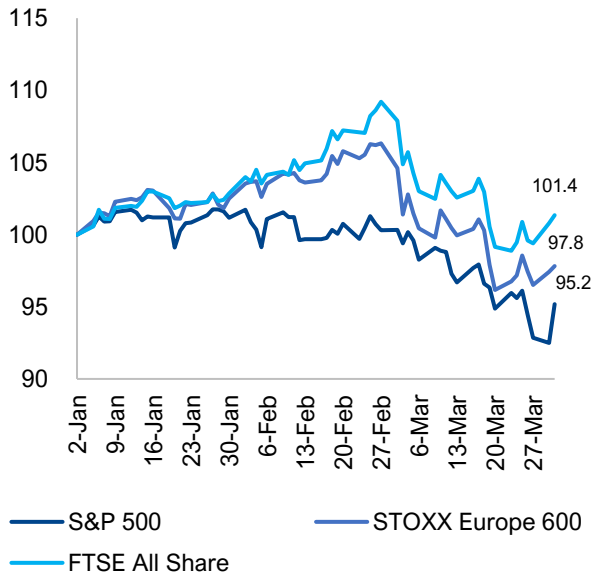


Sources: Bloomberg, Aranca Research

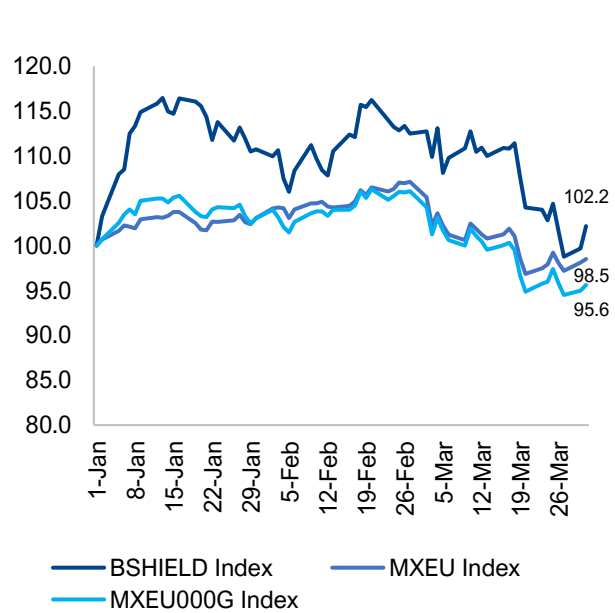
European Equities Weaken in Q1 2026 as Macro Headwinds Intensify

- The STOXX Europe 600 declined in 1Q26, as a sharp sell-off in March offset a firmer start to the year. Higher energy prices, escalating Middle East tensions, and renewed inflation concerns weighed on sentiment and clouded the outlook for Eurozone growth and interest rates.
- Sector performance diverged, with European defense stocks outperforming broader benchmarks in the quarter, supported by structural spending expectations and demand for earnings visibility.
- European banks were weaker over the period and lagged the broader market, as rising risk aversion and a tougher macro backdrop offset otherwise solid earnings, capital positions, and balance-sheet fundamentals

