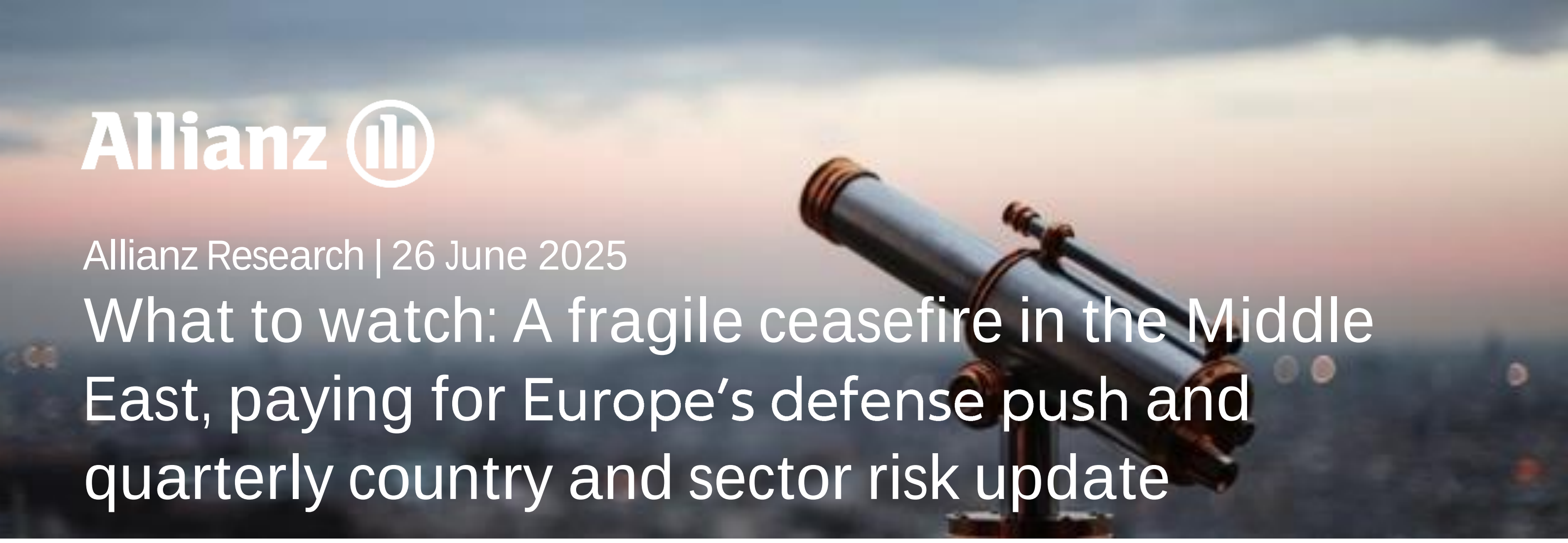

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What to watch: A fragile ceasefire in the Middle East, paying for Europe’s defense push and quarterly country and sector risk update

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In summary

Middle East conflict: Can the fragile ceasefire hold? A ceasefire agreement brokered by the US has temporarily eased fears of a wider regional conflict, bringing down oil prices over -10% to below USD70/bbl, and gas prices down -12%. Global financial markets reacted positively, with both S&P500 and Stoxx Europe 600 up, while corporate bond risk premia narrowed. Regional markets showed varied impacts, notably with Israel's TA-35 index rising 5% above pre-war levels. Yet, uncertainty remains, with ongoing hostilities expected. Our baseline scenario (65% probability) remains a contained military exchange with the current intermittent ceasefire, with 2025 growth at +1.2% in the Eurozone and +1.6% in the US and the oil price around USD68/bbl. However, a downside scenario (10% probability) with escalating conflict would have substantial negative impacts on economic growth (-0.8pp and -0.9pp, respectively) as oil prices would escalate to USD120/bbl in 2025.

Guns, gaps and (industrial) glut: The **state of Europe’s defen**se push. European defense investment has surged +75% since the Russian invasion of Ukraine in 2022. But meeting the proposed 3.5% of GDP target will require Germany to spend USD64bn more per year, France USD45bn, Italy USD47bn and the UK USD41bn relative to 2024 GDP levels. So far, only Belgium intends to raise taxes to finance the increase while the UK opts for a shift in its budget by cutting foreign aid. As taxes or spending cuts are politically costly, financing defense with new debt will be the first choice for many governments. But raising the defense spending ratio is not a one-off stimulus – it implies a structural increase in outlays. Relying on debt will therefore put fiscal slippage to a market test: Raising defense spending by +1-2pps of GDP via debt would almost mechanically inflate debt ratios by +10-20pps over the next decade. This could widen sovereign spreads in the eurozone by +10-40bps, worsening the fiscal situation. Resorting to EU-level funding mechanisms offers little relief as this would largely constitute an accounting exercise – interest payments on common EU debt would still need to be financed by national budgets. Another hurdle is that industrial capacity lags – European defense order books grew +70% since 2022 and backlogs +60% at over EUR 1trn, yet capex remains stuck at around 5% of revenue.

