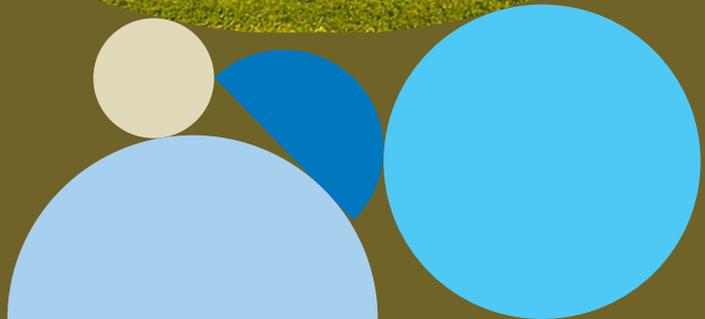


Economic and Market Outlook 2026



Sunny... but with
blustery showers



Overview

Predicting a benign year ahead given the disruptions, distortions and dislocations of 2025 may seem foolhardy, yet we do so while fully expecting markets to sporadically challenge that view. Data suggest prospects are good, which is at odds with the current perception at both the consumer and business levels. In our view, the growth outlook is improving as we see contained inflation leading to some further cuts in monetary policy and easing financial conditions. Fiscal policy is likely to pick up the stimulus baton in the year ahead, particularly in the US, China, Japan and Germany. Importantly, we see the technology sector being in a boom phase rather than a bubble, with capital spending bolstering growth and fuelling financial markets. That noted, the technology revolution will see winners and losers, and is disruptive by nature. Consequently, we would characterise the 2026 outlook as sunny with blustery showers.

Perhaps the most remarkable story, as this peculiar year concludes, is how resilient global growth has been —despite all that was thrown at it. The profound shift in US policy proved manageable, with unorthodox measures generally accepted and, crucially, a global trade war avoided. This sets the foundations for the year ahead.

Notably, a global fiscal impulse, rising capital spending, and technological innovation are likely to define the year. Inflation is expected to be contained, but could potentially darken the sunny narrative should growth prove too robust, particularly in the US.

From a policy perspective, the US may be entering a quieter policy phase as the mid-term elections loom large, though with such an energetic and unpredictable commander in chief, there is clearly room for surprise. The Big Beautiful Bill will deliver meaningful fiscal support in the first half of the year to both US households and businesses, while the President is rolling back tariffs on key essentials as the still-spiralling cost of living undermines an election pledge to his voter base. It certainly seems clear that everything will be done to avoid any risk of recession, which in itself is a key point for the year to come.

China also has an incentive to catalyse its domestic economy with stimulus. Despite tariff turmoil, exports have remained the primary driver of growth, but need to be supplemented with additional support for consumption and capital investment. Unfortunately, we are not expecting the structural weakness around housing to be adequately addressed, and it will remain a drag on growth. The focus on innovation and AI investment will provide some offset, however.

The much-anticipated German fiscal deluge is indeed profound, and the coming year will be the litmus test on how forthcoming and potent it actually is. Sentiment has soured notably in recent months, with expectations

moderating as prevarication and slippage towards consumption rather than structural reform take hold. That noted, growth will unquestionably be boosted and progress could well surprise positively given the mood.

Although the pace of global rate cuts will fade in the year ahead, financial conditions are easing substantially as tight credit spreads and asset appreciation encourages business investment and capital spending. Strong nominal growth in many key regions is boosting corporate profitability, while in the US, tax incentives, a lighter regulatory burden, and lower reserve requirements for banks are powerful stimulants.

This supportive corporate backdrop coincides with perhaps one of the most profound technological shifts in recent memory. The arms race between the two superpowers to dominate in the fields of IT and AI is without precedent. Breakthroughs will emerge and conventions will be broken, but it has to be accepted that capital will be misplaced and value destroyed in the process. Despite rapid build-out by the hyper-scalers, the numbers are still modest in terms of the global economy. This suggests that there is significant runway ahead, though such rapid expansion brings with it bottlenecks in terms of raw materials, and is hugely energy dependent in a time of inadequate grid distribution and environmental constraints. The coming year is likely to be a proof point as to the durability and true significance of this technology boom.

Financial markets have been strong and are likely to be buoyed by the supportive global backdrop in the year ahead, with equities once again offering the greatest upside. That noted, we do anticipate occasional heavy showers across asset classes. Fiscal spending will further weaken government finances at a time when investors are sensitive to debt sustainability. The gyrations in bond markets earlier this year

demonstrated that sensitivity, and we saw market forces corral governments towards credible policy. The current jump in long-dated bond yields in Japan highlights the challenges governments face as investors demand a premium for lending long. Consequently, bond volatility should be anticipated, but broadly-speaking, we see yields oscillating around current levels.

While credit markets have been stoic, risks are building. Rising M&A, capital spending, and AI funding are being increasingly financed through credit. For now we see this debt financing as digestible, with investors keen to lend, but the direction of travel for issuance is higher. With credit spreads so tight, there is a limit to further compression, while risks are rising not falling. In contrast, while there is clearly a vulnerability to richly priced equities, the upside is relatively unconstrained. Given our take on the technology and capital spending cycle, markets with exposure to this offer the greatest potential.

