Outlook 2027 – at a crossroads

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Elections in France, the Iran war, the financing of artificial intelligence – in the new year, important decisions are pending in many areas that will shape the economy. We outline an outlook for the economy and the financial markets. In the coming year, the economy is expected to grow at a similar pace as this year, but lose noticeable momentum in 2028 (Germany forecast 2028: 0.6%). The Fed and the ECB are likely to raise their key interest rates twice more until spring, but cut them again starting in 2028. The global rise in yields is expected to pause for the time being.

The coming year is likely to be a year of decisions. The French will elect a new president, thereby also deciding how France's fiscal crisis will unfold. In addition, the US and Iran must decide how to proceed with their conflict. Investors must also make up their minds about whether they want to continue financing the expansion of AI.

France: Muddling through with the ECB's help

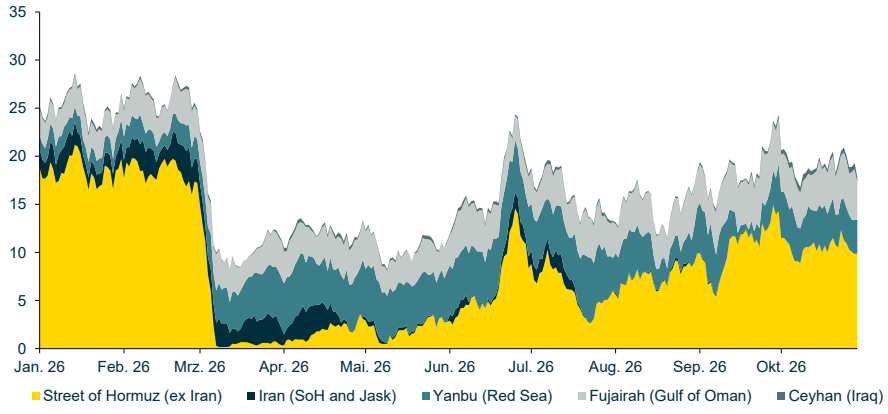
The first round of France's presidential election is scheduled for April 18. According to opinion polls, Marine Le Pen has the best chance of winning. But even if her party were to secure an absolute majority in the parliamentary elections that usually follow (a rather unlikely outcome), she would probably not initiate the urgently needed reduction in France's excessively high budget deficit. There are too many question marks surrounding the budget plan she has presented. France's payments to the EU, for example, are unlikely to be cut drastically. Above all, Le Pen wants to lower the retirement age back to 62. All of this makes a substantial decline in France's excessively high budget deficit unlikely. Nevertheless, we do not expect a sovereign debt crisis like the one 15 years ago. The ECB is standing ready in the background with its TPI bond purchase program. France will muddle through with the ECB's help, without the underlying problem being resolved.

Iran war: Gradual de-escalation and further declines in oil prices

Decisions are also due in the Iran war. The nature of this conflict has changed as a result of so-called dark transits: oil shipments escorted by the US Navy through the Strait of Hormuz with their position signals switched off. As the region's oil exports have now recovered to 80% of their pre-war level (Chart 1), the US, like Iran, now has staying power. A stalemate has developed. If Iran were to reduce its attacks in this situation, the US could ease its blockade of Iranian ports. This would lead to gradual de-escalation, although setbacks along the way could not be ruled out.

Based on this scenario, we expect the price of a barrel of Brent crude to fall to $85 towards the end of this year and to $65 towards the end of next year. For natural gas, which is suffering from more extensive damage to production facilities and benefits less from dark transits, we expect the price to decline to €95 per megawatt-hour by the end of this year (previously: €75) and to €55 by the end of 2027. Gas prices will therefore remain well above their pre-war level for much longer than oil prices.