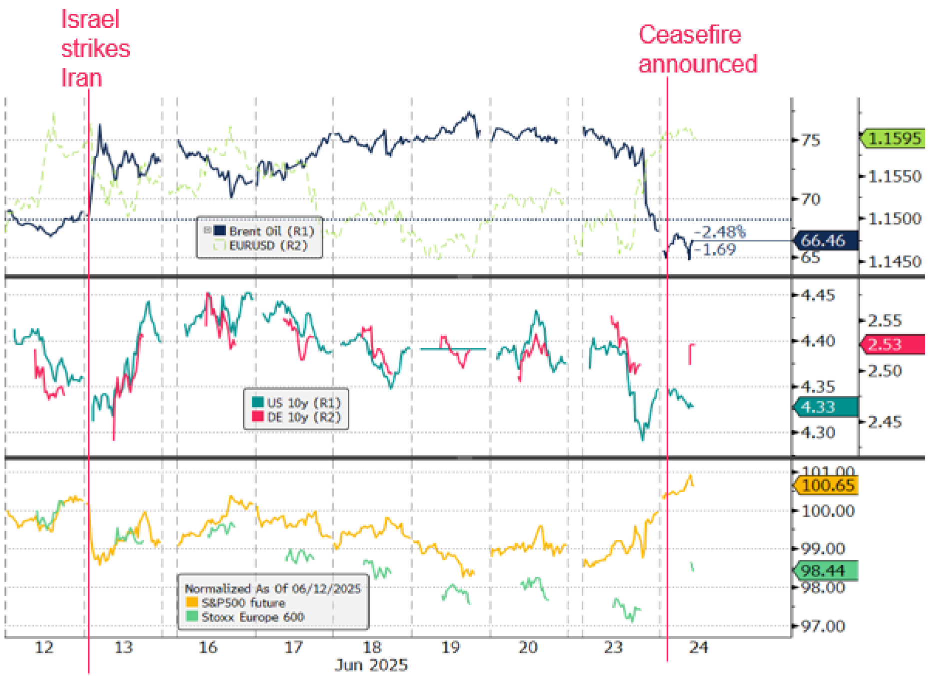
Quarterly country and sector risk ratings: A turning point. After two and a half years of consistent net upgrades, our latest review saw an equal number of upgrades and downgrades, signaling a shift in global economic resilience from high-income to emerging economies. Advanced economies face mounting fiscal and political pressures, leading to downgrades by one notch for the US, France and Belgium, all rated A1, while emerging markets including Argentina, Nigeria and Peru show cautious signs of recovery, with upgrades of one notch to C3 for Argentina and Nigeria and B1 for Peru. For sectors, we find a slight deterioration in the risk outlook for the third consecutive quarter, with 16 downgrades and 12 upgrades. Downgrades occurred in most regions, mostly from Medium to Sensitive risk, but especially in the automotive sector due to the weak demand outlook and intense competition. Transport equipment and software & IT services accounted for half of the upgrades. Overall, risk ratings remain below 2019 levels in most sectors, with the only exceptions being electronics, computer & telecom, metals, software & IT and paper, where upgrades overtook downgrades after the pandemic.

Middle East conflict: Can the fragile ceasefire hold?

After a week of intensifying conflict between Israel, Iran and the US, an intermittent ceasefire agreement was successfully brokered by US President Trump, calming energy markets. Oil markets swiftly reacted, with prices dropping more than 10% to below 70 USD/bbl, after reaching close to 80 USD/bbl on 20 June. Fears over the potential closure of the Strait of Hormuz were alleviated by 24 June. Brent crude oil prices experienced the highest volatility since 2022 due to the conflict, while natural gas prices also saw a 12% decline following the ceasefire announcement. The recent developments underline how energy markets are vulnerable to geopolitical events but inflationary risks recede for Europe and the US as prices normalize.

While oil markets showed the biggest reaction to the ceasefire, a general risk-on move could be observed in global financial markets. The S&P500 gained more than 2% following the easing of tensions in the Middle East, while the Stoxx Europe 600 lagged a bit with 1.5%. Additionally, the euro gained 1.5% against the dollar, so both stock indices are above their pre-war levels in USD terms. A similar pattern could be observed in corporate bonds where risk premia of around 5bps (15bps) on average were priced out on both sides of the Atlantic in the investment grade space (high yield). Government bond yields fell amid lower breakeven inflation, with the exception of Germany where Bunds struggled to rally as additional financing needs by the government pushed against the global trend of lower yields. Regional markets were even more affected, with local stock markets outpacing both developed and emerging market indices. Israel's TA-35 stock index is now 5% above pre-war levels on top of a 2.5% gain of the Israel shekel. The Abu Dhabi stock index gained more than 4% from its recent trough a week ago – though it now stands only slightly above pre-war levels.

Figure 1: Market reactions to war escalation



Sources: Bloomberg, Allianz Research

What happens next remains uncertain, but our baseline scenario remains a contained military exchange with the intermittent ceasefire (with an increased probability of 65%). This scenario (see Table 1) expects reduced tensions but continued hostilities between both sides, similar to the exchanges observed between 13 and 23 June. While the ceasefire has reduced tensions in the region, it is unclear what such an agreement will look like in the long term, and if both Tel Aviv and Teheran will stick to it. Shortly after the ceasefire was announced, Israel announced further retaliation, accusing Iran of violating the agreement.

Table 1: Middle East escalation scenarios update

		Upside (20%) – Comprehensive regional framework in the Middle East (incl. Israel, Iran, US and Arab allies)		Baseline (65%) – Contained military exchange amid intermittent ceasefires		Downside (10%) – Full escalation of war	
		2025	2026	2025	2026	2025	2026
Description		Following an initial Iranian retaliation, which is effectively managed by the United States, Iran, Israel, Gulf States and the US begin conversations for actual comprehensive regional framework.		Iran, Israel, and the United States engage in exchanges of fire, avoiding full-scale war. Intermittent ceasefire established without comprehensive regional framework. Renewed hostilities risk remains.		The war escalates significantly, oil infrastructure in the region as well as US military bases are severely attacked. Circulation through the Hormuz Strait could also be compromised.	
Oil Brent (USD / barrel), eoy		$66 (-3%)	$64 (-3%)	$68	$66	$120 (+60%)	$90 (+36%)
Natural Gas (TTF), eoy		EUR 34 (-9%)	EUR 32 (-10%)	EUR 37.2	EUR 35.3	EUR 60 (+38%)	EUR 50 (+29%)
GDP	EZ	1.3% (+0.1pp)	1.2% (+0.1pp)	1.2%	1.1%	0.4% (-0.8pp)	0.1% (-1pp)
	US	1.7% (+0.1pp)	1.7% (+0.1pp)	1.6%	1.6%	0.7% (-0.9pp)	0.6% (-1pp)
Inflation	EZ	1.8% (-0.1pp)	1.8% (-0.1pp)	1.9%	1.9%	2.6% (+0.7pp)	2.4% (+0.5pp)
	US	3.1% (-0.1pp)	2.6% (-0.1pp)	3.2%	2.7%	4.4% (+0.7pp)	3.3% (+0.6pp)
EURUSD		1.15 (unch.)	1.15 (unch.)	1.15	1.15	1.10 (-5%)	1.10 (-5%)
Monetary Policy	ECB	1.5 (unch.)	1.5 (unch.)	1.5	1.5	2.0 (+50bp)	1.50 (unch.)
	Fed	4.25 (unch.)	3.5 (unch.)	4.25	3.5	4.25 (unch.)	4.00 (+50bp)
10y	DE	2.2 (-10bp)	2.2 (-10bp)	2.3	2.3	2.8 (+50bp)	2.5 (+20bp)
	US	4.4 (-10bp)	4.1 (-10bp)	4.5	4.2	5.0 (+50bp)	4.5 (+30bp)
Equity market	EZ	23 (+5pp)	10 (+3pp)	18	7	8 (-10pp)	6 (-1pp)
	US	10 (+6pp)	9 (+2pp)	4	7	-8 (-12pp)	10 (+3pp)
IG Credit spread	EZ	90 (-10bp)	80 (-10bp)	100	90	130 (+30bps)	110 (+20bps)
	US	90 (-10bp)	80 (-10bp)	100	90	130 (+30bps)	120 (+30bps)