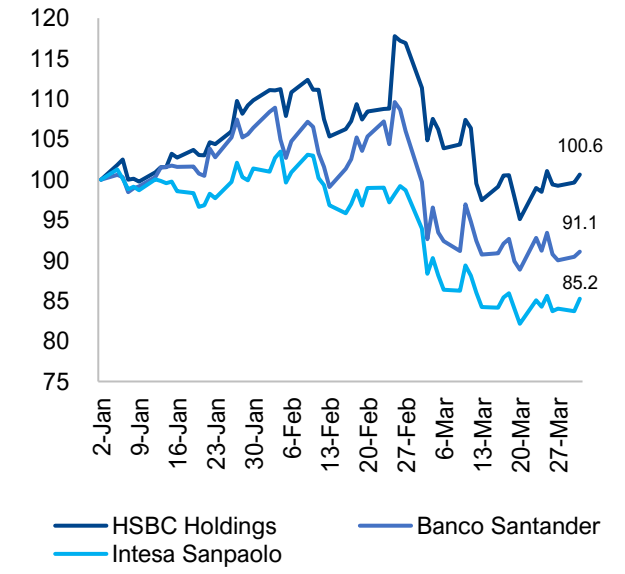
European Index Performance



European Defense vs. Broader and Growth Benchmarks



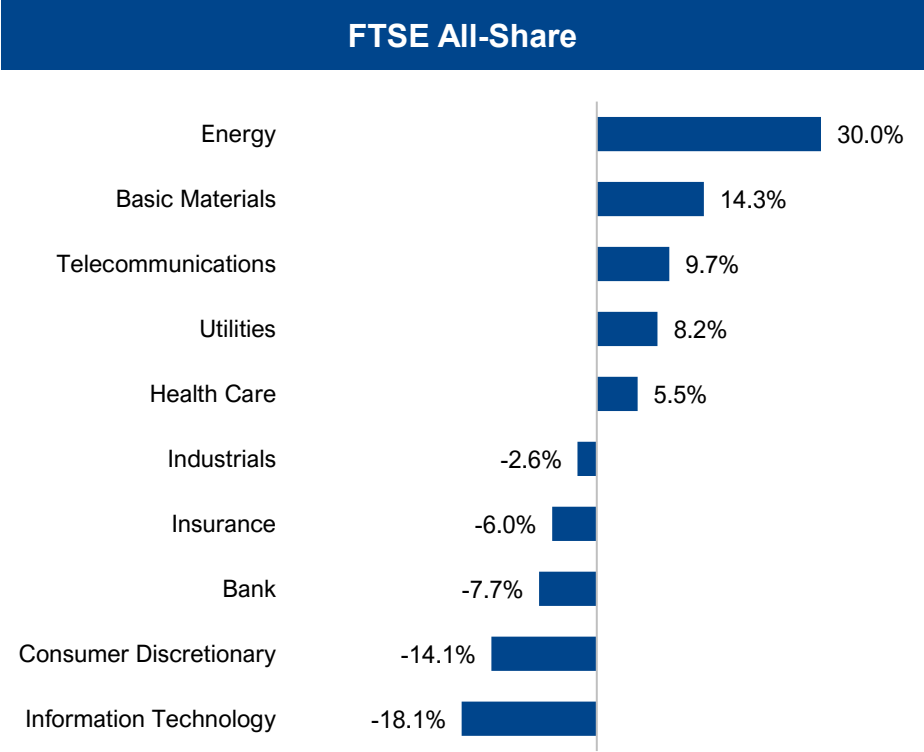
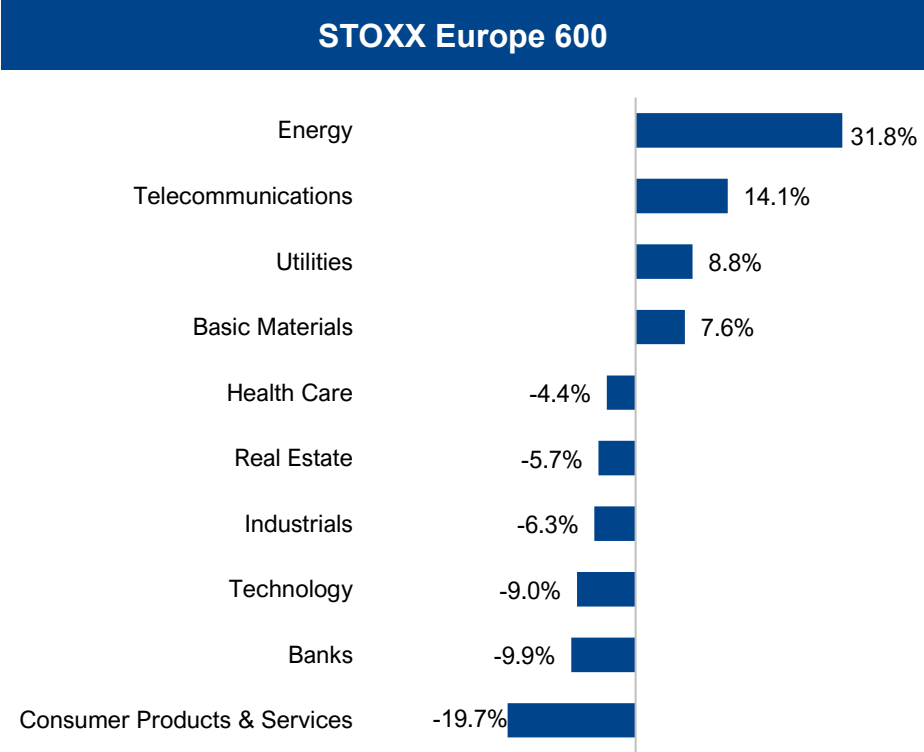
STOXX Europe 600 Banks (Top 3)



Sources: Bloomberg, Aranca Research; all charts rebased starting from Jan 2, 2026
 BSHIELD Index: Bloomberg Europe Defense Index, MXEU Index: MSCI Europe Index, MXEU000G Index: MSCI Europe Growth Index