In a world of rapid change and polarising views, underlying trends and fundamental drivers matter more than ever. While acknowledging risks are high and uncertainty prevails, we still need to ask: what could possibly go right? In answer to that, we are encouraged by some of the trends leading us to see the year ahead rather like a British summer, sunny with blustery showers.



Guy Miller

Chief Market Strategist & Economist

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Global

The Outlook

- Global growth to remain resilient amid fiscal expansion, robust investment, and manageable tariffs
- Inflation grinding lower globally as goods disinflation persists and services price pressure continues to moderate
- Additional rate cuts to come, but prospects for further monetary easing are limited

Implications

- Modest downside for US and global government bond yields over the coming year
- Credit spreads offer carry type returns and are likely to underperform stocks
- Global equities prosper, with the tech cycle set to continue

Risks

- US inflation rebounds, driving a significant shift in the Fed rate outlook
- Large company bankruptcies and uncertainty about AI returns cause distress in credit and stocks drop
- Escalating US-China trade war triggers disruptive economic and financial market developments

A resilient global economy

The global economy has been remarkably resilient in 2025, with growth accelerating to a trend-like pace in the second half of the year, despite tariff headwinds. Activity has been supported by monetary easing, expansionary fiscal policy, and solid investment, in part reflecting tech related spending. US tariffs have landed at levels close to the pledges that were made during the election campaign but significantly below the 'liberation day' announcements, with retaliation largely avoided. While tariffs are a headwind for global growth, the US-China trade truce has been critical for avoiding more disruptive developments. The one-year extension of the truce, agreed in November, confirms that the mutual dependencies between the US and China are recognised. This reduces the risk of disruptive decoupling between the two countries in the near to medium term and underpins our view that tariff developments should remain manageable for the global economy.

Growth to hold up in 2026, amid fiscal and investment spending

We anticipate that economic activity will hold up in 2026, with growth slightly below its historical trend. Weak domestic demand in China will be a headwind, but the upshot is that China remains a disinflationary force globally, given deflationary producer prices and overcapacity in the industrial sector. Growth dynamics in the US and Europe will be supported by fiscal easing, with infrastructure and defence spending ramped up in Germany while the US sees tax cuts and investment incentives. In contrast to the pre-pandemic decade, the global investment cycle is likely to be robust, given strong AI and tech related spending and more traditional defence and infrastructure investment. By contrast, upside to private consumption is limited as labour markets are softening while household sentiment remains notably downbeat.

Inflation is contained globally, though tariffs are driving divergences

Inflation is contained globally. While tariff pass-through is underway in the US, US tariffs are weighing on prices elsewhere. This is most notable in the auto and pharma sectors, but other sectors are also being impacted, with over-capacity in China also contributing. As a result, global export price dynamics are weak. Services inflation is still holding up in many regions, but wage growth and labour market dynamics are softening, with slowing job growth. We expect underlying inflation to grind lower in most regions in 2026 as services inflation tick lower and downward pressure on global export prices persist. In the US, tariff pass-through is still incomplete, with some further tariff-related price rises still in the pipeline, but slowing services inflation should help to contain broader price pressures, with inflation moving largely sideways. The risk is that consumption and growth hold up better than expected, keeping price pressures and inflation higher for longer.

Most of the rate cutting cycle is behind us, but some further easing is expected

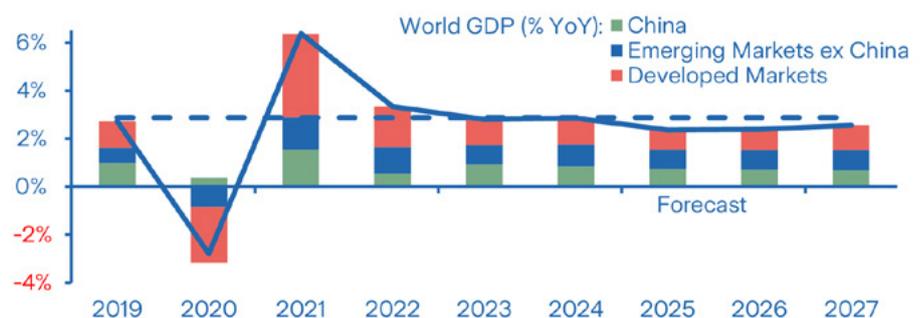
The global rate cutting cycle has further to go, but prospects for additional policy easing are now limited, with interest rates

generally deemed to be approaching what would be considered a neutral level. While unemployment has begun to rise, the pace of labour market deterioration is not worrying, with recessionary concerns muted. Financial conditions more broadly are also deemed to be supportive, given the strong performance of global stock markets over the past year. As a result, as long as growth holds up, we anticipate only a few further rate cuts from the major central banks over the coming year. One exception is the Bank of Japan, which we expect will continue to hike rates.