Note: 5% probability left for tail risk. Source: Allianz Research

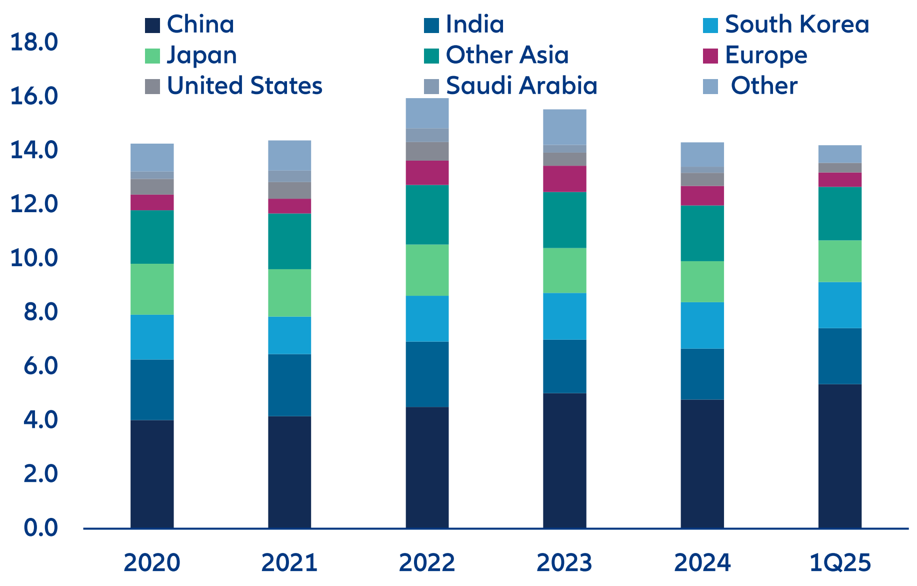
An upside scenario leading to a comprehensive regional framework in the Middle East (probability of 20%) would significantly change the growth outlook in the US and Eurozone. GDP would increase by +0.1pp in the US and Eurozone, and inflation would fall by -0.1pp in both markets, given the restrained drop in oil prices. We project crude prices would decrease by 3%, to USD66/bbl in 2025 and USD64/bbl, demonstrating that current oil prices are already on the lower end of the price scale. Notably, this scenario would lead to a reduction in natural gas prices by approximately 10%, lowering them to EUR34 from the current average of EUR37 in 2025, and to EUR32 from EUR35 in 2025. Lower natural gas prices would be beneficial for European industry and consumers.

The downside scenario would bring much greater risks to the global economy as oil prices could increase by +60% to USD120/bbl in 2025 and by +36% to USD90/bbl in 2026. A potential escalation of the conflict hitting oil infrastructure in the region and leading to a blockage of the Strait of Hormuz would see Eurozone and US GDP deteriorate by 1pp, and inflation rise by 0.5pp in the Eurozone and 0.6pp in the US. Consequences for the Asian continent would be greater as Asian oil flows are highly dependent on flows through the Strait. This could prompt Asian economies to consider diversifying sources of oil, looking to other markets such as those in Africa or other Middle Eastern sources.

Consequences in the region will be enduring as geopolitical risk has been made more apparent following the 12-days war. Consequences will vary across the region. Iran could emerge as a weaker regional player and become more unstable internally. In addition to the damage to nuclear and military infrastructure, Israeli strikes have decimated a significant portion of Iran's military and political leadership, leaving less experienced leaders in control of the Islamic Republic. Although the regime is shaken, it has not collapsed as no internal defections from the leadership or civil society have been reported, with Iranians rallying around the flag.

In Israel, the societal response to the war and its impact on support for the Netanyahu government remains to be seen. Prior to the artillery exchanges with Tehran, opinion polls indicated low approval ratings for the government, predicting a loss if elections were held. But the Iranian war was popular, and it has been reported that Netanyahu is weighing whether to call for snap elections, which should take place during the second half of 2025. In the Gulf, the return of risks has disrupted years of perceived peace in the region. Monarchies will likely ramp up their security arrangements, given the consequences of a destabilized Iran. Among the direct consequences could be a diversification of oil routes through new pipelines avoiding the Strait of Hormuz, especially from Asian crude importers that are the crude's main client (See Figure 2). This could include a faster reopening of the pipeline connecting Iraqi oil fields to Turkey via Iraqi Kurdistan and renewed investment for pipelines connecting Saudi oil fields to the Red Sea, as well as potential new pipelines connecting Persian Gulf oil to the Arabian Sea. We would also expect the increased reassurance of a US security umbrella for all parties in the region.