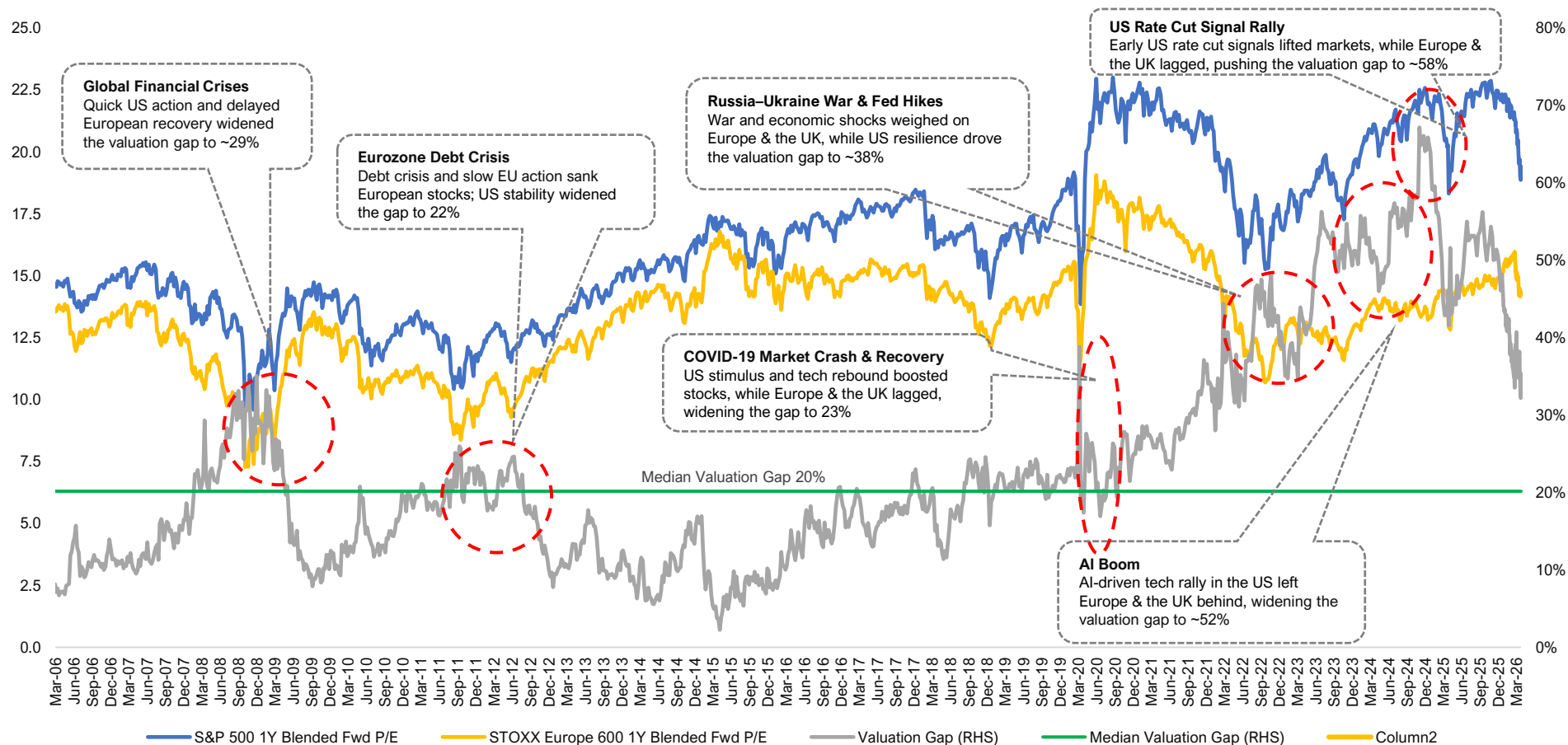
Energy-Led Rotation in 1Q26

- The STOXX Europe 600 in 1Q26 reflected a sharp rotation rather than a broad-based rally. Energy led decisively, while telecommunications, utilities, and basic materials also advanced, supported by higher oil and gas prices and resilient demand for defensive exposures. Consumer products & services, banks, technology, industrials, and real estate lagged, as weaker growth expectations and renewed inflation concerns weighed on cyclical and rate-sensitive sectors.
- The FTSE All-Share showed a similar pattern, with energy and basic materials outperforming, aided by the UK market’s commodity bias and weaker sterling, while consumer discretionary, banks, and information technology underperformed on subdued domestic growth, a firmer rate outlook, and broader risk aversion.