Limited downside to government bond yields, with volatility settling down

Government bond markets remained turbulent in 2025, with tariff announcements and fiscal news adding to volatility. In contrast to previous years, idiosyncratic factors became more important, with significant divergences across markets. The 10yr US Treasury yield fell during the year, largely in line with the Fed rate, with dynamics also supported by the Fed's decision to end its quantitative tightening policy. Bund yields, by contrast, ended the year higher on the back of the material shift in the fiscal and growth outlook for Germany. UK gilt yields moved sideways with

Global growth to remain resilient



Note: Dotted line shows thirty-year average for global growth

Source: ZIG, Bloomberg

significant volatility as inflation was sticky and fiscal concerns resurfaced. In Switzerland, yields approached zero as inflation faded. Japanese JGB yields, finally, surged on fiscal expansion and concerns around inflation and central bank independence.

Going forward, we see limited further downside for government bond yields as growth should hold up while the policy rate outlook appears fairly priced, with the 10yr Treasury yield likely to remain close to 4%. We maintain our view that yields are capped to the upside as long as inflation is contained and would generally view a rise in yields towards prior highs as a buying opportunity. One exception is the Japanese market, where a structural change in inflation dynamics is underway. We also expect US Treasuries to retain their safe-haven properties as the geopolitical environment serves to keep demand in place despite fiscal concerns.

We expect a continuation of the stable Eurozone sovereign spread environment in 2026. Valuations have gone from unexciting to unattractive as we reach levels not seen since before 2010. Italy will likely see ratings upgrades, but long-term growth remains uncomfortably low. French bonds remain particularly vulnerable given continued political instability amid fiscal concerns.

Credit in 2026: Unexciting returns but compelling as a hedging tool

Credit is likely to end next year with almost unchanged spreads but a propensity to widen more during episodes of risk aversion while grinding in only a bit during risk-on rallies. This makes underweighting credit versus equities a good proposition in multi-asset portfolios.

Modest returns are likely to tempt investors to dip into lower quality parts of the market at a time when spreads are already low and risks are rising.

AI is likely to remain a key driver of the financial markets next year. Large and small technology companies alike are expected to use forms of credit to fund AI capex as cash holdings on the balance sheet have been reduced during the last couple of years. While investors are not yet concerned about being creditors to large and extremely cash generative technology behemoths, prudence is warranted for debt that has complex structures and less diversified cash flows backing the issuer. Unlike equity investors who can gain from the potential upside from AI on revenues, creditors only have the downside were AI not to live up to its promises as the debt is issued at tight spread levels.

Rising M&A is expected with an increasing share being debt funded. Together with capex funding this will ensure heavy supply that is likely to act as a headwind and limit spread tightening potential. Fundamentals, however, are likely to limit spread widening as earnings are likely to remain decent. Default rates are set to remain above average with High Yield spreads particularly vulnerable.

Within credit markets, apart from global High Yield and US Investment Grade credit, other segments offer better value for investors. European credit is likely to continue outperforming US credit, although the value proposition has diminished since last year, while Japanese credit remains a high-quality offering. US ABS, Municipals and higher

rate tranches of CMBS also offer better risk-reward potential than corporate credit.

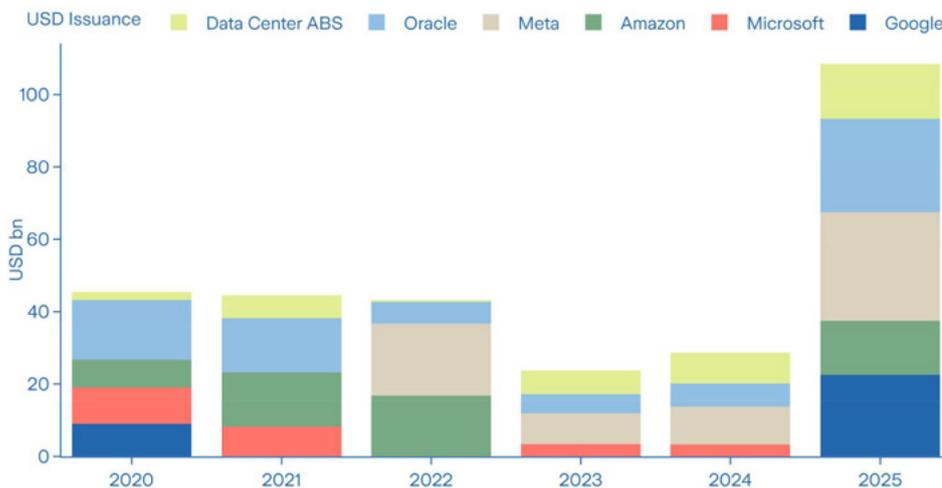
Prospects for equities are good, albeit in a more turbulent flight path

Equity markets have enjoyed a stellar run over the past three years, and we believe that they have further to go in the year ahead. The macro backdrop is supportive, with nominal growth running at a robust level in key regions, boosting profitability. Importantly, policy rates are continuing to be cut as inflation outside of the US moderates rather than because growth is falling. Historically, this has been a powerful dynamic leading to easing financial conditions and rising corporate activity. Consequently, we see merger and acquisitions rising while the Big Beautiful Bill in the US is creating tax incentives for capital spending and investment. What is particularly noteworthy, is that this coincides with a profound inflection point in technological innovation.