Figure 2: Destination of oil flows passing through the Strait of Hormuz



Sources: IEA, Allianz Research

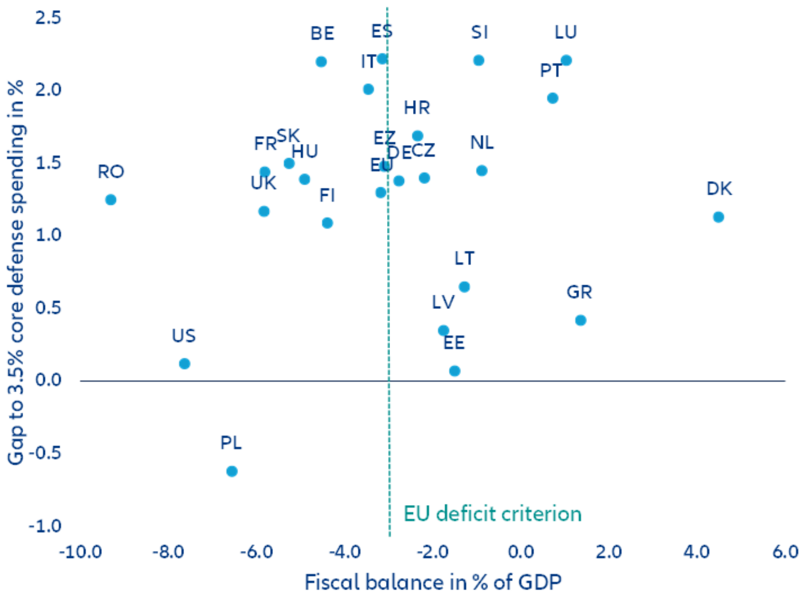
Guns, gaps and (industrial) glut: **The state of Europe's defense push**

One target, multiple paths and uneven commitments. Since Russia's full-scale invasion of Ukraine in 2022, Europe's defense investments have skyrocketed (+75%), with the lion's share directed towards equipment procurement (85% of the increase). Research and development spending has risen by a more modest +26%. In 2023, defense investment surpassed EUR100bn for the first time – close to one-third of total defense spending that year. The prospect of a 3.5% of GDP target for core defense expenditure is now reshaping strategic planning. If this benchmark is adopted and GDP grows at a conservative average of +1.5% between 2026 and 2029, cumulative defense spending could reach EUR2.6trn. Of this, between EUR660bn and EUR925bn could be earmarked for procurement and innovation. If 2024 trends continue, investment spending could total around EUR845bn over the period – close to what the EU has projected as necessary to rearm by 2030. But if spending growth tracks 2023 levels, total investment would fall toward the lower bound of that range.

The challenge is not just how much is spent, but where the money goes. In 2023, nearly 42% of European defense budgets were absorbed by personnel costs. For comparison, the US allocates 37% of its defense budget to procurement and R&D. Europe must pivot towards industrial investment – setting a baseline of at least 30% of total defense expenditure – in order to modernize capabilities and align with transatlantic standards. Moreover, the path to 3.5% of GDP spending is uneven. Reaching that level would require an additional USD261bn annually cumulatively across EU NATO members compared to 2024 levels, but Germany plans to reach the target by 2029, France by 2030 and the UK by 2035. Italy has committed to the goal but warns it could take a decade to get there.

Poland has already cleared the bar, spending 4.1% of GDP on defense in 2024 (Figure 3). For Germany, the gap is steep. Raising defense spending from 2.1% to 3.5% of GDP would mean an annual increase of USD63.6bn. France would need to add USD44.9bn, Italy USD46.5bn and the UK USD41.2bn. Broader security-related spending – on infrastructure, energy resilience and cybersecurity – is already around 1.5% of GDP across most European NATO members. While definitions remain flexible, current levels suggest many countries could meet the 1.5% non-core defense benchmark by 2035 through reallocation and targeted investment. Sectoral data from larger economies supports this, even when excluding social or environmental spending. Still, cracks in the consensus are emerging. Spain, while committing to raise defense spending from 1.3% to 2.1% of GDP by the end of the decade, keeps an opt-out of the 3.5% target. Prime Minister Pedro Sánchez's decision appears more political than economic as Spain's fiscal position has improved. But it risks setting a precedent for other states facing similar political constraints. Slovakia has reservations, and several EU members still fall short of NATO's 2% GDP minimum.

Figure 3: Gap to the 3.5% core defense spending target from 2024 levels (in %) and fiscal deficits (in % of GDP)



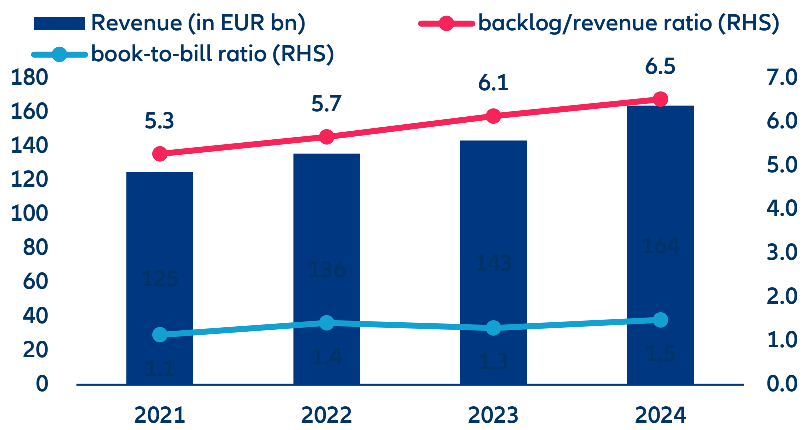
Sources: ECB, NATO, Allianz Research. Note: Fiscal balance for US from 2023.