Chart 1 - Middle East crisis: Oil exports recovered
Volume of crude oil and oil products which left the Middle East, in million barrels per day, 7 day averages



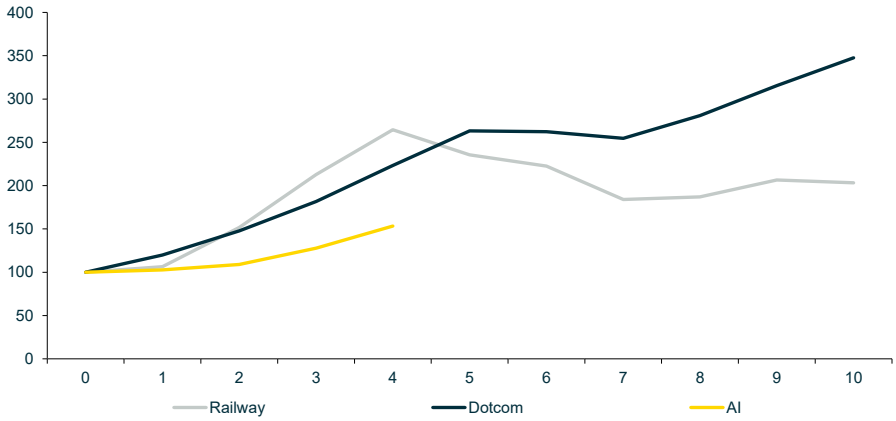
Source: Vortexa, Bloomberg, Commerzbank Research

Investors are likely to continue financing AI

In the coming year, investors will have to decide whether, and for how long, they want to continue financing AI. Rapid technological advances naturally always raise concerns, especially as they have often led to excesses in economic history. But looking at the next two years, there are compelling arguments for a continuation of the AI investment boom, which is important for the US economy:

- Strong demand: AI offers companies considerable scope to increase productivity, including by redesigning their business processes around AI. This process is already well underway at many companies and requires vastly more computing power.
- Strong AI companies: US hyperscalers are long-established and highly profitable—unlike neoclouds, which, however, account for only a minor share of AI investment. Hyperscalers have probably increased their profits by more than a third this year. They have generally continued to exceed analysts' earnings estimates.
- Investment is not excessive by historical standards: The major US hyperscalers alone are estimated to invest $900 billion in AI infrastructure in 2026. These are enormous sums. But compared with the internet boom around the turn of the millennium or the railway boom in 19th-century Britain, there is still considerable room for further growth (Chart 2).
- Reasonable valuations: With a price-to-earnings ratio of around 23, the seven major AI companies (the "Magnificent Seven") are not excessively expensive. There is no valuation bubble—unlike before the internet bubble burst in early 2000.
- The geopolitical importance of AI: The new governor of Texas has announced legislation against the construction of new data centres, prompting a sharp fall in AI stock prices. But it should not be overlooked that AI plays a major role in the competition between systems with China. President Trump is likely to veto any planned tightening of AI regulation at the federal level. Moreover, both Republicans and Democrats regard China as a threat and are therefore unlikely, ultimately, to put major obstacles in the way of AI—including for military reasons.

Chart 2 - Investment booms: AI and its forerunners
Investment in the years after boom started, indexed at 100 in year 0. Railway boom: real invetsment in the UK (1843=0); Dotcom: real investment in IT equipment & software (1995=0); AI: real investment in IT equipment & software (2022=0), annual data



Source: BEA, BoE, BIS, Commerzbank Research

Implications for the economy: Largely unchanged growth rates in 2027, ...

The coming year will be marked by considerable risks. But in our baseline scenario, we assume that investors will continue financing AI investment in 2027, that a sovereign debt crisis in the euro area will be avoided thanks to the ECB, and that the conflict between the US and Iran will de-escalate, with energy prices declining. Ultimately, we do not expect the economy to be derailed by these factors. However, there are arguments for a slight fading of the growth stimulus over the next two years:

- According to their own statements, hyperscalers will not double their investment again in the coming years as they have done this year. The contribution of AI investment to growth—estimated at 0.5 percentage points in the year now drawing to a close—will diminish, particularly in 2028.
- Financial conditions in the US and the euro area are no longer quite as favorable as in the year now drawing to a close, owing to policy rate increases and rising bond yields. The corresponding indicator from the Federal Reserve has already turned down (Chart 3); the same applies to the euro area.
- The fiscal stimulus will fade, as the US budget deficit will not rise further in 2027 and the allocation of funds from the coronavirus recovery fund in the euro area will already have ended by the end of this year.