Despite such strong drivers for equities, the year ahead is likely to be a more volatile period, punctuated with sizable wobbles as the cycle ages. Like all technological evolution, there will be winners and losers. Capital will be destroyed, and innovation will lead to obsolescence and creative destruction—all of which needs to be priced into equity valuations. It is also the case that a rise in vendor financing and cross-shareholdings have historically been warning flags for investors, and we see clear risks to our bullish outlook. In aggregate, however, we continue to favour equities as an asset class and define the technology sector as being in a boom rather than bubble phase for the time being, with earnings and margins giving credence to that view.

From a regional perspective, we see US equities as offering the most dependable returns in 2026. That noted, there will be opportunities in other regions. China is attractive given its exposure and focus on technology, while more decisive government stimulus is required to improve investor sentiment. We see Japan and Europe offering trading opportunities. In Japan, shareholder friendly measures continue to be implemented by companies and earnings growth should be healthy at a time when investors are lightly positioned. We need to see evidence of a change in sentiment, however, to become more enthusiastic. As for Europe, having performed strongly in the first half of 2025, investors have grown tired of waiting for change in the region and sentiment is turning increasingly negative. This will create an opportunity at some point as we do see Eurozone prospects improving over time—but again, this is for another day.

AI investment and related debt to continue booming



Source: Bloomberg

US

Outlook

- Fiscal stimulus will help to drive economic growth in 2026
- The inflationary impact of tariffs will fade over the course of the year
- The Fed will further ease monetary policy

Implications

- Bond yields are expected to remain rangebound
- Credit returns to trail that of stocks, with risk reward skewed to the downside
- Equities are attractive, but high expectations are likely to lead to higher volatility

Risks

- Reaccelerating inflation rates could challenge the Fed's easing bias
- Unexpected disruptions in the AI sector may lead to market setbacks
- Real yields could rise further if investors start to worry more about fiscal sustainability

The US economy is holding up despite the biggest tariff surge in a century

The US economy has been remarkably resilient in 2025 despite President Trump implementing the highest tariffs on imports in more than a century. While growth was distorted by a significant amount of pre-emptive buying earlier in the year, consumer spending in particular remained robust over the course of the year defying very modest consumer sentiment. Households' real income expectations fell to the lowest on record over the summer. This underlines consumers anxiety about a weakening labour market and still elevated inflation but also puts in question the current reliability of the survey measures as they contrast strongly with the actual behaviour.

Nevertheless, the employment situation deteriorated over the summer as tariffs and trade uncertainty weighed on the economic outlook, with many companies becoming more reluctant to hire. Meanwhile, layoffs have not increased substantially and initial jobless claims remain low. Continuing claims have been climbing higher over the course of the year, however, signalling increasing challenges in getting back into the labour market.

Fewer new jobs are needed to keep the labour market in balance

The unemployment rate has risen to 4.3% in the second half of 2025, the highest level since October 2021, but still low by historical standards. Households feel more uncertain about their job prospects, with the perceived likelihood of a family member losing their job rising to the highest since Covid. At the same time, stricter immigration rules are weighing on the supply of labour, effectively lowering the equilibrium level of new payrolls to roughly 50'000. This environment is likely to persist in the coming months, but with the tariff impact likely to fade and positive fiscal effects kicking in, companies are expected to expand their workforce, creating enough new jobs to employ the growing labour force.

Consumer spending will benefit from wealth effects and tax cuts

While the purchasing power of lower income households has come under pressure, exacerbated by the substantial rise in tariffs, wealthier households have benefited from rising stock markets, with the positive wealth effect supporting consumer spending. In addition, households' overall leverage has fallen substantially in recent years, with the debt-to-disposable income ratio dropping to the lowest in almost three decades, excluding a brief period during Covid. So, while households' income expectations may have suffered, many of them still don't feel the need to cut their spending.

In the absence of a major stock market correction this should continue to support consumer spending in 2026, further fuelled by substantial tax refunds in the first half of the year as part of the Big Beautiful Bill (OBABA) passed by Congress in summer 2025. The Congressional Budget Office (CBO) estimated that the net of taxes and

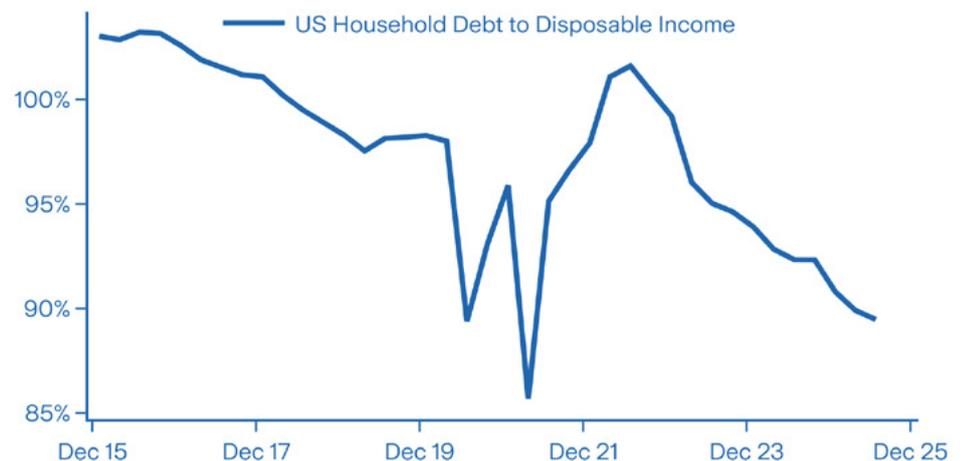
spending would boost the deficit by 0.9% of GDP in FY26 and by 0.5% in FY26, relative to a world where the prior tax policy was maintained, so there will be a sizeable tailwind from the fiscal side.