European industry is still catching up and cannot deliver much more. The post-Ukraine investment wave has translated into surging order books at Europe's major defense firms. New orders among the 30 leading European defense companies have risen +70% since end-2021, while backlogs are up more than +60% and outpaced EUR 1trn last year. Orders in 2024 are estimated at 1.5 times annual revenues, while backlogs stand at 6.5 times yearly sales (Figure 4), indicating that many firms are operating near full capacity. Rheinmetall, a key supplier of artillery and ammunition, has seen its backlog triple since late 2022, reaching EUR33bn in Q1 2025. Yet, despite booming demand, capital expenditure across the sector remains lackluster. In 2023, defense companies invested just over 5% of revenues (Figure 5) – on par with 2020 levels and far below other capital-intensive industries such as automotive or tech. This reluctance reflects persistent doubts among corporate boards about the durability of the current defense upturn. A formal commitment from EU member states to maintain a 3.5% of GDP target could help anchor expectations and unlock larger-scale investment in production capacity.

External dependence is another concern – but the picture is mixed. While the European Commission reported that 78% of EU military imports between February 2022 and July 2023 came from outside the EU – mostly the US – trade data tells a more nuanced story. For France, Germany, Italy, Spain and Poland, the intra-EU share of weapons and ammunition imports remains around 50%. Though the share of imports from the US, Israel and South Korea has risen slightly – from 28% to 32% – there is no evidence of an overwhelming dependence. However, gaps in certain segments are glaring. Europe lags behind in key technologies like drones, semiconductors, cloud services and advanced sensors.

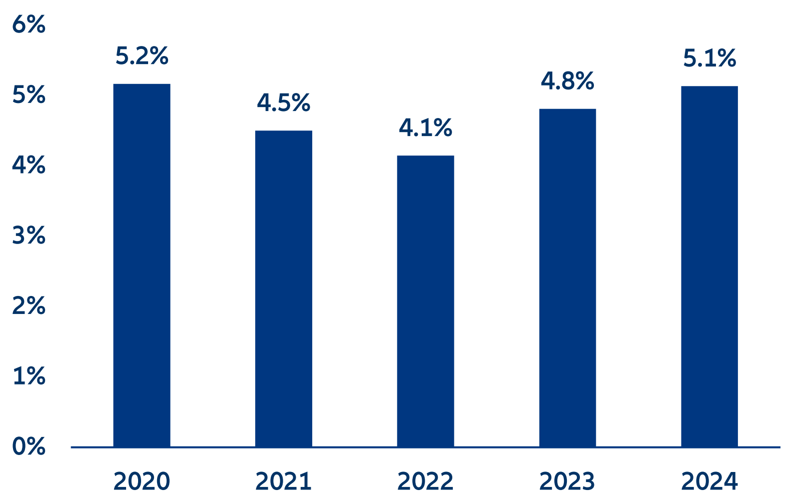
Ukraine still imported 95% of its drones from China in Q1 2025 – underscoring the absence of a competitive European alternative. The EU's weak industrial position in next-generation military tech is a vulnerability, especially in a world where conflicts are as likely to erupt in cyberspace and the stratosphere as on land or sea. The EU's defense industry expansion has so far focused on short-term battlefield needs: ammunition, drones and land systems. But a durable defense base requires investments across the board, including in naval, aerospace and emerging technology sectors. That includes AI, robotics and secure communications – critical for strategic autonomy. Europe must also scale cooperation. Lead times for new military platforms range from 5 to 15 years. Without coordinated planning, the risk is that new money gets mired in duplication, delays and waste. A detailed industrial roadmap and strategy are needed[1].

Figure 4: Annual backlog/order to revenue ratio of top European defense companies



Figures from the defense departments of Airbus, Thales, Rolls-Royce, Kongsberg, Northrop Grumman and Thyssenkrupp (marine systems segment). Sources: Corporate filings, LSEG Datastream, Allianz Research

Figure 5: Annual capex ratio of top European defense companies



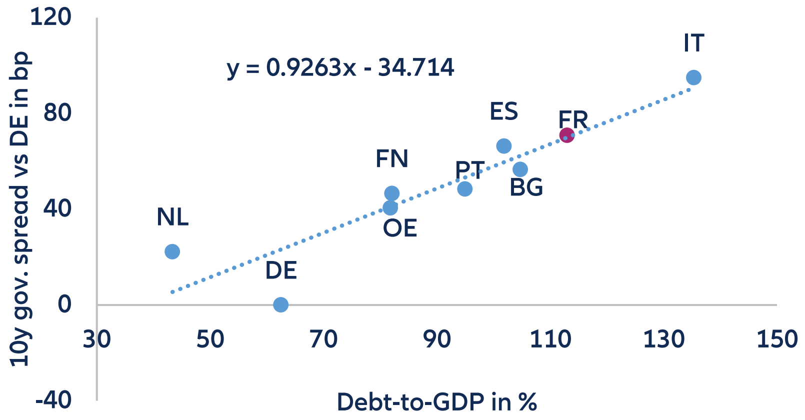
Sources: Corporate filings, LSEG Datastream, Allianz Research

[1] *See our report* [Captain Europe: Five ways to forge the region's defense shield.]

The question remains: how to finance re-armament without blowing deficits? The reinstatement of EU fiscal rules in 2024, alongside the reactivation of the National Escape Clause, provides some breathing room. For the seven EU member states still under the 2% threshold, that leeway reduces excuses for further delays in the ramp-up in defense. In the near term, debt-financed spending – either through national borrowing or EU-level instruments – offers the most viable path. Germany and Sweden are opting for debt; Greece plans to reprioritize within its existing budget. Belgium is pursuing tax increases, while the UK has opted to slash foreign aid. But none of these strategies offer a permanent fix. Reallocation of EU funds could help bridge the gap temporarily. Roughly EUR90bn could be redirected from the Next Generation EU (NGEU) program to support dual-use and defense-related projects through targeted loans – particularly for fiscally constrained states. Poland has floated a model that shifts EUR6bn from green to dual-use defense spending via its development bank, side-stepping NGEU disbursement deadlines. Similar models could be replicated using national institutions such as Germany's KfW, France's CDC or Italy's Cassa Depositi e Prestiti. At the EU level, the proposed ReArm Europe Plan – potentially funded through SAFE (Strategic Technologies for Europe Platform) joint borrowing – could mobilize up to EUR150bn. Looser debt rules would help Italy, Spain and other strained budgets participate. In theory, the EU could collectively mobilize up to EUR800bn. But as always, implementation will depend more on national political will than Brussels' toolkit, while the ultimate challenge is to convince markets to buy the additional debt without demanding much higher interest rates, and hence avoiding a fiscal blowback.