Sources: Bloomberg, Aranca Research

Valuation Gap Reflects Growth Expectations and Structural Differences



In Q1 2026, US equities traded at a premium to Europe, with the S&P 500 at ~19x forward P/E vs. ~14x for European markets (~35% valuation gap). The differential was underpinned by stronger US earnings 1-year momentum (~17% NTM EPS growth vs. ~11% in Europe) with AI and technology sector tilt reinforcing the differential.

Sources: Bloomberg, Aranca Research

Europe's LNG Shock Repricing Gas and Power Markets

- Europe is structurally reliant on imported LNG following the reduction in Russian pipeline gas, making regional gas and power prices highly sensitive to global supply disruptions.
- Middle East disruptions tightened global LNG markets at a time when Europe remains highly dependent on imported LNG. The result is a renewed gas risk premium across European gas and power markets.

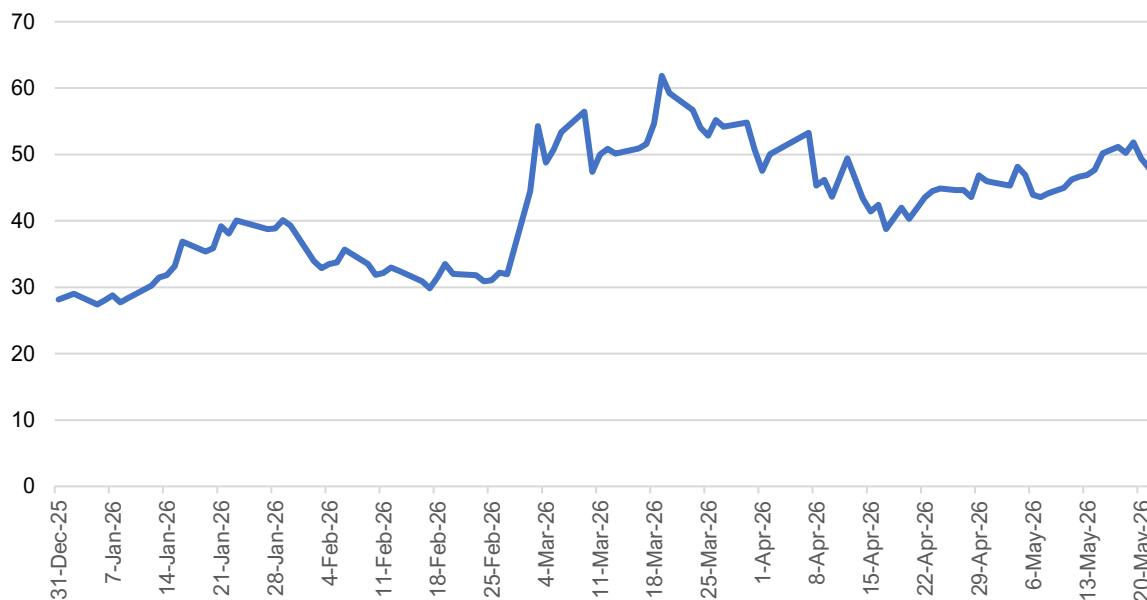
Why this Matters?

- Europe repricing energy security risk
- Low LNG availability
- Rising storage refill costs
- Gas volatility feeding through into power prices

What is Driving it?

- Middle East LNG supply disruption
- Reduced flexibility in global LNG trade
- Cargo rerouting and freight pressure
- Competition for replacement supply

ICE Dutch TTF Natural Gas Future



Key Takeaways

Higher LNG procurement costs



More volatile power markets



Renewables and storage become relatively more attractive

Source: Aranca Research

European Utilities: Who Benefits, and Who Gets Pressured

Ability to protect margins during volatility

Defensive Regulated Networks - Regulated returns and pass-through reduce commodity risk

Low gas-price sensitivity | High cost pass-through



Volatility & LNG Beneficiaries - LNG exposure and trading flexibility support earnings

High gas-price sensitivity | High ability to monetize volatility



Direct gas exposure

Low-Cost Generation Beneficiaries - Renewables and hydro gain competitiveness vs. gas

Low gas-price sensitivity | Benefit from cheaper generation mix



Margin Pressure Names - Fuel cost inflation can outpace tariff recovery

High gas-price sensitivity | Lower or delayed pass-through



The impact of Europe's LNG shock depends on pricing flexibility, generation mix, and direct gas exposure



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500+

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120+

Sectors and sub-sectors researched by our analysis

80+

Countries where we have delivered projects

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