Tariff uncertainty still weighs on investment and hiring decisions

Tariffs remain an important topic in 2026, not least because of the Supreme Court's pending decision on the legality of implementing them based on the International Emergency Economic Powers Act (IEEPA). If the Supreme Court rules against the administration's use of the emergency act, we would expect the government to pursue other ways to reach similar tariff levels. Nevertheless, this would create more uncertainty in the short run and raise the question of potential refunds, which could amount to more than USD 200bn by the time of the decision.

Business confidence has remained relatively upbeat through most of 2025. While manufacturing activity has been under

Strong household balance sheets support consumer spending



Source: Bloomberg

pressure because of the tariffs, the services sector has been holding up very well, though trade-related uncertainties remain. Business investment is expected to remain robust in 2026, helped by a number of tax changes provided by OBBBA.

The AI-driven capex boom is likely to continue in 2026

While broad-based productivity gains driven by AI are probably still a ways off, AI-related capex spending has been a major growth driver in 2025 and is likely to remain so in 2026. It is projected that investment in computer and communications equipment, software, and data centres will continue to have a substantial impact on the economy, although growth rates are bound to recede from extremely high levels.

Longer term, there should be some additional upside to overall business investment coming from commitments related to a number of trade agreements, but these effects need more time to materialise.

Inflation is expected to recede, but risks remain

While the growth environment is expected to remain benign in 2026, supported by fiscal stimulus and further rate cuts, inflation is a potential risk. Headline CPI accelerated to 3.0% YoY in September 2025 from a low point of 2.3% YoY earlier in the year. Tariffs have left their mark in certain segments of goods prices, but stubbornly high services inflation throughout 2025 is the main reason that overall inflation has not moved closer to the Fed's target.

Part of the reacceleration can be explained by sector-specific outliers like healthcare and financial services, but business surveys including the ISM continue to reflect broader-based price pressure. A weaker

labour market should help to keep a lid on wage growth, mitigating a potential inflation risk, while the fading impact of the tariff surge will weigh on goods prices later in the year. Meanwhile, shelter inflation should continue to fade as indicated by more modest home prices and rental inflation.

The Fed will continue to ease monetary policy

The Fed has resumed its rate cuts and is expected to keep easing monetary policy in the first half of 2026 despite some recent divergence of views within the FOMC. Further on, the end of the Fed's quantitative tightening will also help to ease financial conditions. Longer-term Treasury yields have fallen over the course of 2025 as inflation rates stabilised, and the Fed reduced its target rate. Nevertheless, the term premium on Treasury bonds has risen and is expected to remain elevated as investors want to be reimbursed for the higher potential risk of an increasingly unsustainable fiscal deficit. This is being reflected in real yields, with yields on 30yr Treasury bonds rising to the highest level in decades over the summer of 2025, temporarily triggering anxiety amongst bond investors.

The US government's debt service costs have risen substantially in recent years and will continue to do so as maturing debt will have to be refinanced at higher rates. Higher borrowing costs are likely to be a headwind to growth in the longer term, but in the short term both the government and the Fed have the tools to keep a lid on longer-term yields. With the end of QT, the Fed is more flexible with regard to its balance sheet policy and could alter the maturity mix of bonds it invests in. Similarly, the Treasury is expected to increase bond issuance at the shorter end while limiting longer durations, which should help to control the level of longer-term yields.

Credit: lacklustre returns to trail stocks

Credit markets remain expensive with Investment Grade (IG) credit spreads at historic lows while High Yield (HY) spreads are back to pre-GFC (Global Financial Crisis) tightness. While upside is naturally limited at these low spread levels, credit remains sensitive to the downside, as was evident during the technology driven sell-off in October. That said, given the anticipated support from both fiscal and monetary policy in coming quarters, we expect earnings to hold up and credit metrics are not expected to deteriorate. This is likely to limit spread widening due to headwinds such as supply—which we expect to pick up due to M&A and Capex, and a surge in AI driven debt raising. AI will remain in focus next year for both equities and credit, but credit investors are likely to face downside risks if returns on AI related investments are not significant while equities have both upside and downside risks. Consequently, we remain of the view that while credit may not be a great investment it is an excellent hedge against long equity exposure in multi asset portfolios.

Within credit, although both IG and HY remain expensive in our view, we believe HY is more vulnerable. Firstly, HY defaults are likely to remain above average and secondly, even at our projected default rates, if the composition of defaults were to shift from smaller to larger companies, spreads would seem grossly underpriced based on historical trends. We believe ABS and Municipals offer decent risk reward, as do higher rated tranches of CMBS.

Equities remain attractive

Robust growth supported by fiscal stimulus in combination with further Fed rate cuts is expected to provide an attractive environment for equities despite their rich valuations. While the stock market should benefit more broadly, AI will remain a major topic in 2026. The threshold for further gains may be higher given stretched valuations and increased investor anxiety about a potential AI bubble. But overall sentiment does not feel exuberant, and most of the technology companies that are driving the market continue to deliver on investors' expectations.