Defense spending is not a one-off stimulus; it implies a structural increase in outlays. Annual increases in defense budgets of 1-2pps of GDP would raise debt ratios mechanically by at least 10-20pps over a decade if financed via debt. Unlike one-off stimulus packages, a country cannot outgrow a structural rise in its deficit ratio. Even if the fiscal multiplier on defense spending were greater than one, the resulting higher GDP level would simply raise spending further as a share of GDP. Sovereign spreads, which compressed in recent years thanks to tighter fiscal management, would almost certainly widen. A 1pp rise in the debt-to-GDP ratio typically increases spreads by 1-2bps (see Figure 6).[2] Over ten years, that could mean a 10-40bps jump in borrowing costs, depending on country and credit rating. So far, improved primary balances have kept markets calm. Italian and Spanish deficits are near balance, and spreads remain below 100bps – far from the crisis-era highs of above 400bps. But once lost, investor trust is slow to recover. Resorting to EU-level funding mechanisms offers only temporary relief, as this would largely constitute an accounting exercise—interest payments on common EU debt would still need to be financed by national budgets. Europe's political leaders must therefore sequence spending carefully and communicate clearly to avoid spooking bond markets. One potential offset: global geopolitical uncertainty. As US politics grows more unpredictable, investors may seek alternatives to Treasuries. European sovereign debt could emerge as a safe-haven substitute, providing a window of lower borrowing costs even amid rising issuances. But that reprieve may prove temporary.

Figure 6: Debt-to-GDP in % (of 2024) versus current 10y government bond spreads in bps



Sources: LSEG Datastream, Allianz Research

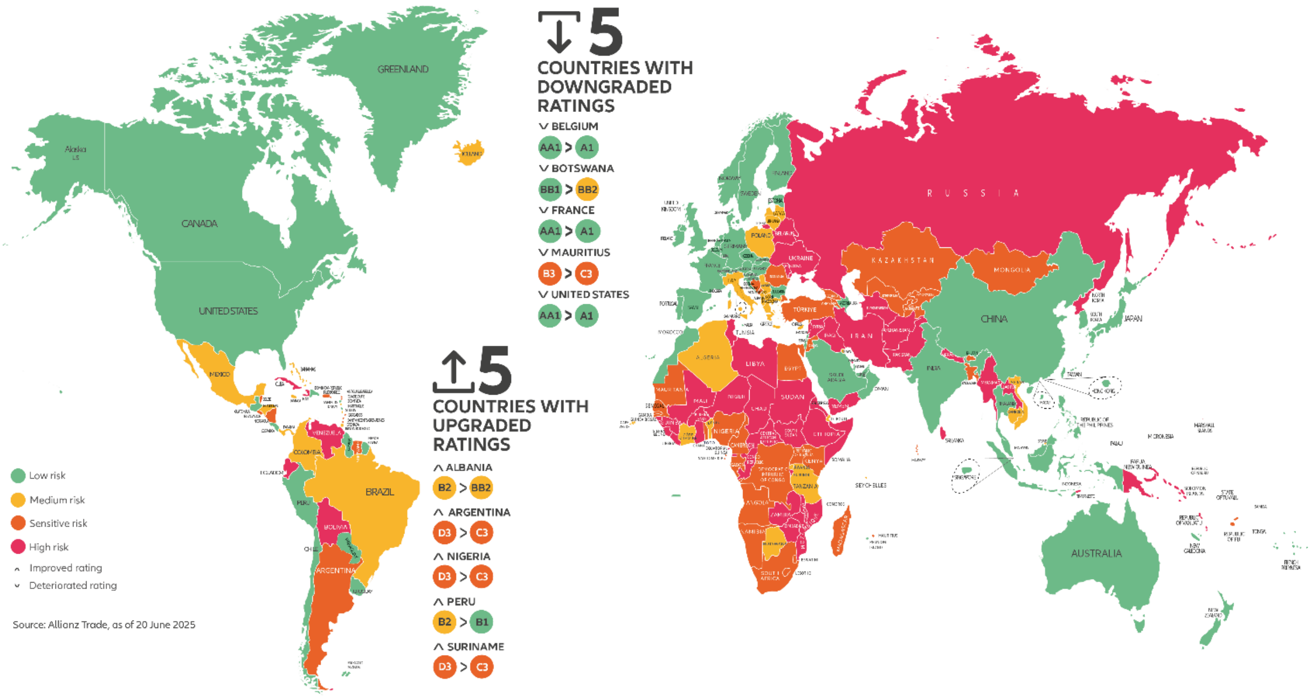
[2] A direct relationship shows an elasticity of one between debt-to-GDP and government bond spreads as shown in Figure 6. Using more sophisticated panel regressions with additional variables the beta rises to two.

The EU will help to ramp up defense investment while preserving security and autonomy. The new SAFE instrument provides a framework for EU budget-backed loans and common procurement, while introducing several new tax incentives. Under SAFE, financial assistance will only be granted to procurements involving at least one member state and a second eligible country (EU-EEA-EFTA state members and Ukraine are eligible and all countries that signed a Security & Defense partnership with the EU, like Canada). Eligibility applies not only to countries, but also to the contractors and subcontractors of defense products and services, and all involved in the procurement process should have not only their executive management but also their facilities and assets located in the eligible country and should not in any case be controlled by a third country or entity for safety and security reasons. Contractors from third countries are allowed to participate if their involvement does not exceed 35% of the contract value. The SAFE framework provides some contractual flexibility to procurement parties: the value of contracts can be changed, while new contractors can also be included if necessary. Products under SAFE are exempt from VAT, and a new threshold of EUR900,000 has been set for supply and service contracts to bypass EU procurement rules as the Commission aims at providing flexibility for small contracts and allowing a bigger share for European SMEs.