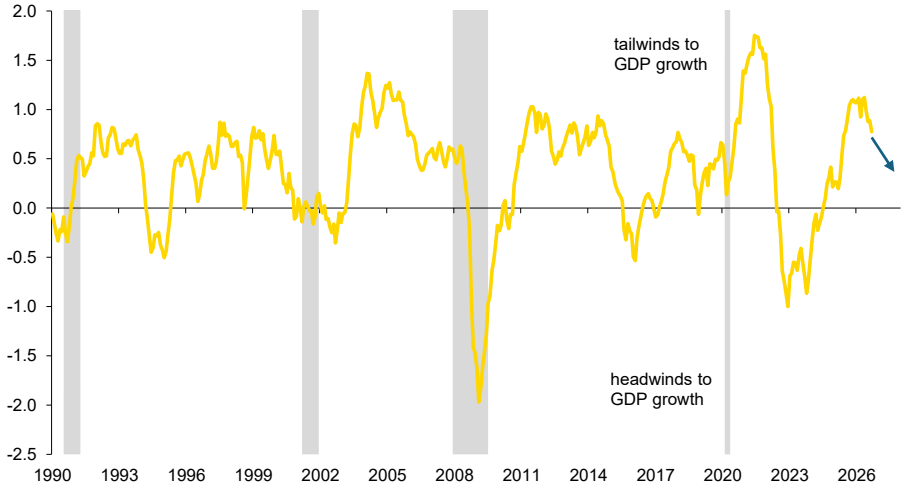
However, these fading growth impulses will be offset by the decline in energy prices we expect. On balance, the stimulus to the economy will barely diminish next year. We therefore forecast largely unchanged growth rates for 2027. For the US, we expect growth of 2.3%

in 2027 (after 2.4% in 2026), while our forecast for the euro area remains unchanged at 1.1%. In Germany, growth should ease slightly from 1.3% (2026) to 1.2%.

… but somewhat slower growth in 2028

In 2028, the overall stimulus to the economy will fade more noticeably, primarily on the AI investment side, while lower energy prices will then provide less relief. Accordingly, US growth is likely to slow from 2.3% to 1.9% in 2028, and euro area growth from 1.1% to 0.8%. In Germany, growth should fall from 1.2% (2027) to 0.6% in 2028, partly because of an expiring fiscal stimulus, with 0.2 percentage points of the decline attributable to an unusually low number of working days. Germany's recovery is also suffering from the fact that companies' investment in machinery and equipment has continued to trend down and is likely to increase only marginally in the future. This is mainly because the federal government is divided over economic policy. It cannot agree on the reforms needed to achieve a substantial improvement in Germany's battered attractiveness as a business location.

Chart 3 - Tailwinds from financial conditions abate
Financial Conditions Impulse on Growth (FCI-G), contribution to US GDP growth over the next year in percentage points. Recessions shaded



Source: Fed, Commerzbank Research

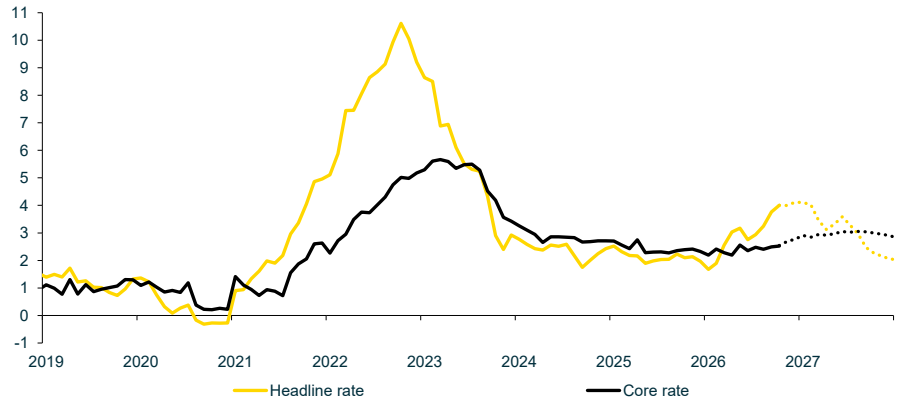
Inflation falls, but more slowly than expected, at least in the euro area

Inflation in the US and the euro area probably peaked in October. The recent sharp decline in energy prices points to a fall in inflation over the coming months, as does the base effect that should kick in in March 2027, one year after the start of the Iran war.