Profit margins are at historically high levels and earnings growth has been phenomenal. Nevertheless, expectations are already high, and the spread of new technologies rarely happens without disruptions, which are inherently hard to predict and could lead to a setback in the stock market. Therefore, while the outlook for both the economy and financial markets look benign, we expect volatility to increase in 2026, particularly compared to the relatively smooth rise in the second half of 2025.

Corporate profit margins are close to their highest on record



Source: Bloomberg

UK

Outlook

- The UK economy is expected to grow at a modest pace
- Inflation is likely to recede further, allowing the BoE to keep easing policy
- Fiscal headroom remains limited, potentially providing headwinds to growth

Implications

- Risk premium on gilts will remain elevated, but bond yields should stabilise
- Credit spreads remain tight, with risk reward skewed to the downside
- UK equities lack significant AI exposure but should shine in times of volatility

Risks

- Investor anxiety about fiscal sustainability flares up again, pushing gilt yields higher
- Inflation proves to be stickier than expected, challenging further rate cuts
- The labour market weakens substantially, undermining consumer spending

Modest expectations

Looking ahead to 2026, the economic outlook is shaped by three main themes: slowing but still positive growth, a gradual return of inflation toward target, and a cautious but continued easing of monetary policy.

Economic conditions in the UK remained mixed throughout 2025 as the economy continued to adjust to high real yields, fiscal policy changes, and a more challenging global environment. After a solid rebound at the start of the year, supported by improving real incomes and the lingering effects of fiscal expansion, momentum softened gradually into the second half of 2025 with GDP hardly growing anymore. Business activity indicators signalled that private sector firms became increasingly cautious as order books weakened and uncertainty related to global trade and domestic political developments weighed on confidence.

Services continued to perform better than manufacturing, although both sectors felt the impact of slowing external demand and higher operating costs. Some firms delayed investment projects as financing costs remained elevated compared to pre-pandemic norms, and President Trump's erratic trade policy encouraged risk aversion. Although input cost pressures eased over the course of the year, companies were less willing to expand their workforce, with hiring intentions moderating across most industries.

The employment situation has softened markedly

The labour market retained a degree of resilience in early 2025, supported by past employment growth and solid demand for labour. However, as the year progressed, the employment situation began to cool more noticeably with the unemployment rate rising to 5% in September, the highest level since February 2021. Survey measures

of hiring slowed, vacancy numbers drifted down from previously high levels, and some firms reported a shift from expansion to consolidation.

Wage growth remains above historical averages, contributing to persistent cost pressures in labour-intensive service sectors. Nevertheless, the cooling of labour demand has helped to temper wage pressure, which will allow the Bank of England to cut rates further despite still elevated inflation.

Consumer spending is holding up

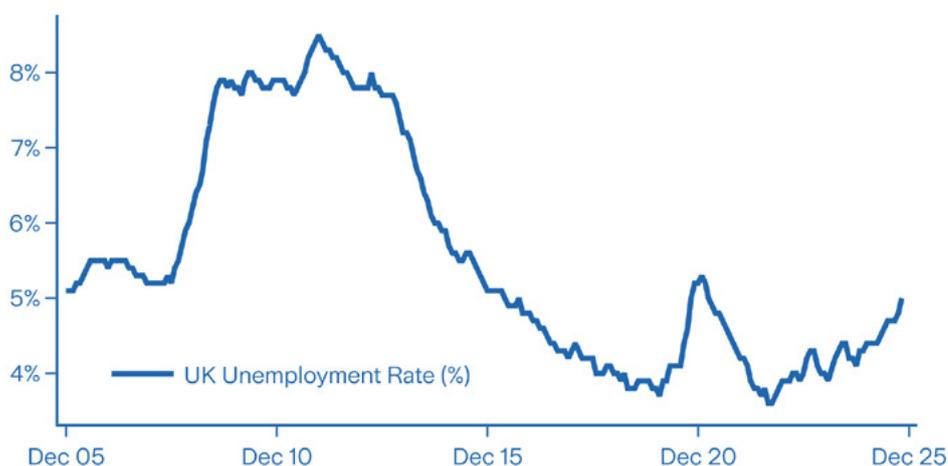
Consumer spending, a crucial driver of economic activity, held up reasonably well through most of 2025 and even accelerated modestly in Q3 despite an overall weaker growth picture. Real income growth benefited from moderating inflation and robust wages, although the pace of improvement slowed over the year. Households' purchasing power was supported by lower energy prices and stabilising food inflation, which helped sentiment improve from the lows of the previous two years. Further falls in inflation in 2026 should help to offset the weaker employment outlook.

Nonetheless, structural headwinds remain. Mortgage refinancing continues to put pressure on disposable incomes as many fixed-rate plans expire and have to be refinanced at higher rates. The rise in debt-servicing costs may continue to act as a drag on consumer spending, particularly among lower- and middle-income households. Even so, consumer demand remained resilient and is expected to continue to hold up in 2026.