Quarterly country and sector risk ratings: A turning point

Our latest quarterly country risk updates show that clouds are looming over some advanced economies but clearing over some emerging markets. After two and a half years of consistent net upgrades, our latest review saw an equal number of upgrades and downgrades (five on each side), with downgrades particularly among high-income economies and upgrades benefiting emerging economies only. The effects of uncertainty are unfolding with greater intensity in advanced countries, highlighting cracks in fiscal policy and the foreseeable medium- to long-term consequences of both policy disruptions and policy inaction. In particular, the US, France and Belgium have seen a deterioration in their macroeconomic outlooks, reflected in the indicators we use for our medium-term assessments, prompting a downgrade from AA1 to A1 for all three.

Figure 7: Country risk map, Q2 2025 (colored by short-term risk ratings)



Source: Allianz Research, based on the Country Risk Methodology and Q2 2025 Country Risk Ratings

In the case of the US, both macroeconomic and political risks have worsened. Key fiscal indicators, including fiscal balance, public debt and interest payments, have deteriorated markedly over the past few years. The fiscal outlook remains challenging. The anticipated passage of a significant fiscal package by fall – expected to add materially to the primary deficit by 2026 – will likely exacerbate pressures, especially in an environment of persistently high interest rates. Interest costs are rising sharply, and the federal deficit could reach over 8% of GDP in 2026 amid limited evidence of imminent fiscal consolidation. In parallel, political risks have increased, with volatile decisions on trade policy and multilateral cooperation.

For France, Macroeconomic Risk worsened based on poor fiscal metrics (fiscal balance, public debt, external debt and servicing costs). These metrics are unlikely to improve in the foreseeable future. We expect the fiscal deficit to reduce next year (to 5% of GDP) but to remain higher than projected by the government, with refinancing costs tilted to the upside. Political deadlocks over the 2026 budget bill will come back to the fore by this autumn, with the government likely to struggle to find substantial savings amid increasing defense spending needs. The dissolution of the National Assembly is still a real possibility, albeit not what we expect in our baseline scenario. With fiscal consolidation not in sight and a slower-than-expected economic recovery, long-term concerns remain clearly visible.

Belgium's fiscal position has weakened, driven by persistent deficits, rising expenditure and limited progress on consolidation. Planned structural reforms have stalled, while new spending commitments continue to add pressure to public finances. Modest GDP growth expected over 2025-2026, combined with structural imbalances and growing fiscal obligations, reinforces long-term concerns. The absence of credible and coordinated measures to restore fiscal sustainability at both the federal and regional levels is particularly notable. These dynamics contribute to a deteriorating fiscal outlook, with increasing strain on debt metrics. Although Belgium retains its investment-grade status, it now stands at its lowest rating level in over three decades – underscoring the urgency of renewed fiscal discipline and policy clarity to safeguard fiscal stability over the medium term.

Meanwhile, despite ongoing political or economic challenges, several emerging economies are showing signs of gradual recovery. This quarter's upgrades include Albania (BB2), Argentina (C3), Nigeria (C3), Peru (B1) and Suriname (C3), highlighting cautious optimism in these markets. On the other hand, Botswana (BB2) lost its 'green' status on our map, reflecting mounting pressures in its diamond sector. Mauritius (C3) was also downgraded, amid lower-than-expected tax revenues that are beginning to hinder long-term fiscal planning.

In April 2025, the IMF approved a new four-year, USD20bn Extended Fund Facility for Argentina, with an initial USD12bn disbursement to support ongoing stabilization and reform efforts. President Milei's administration has delivered notable progress, including a smooth rollout of a new FX regime, a decline in monthly inflation to 2.8% in April, fiscal surpluses reaching 0.6% of GDP and a rebound in economic activity, real wages and poverty reduction. Key goals include strengthening external buffers and regaining access to international capital markets. The government has also committed to enhancing financial transparency and deregulating the economy to boost formalization. Improved market sentiment is reflected in the drop in Argentina's risk premium, paving the way for fuller market re-entry.

Peru experienced a strong economic recovery in 2024, with growth reaching +3.3%, inflation anchored within the target band and a current account surplus of 2.2% of GDP. Growth was driven by a rebound in primary sectors, rising private consumption and robust public investment. Although the fiscal deficit rose to 3.5% of GDP, Peru maintained strong buffers, including low public debt and high international reserves. In 2025, growth is expected to moderate to 3%, with resilient private consumption offsetting weaker public investment and political uncertainty. The financial sector remains sound, and reforms are underway to enhance resilience and revive capital markets. We do not expect major structural reforms in a pre-election year, but Peru's strong fundamentals, sizable reserves, limited exposure to US trade and a slightly undervalued currency should support competitiveness and provide room for maneuver.

Nigeria's external position has improved over the last 12 months, thanks to the introduction of orthodox macroeconomic policies. After allowing the naira to float, the official exchange rate aligned with the parallel market rate, triggering an inflation shock but returning control of the external position to the central bank. Since then, international reserves have substantially increased, and import cover now exceeds 3.5 months of imports. On the fiscal front, the Nigerian government has removed energy subsidies, and the public debt outlook has also improved. However, inflation remains over 20%; widespread insecurity and the run-up to the 2027 election indicate that underlying fragilities persist.

Meanwhile, sector downgrades were mostly concentrated in the automotive sector. Sector risk ratings deteriorated in net terms for the third consecutive quarter, with 16 downgrades (compared to 23 in Q1), notably in the automotive sector, and only 12 upgrades (5 in Q1). This slight deterioration in the risk environment reflects the challenges companies continue to face in the short term, including a slowing economic cycle, diverging monetary cycles, rising input costs, high uncertainty, a persistent trade war and new risks related to the escalation in the Middle East conflict.