However, the decline in inflation is likely to be slowed, particularly in the euro area, by so-called indirect effects: companies passing on higher energy costs, especially for gas, to the prices of other goods and services with a time lag. Our machine-learning-based inflation model for the euro area expects core inflation (excluding energy, food, alcohol and tobacco) to rise from its latest level of 2.5% to just over 3% by autumn next year. We have raised our inflation forecast substantially and now expect inflation still to be almost 4% in the first quarter (previously: 3.4%). For 2027 as a whole, we expect an inflation rate of 3.1% (Chart 4).

By contrast, inflation in the US is likely to fall faster than in the euro area. This is mainly due to gas prices, which have risen nowhere near as sharply in the US as in the euro area and should therefore generate fewer indirect inflation effects. We forecast an average inflation rate of 2.8% for 2027.

Chart 4 - Underlying inflationary pressure to remain high even as headline rate falls
Euro area, consumer prices, total and excluding energy, food, alcohol and tobacco, year-on-year change in %. Dotted line forecasts



Source: Eurostat, Bloomberg, Commerzbank Research

Fed & ECB: Two more rate increases

As far as central banks are concerned, we now expect not just one US rate increase in December (raising the upper bound of the target range from 4.0% to 4.25%), but a further move in March. The unexpectedly high October inflation reading means that the trend in core inflation is pointing upwards again. In response, some Fed officials have raised the possibility of more decisive action against inflation.

In the euro area, we now likewise expect a further rate increase in March, following one in December. By then, inflation is likely to have barely declined, not least because of the knock-on effects of very high gas prices, while core inflation is likely to be still rising. In this environment, the new ECB president—probably Spain's Pablo Hernández de Cos—would be unlikely to want to halt the rate-hiking cycle, in the interests of establishing his reputation as an inflation fighter. This forecast naturally rests on the assumption that France does not experience a sovereign debt crisis.

In spring 2028, the ECB will cut its policy rates again, as inflation should by then be clearly trending downwards. The same applies to the Federal Reserve from the second quarter onwards.

Financial markets: The rise in bond yields pauses …

Yields have risen substantially in most Western government bond markets in the year now drawing to a close—mainly because inflation has increased as a result of the Iran war, investors have revised their policy rate expectations upwards, and governments and AI companies are raising unusually large amounts of funding. In the coming year, by contrast, bond yields are more likely to fluctuate sideways. Taken in isolation, high budget deficits and hyperscalers' capital requirements point to rising bond yields. Ultimately, however, inflation rates are likely to decline as a result of our assumed de-escalation of the Iran conflict and further falls in energy prices, even though this process will be slower in the euro area than in the US. In addition, both the Fed and the ECB are likely to end their rate-hiking cycles in the spring. A slowdown in economic growth is also likely to become apparent towards the end of 2027. All in all, the arguments for falling and rising bond yields in 2027 are likely to more or less balance each other out. The trend towards higher bond yields should pause for the time being.

… EUR-USD suffers from France's fiscal crisis and …

We had long forecast a weaker dollar because Donald Trump is undermining the independence of the Federal Reserve. But following the Democrats' surprisingly decisive election victory, Trump is a lame duck. He will no longer be able to secure Senate approval for his preferred candidates for the Federal Reserve's Board of Governors. The Fed is also likely to be less concerned about a conflict with a politically weakened Trump. This leaves high government debt as the only source of pressure on the Fed's independence. But the same applies to the ECB, whose independence could arguably suffer more from France's fiscal crisis and the structural flaws of monetary union (the absence of political union). All in all, we therefore expect a moderate decline in EUR-USD in 2027 (end-2027 forecast: 1.08).

… and equity markets could rise in line with earnings growth

In the year now drawing to a close, share prices, particularly in the US, have risen nowhere near as strongly as corporate earnings. The S&P 500, for example, is up around 10% since the start of the year, while companies are likely to increase their earnings by more than 30%. The corresponding decline in the price-to-earnings ratio was mainly due to the substantial rise in bond yields. For the coming year, however, we do not expect yields to rise significantly. The headwind from this source should therefore ease noticeably. In this environment, we see

a good chance that share prices will rise roughly in line with corporate earnings. We consider global earnings growth of 8 to 10% likely in 2027. Companies in the DAX are likely to increase their earnings by 6 to 8%.

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