The housing market still faces some headwinds

The housing market saw moderate improvement early in 2025 as mortgage approvals increased and buyer interest picked up, partly in anticipation of changes in property-related tax thresholds and

The employment situation has softened markedly



Source: Bloomberg

expectations of eventual BoE rate cuts. However, activity stabilised later in the year as buyers remained sensitive to borrowing costs and affordability constraints. House prices recovered from their slump in 2023 and 2024 before facing new headwinds in the second half of the year. The expected softening of mortgage rates provides some support, yet the market remains vulnerable to fluctuations in interest rate expectations and household confidence.

The fiscal situation remains challenging

Fiscal developments continue to play an important role in shaping the trajectory of the economy. The expansionary impact of earlier budgetary measures was still being felt in 2025, but the fiscal impulse waned as the year progressed. Higher public sector pay and increased departmental spending supported near-term growth, while targeted measures aimed at investment and public services provided a temporary lift to activity. Concerns about the government’s fiscal position have eased in the aftermath of the Autumn Budget as Chancellor Reeves has restored fiscal headroom and signals a continued commitment to the longer-term fiscal target. Nevertheless, investors will continue to monitor the fiscal situation closely, with gilt yields vulnerable to shifting expectations about fiscal direction and monetary policy.

30yr gilt yields reached the highest level in almost three decades over the summer as investors grew increasingly anxious about the fiscal situation. Gilt yields eventually fell back, helped by a global fall in bond yields, but the spread to US Treasuries remains

elevated despite a more modest growth outlook. While Chancellor Reeves stuck to her longer term fiscal rules, fiscal headroom remains limited and highly depended on the future growth path. The lack of action on the spending side puts a disproportionate burden on the taxpayers.

Inflation to recede further, allowing the BoE to keep easing policy

Inflation is projected to ease further in 2026, moving closer to the Bank of England’s 2% target as price pressures unwind and domestic cost growth normalises. However, services inflation may remain sticky due to structural labour shortages in key sectors and the lingering effects of wage increases. Core inflation is expected to fall gradually, although energy price volatility and global geopolitical disruptions remain upside risks.

Given this environment, the Bank of England is expected to continue lowering interest rates through 2026, but at a measured pace. Policymakers are likely to remain cautious, balancing the need to support growth with the risk of reigniting inflation. Market expectations point towards a slow and steady easing cycle, with the BoE preferring clarity on inflation dynamics before committing to more substantial cuts. The yield curve is therefore expected to steepen modestly as short-term rates decline while long-term yields remain anchored by fiscal concerns and global financial conditions.

Credit appears expensive

Sterling credit spreads appear expensive on both a historical basis as well as relative to European credit spreads. We believe credit

globally has risk reward skewed towards the downside as the upside remains limited due to tight spreads, and risk aversion still feeds into spread volatility. ABS and covered bonds are likely to offer better stability and diversification while High Yield remains vulnerable.

UK equities lack significant AI exposure, but can shine in times of volatility

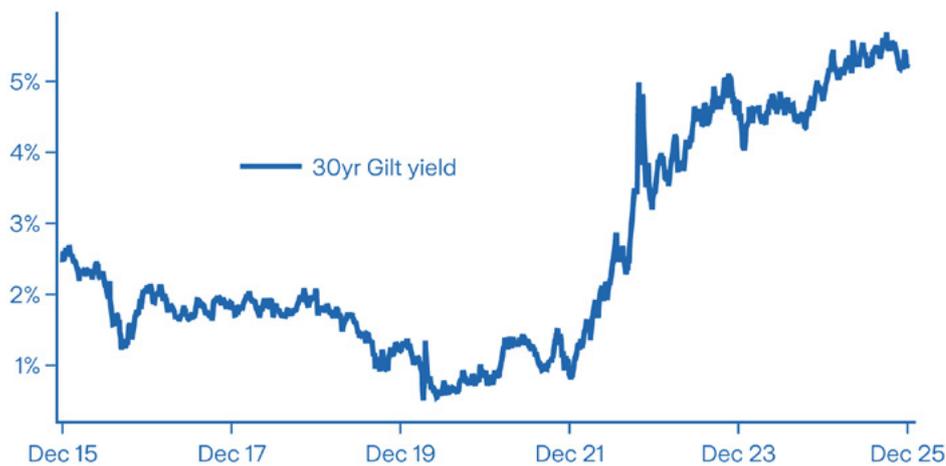
In an uncertain environment influenced by the US administration’s unpredictable trade policy, the UK stock market has developed fairly well, outperforming many of its US and European peers. For an equity market with a defensive tilt this is not necessarily something one would expect in an environment that was driven to large degree by developments in the technology and particularly the AI sector. The overall environment for equities should remain benign in 2026, with stable growth and easing financial conditions. Given that we expect stock market volatility to pick up compared to the relatively calm second half of 2025 there will be periods where investors will prefer UK stocks for their defensive properties. Nevertheless, we also expect AI to remain an important topic in 2026, a sector in which the UK stock market has less to offer than other markets.

Moderate growth ahead

Growth in 2026 is expected to be modest as the economy transitions into a stable but less dynamic phase. The fading of fiscal stimulus combined with restrictive financial conditions is likely to weigh on business investment. However, improving real wages and the gradual easing of mortgage burdens should support household consumption. Export performance will depend heavily on global conditions, particularly developments in the Eurozone and the United States, where trade tensions and fluctuating demand remain potential headwinds.