Downgrades occurred mainly in Latin America (7) and APAC (5). Most of the cases (10) were in the automotive sector, with downgrades for both manufacturer and suppliers in Mexico (to high risk) and in Japan, South Korea and Ecuador (to sensitive risk), and a downgrade for automotive manufacturers in Germany and Finland. These downgrades were all driven by tariff-related risks and the fact that automakers – and in turn their suppliers – will have to manage additional costs amid a perfect storm of soft demand, intense price competition and reduced state incentive policies, which have strongly impacted profitability. Japanese and South Korean carmakers are particularly exposed to the US market, while the US auto industry's supply chain is closely intertwined with Mexico. For European manufacturers, the deteriorating global trade outlook is a new hurdle to overcome in addition to the tighter regulatory framework (on data & carbon emissions), the region's overall weak economic outlook and rising competition from Chinese brands.

Other downgrades were spread across sectors, all from medium to sensitive level of risk: agrifood in Panama, electronics in Hungary, machinery equipment in South Africa, paper in Colombia, metals in Japan and pharmaceuticals in Mexico. Conversely, better risk ratings were mainly found in transport equipment (in France, Chile and the UAE, all to medium) and software & IT services (in Czechia and Malaysia to low level of risk, and Colombia to medium), together accounting for half of the upgrades. Yet, the construction sector stands out with improvements in Western Europe (Spain and Ireland), and retail in Latam (Chile, Colombia).

Overall, those adjustments led to a broadly stable global picture of ratings, with a small majority of sectors (54%) on the positive side (either low or medium risk). Yet, sector ratings are mostly either medium (45% i.e. stable q/q) or sensitive risk (43%, i.e. -1pp q/q) across all regions. The overall risk dispersion is noticeable between the comparatively safest region (Asia) and the riskiest (Latin America, and to a lesser extent Central and Eastern Europe). Overall, there are still fewer low-risk sectors (9%) than before the pandemic (15% in Q4 2019).

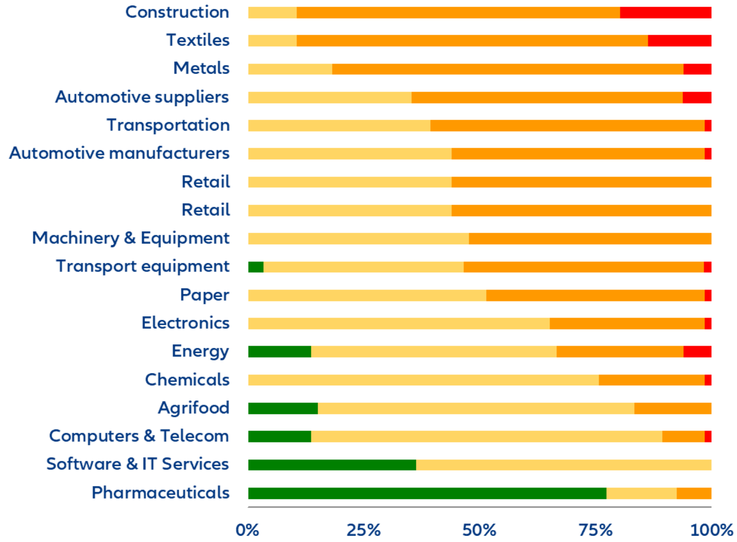
Figure 8: Q2 2025 changes in sector risk ratings

WORSE RISK RATINGS (DOWNGRADES)			
Sector	Country	Q1 2025 rating	Q2 2025 rating
Agrifood	Panama	2 (medium)	3 (sensitive)
Auto. manufacturers	Ecuador	2 (medium)	3 (sensitive)
Auto. manufacturers	Finland	2 (medium)	3 (sensitive)
Auto. manufacturers	Germany	2 (medium)	3 (sensitive)
Auto. manufacturers	Japan	2 (medium)	3 (sensitive)
Auto. manufacturers	Korea	2 (medium)	3 (sensitive)
Auto. manufacturers	Mexico	3 (sensitive)	4 (high)
Auto. suppliers	Ecuador	2 (medium)	3 (sensitive)
Auto. suppliers	Japan	2 (medium)	3 (sensitive)
Auto. suppliers	Korea	2 (medium)	3 (sensitive)
Auto. suppliers	Mexico	3 (sensitive)	4 (high)
Electronics	Hungary	2 (medium)	3 (sensitive)
Machinery & Equipment	South Africa	2 (medium)	3 (sensitive)
Metals	Japan	2 (medium)	3 (sensitive)
Paper	Colombia	2 (medium)	3 (sensitive)
Pharmaceuticals	Mexico	2 (medium)	3 (sensitive)

BETTER RISK RATINGS (UPGRADES)			
Sector	Country	Q1 2025 rating	Q2 2025 rating
Agrifood	Ecuador	4 (high)	3 (sensitive)
Construction	Ireland	4 (high)	3 (sensitive)
Construction	Spain	3 (sensitive)	2 (medium)
Retail	Chile	3 (sensitive)	2 (medium)
Retail	Colombia	3 (sensitive)	2 (medium)
Software & IT services	Colombia	3 (sensitive)	2 (medium)
Software & IT services	Czechia	2 (medium)	1 (low)
Software & IT services	Malaysia	2 (medium)	1 (low)
Transportation	Finland	3 (sensitive)	2 (medium)
Transport Equipment	Chile	3 (sensitive)	2 (medium)
Transport Equipment	France	3 (sensitive)	2 (medium)
Transport Equipment	UAE	3 (sensitive)	2 (medium)

Source: Allianz Research, based on the Sector Risk Methodology and the Q2 2025 Sector Risk Map

Figure 9: Sector risk ratings as of mid-June 2025, in number of countries, by level of risk



Sources: Allianz Research, based on the [Sector Risk Methodology] and the [Q2 2025 Sector Risk Map]

These assessments are, as always, subject to the disclaimer provided below.

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The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.

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