In summary, the UK economy in 2025 experienced a period of uneven but broadly stable performance, characterised by resilient consumer spending, easing inflation, and gradually weakening labour market dynamics. The outlook for 2026 suggests a continuation of these trends, with moderate growth, a gradual return to price stability, and a cautious but supportive monetary policy stance. While risks remain, from global trade tensions to domestic fiscal uncertainty, the broad direction of the economy points toward a slow normalisation.

Fiscal concerns push up longer term gilt yields



Source: Bloomberg

Eurozone

Outlook

- We expect 2026 to be a transitional year for economic activity, with GDP growth similar to that in 2025
- A tug-of-war between fiscal support and structural trade headwinds develops
- Inflation should fall below 2%, but weakening labour markets bode poorly for consumer spending

Implications

- Equity markets to diverge with tailwinds for domestically-oriented firms and headwinds for exporters
- Bond yields to remain in the post-2022 trading range as weakening inflation is offset by the ECB's QT
- Sovereign credit spreads to remain tight, but valuations are rich and risks underpriced

Risks

- Europe's regulatory simplification and market integration ambitions stall in Brussels committees
- Fiscal policy loosening from Germany is less impactful than anticipated
- France's political and fiscal instability worsen further

Delayed gratification

2026 is a crucial year of transition for the Eurozone economy. We expect GDP growth in 2026 of around 1%, similar to that of 2025. Unshackled German fiscal policy, broader regional defence spending, overdue regulatory simplification ambitions, and rising business investment intentions all bode well. Offsetting this are structural factors weighing on the outlook, including flatlining export levels. There is more reason for optimism than in many years, but the scope for disappointment is real and growing.

It is illustrative to break this down into GDP components. We expect business investment and government spending to be the drivers of growth. The former is likely to be more reliable as a base for permanent productivity enhancements. The latter will likely boost Germany out of a six-year growth stupor, with increasing questions as to whether it will persistently boost trend growth. Beyond Germany, the overall Eurozone fiscal stance will be tighter than in 2025, with France facing significant pressure to rein in its deficit. Net trade is likely to be a drag overall as the impact of US tariffs and increasingly uneven trade with China continue to be felt. We are notably more downbeat regarding the consumer outlook, and our view is pessimistic versus the consensus. Consumer confidence remains subdued, and retail sales data has recently corroborated this caution. We see no path to sustained future growth without private household consumption accelerating, and we are waiting to see evidence of this.

The State of Play

To give credit where credit is due, the Eurozone economy proved resilient against a difficult global backdrop in 2025. But that resilience needs context, and real GDP growth is still low in both absolute and relative international terms. It is, however, close to the Eurozone's 'trend'. Currently, many activity surveys signal reasonable, if underwhelming, growth for the end of 2025. Forward-looking expectations suggest

rising optimism among corporates about the economic outlook and that should stimulate investment next year. The aggregate Eurozone unemployment rate remains close to a historic low at 6.3%. Yet, this figure masks two distinct trends, with steadily rising unemployment in many northern economies, and the opposite in southern nations.

The long-awaited EU regulatory simplification agenda has seen mixed results. There is welcome ambition on deregulation. This includes a confirmed reduction in scope for corporate sustainability reporting and due diligence, proposed simplification of General Data Protection Regulation (GDPR), and postponed enforcement of the AI Act. The Savings & Investment Union has correctly identified areas like encouraging retail participation in capital markets, including equity products, but still lacks coordinated national government buy-in. Barriers to services trade within the Eurozone remain too high.

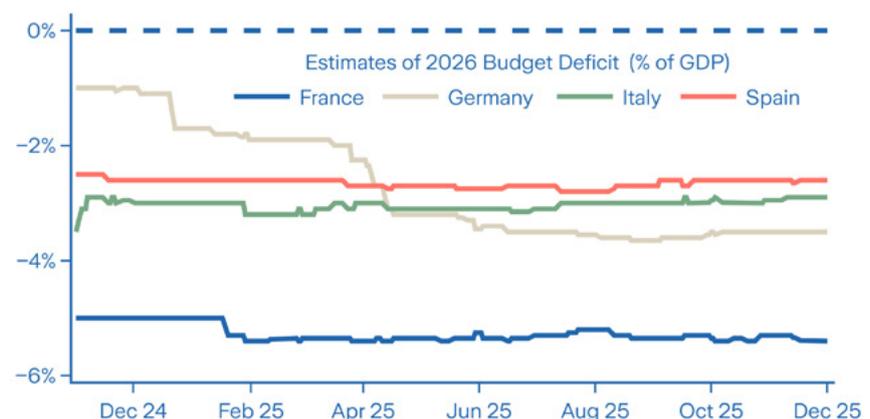
With an uncertain geopolitical environment in Ukraine and more broadly, greater defence spending will remain a theme. Significant spending commitments from

NATO countries, including on dual-use infrastructure, should support economic activity. This is helped by a new EUR 150bn 'Security Action for Europe' (SAFE) joint borrowing facility. The greater the role of R&D and infrastructure spending, the more persistent the economic boost is likely to be.

Spain sails leagues ahead of the pack

Spain should remain the fastest growing large national economy. We expect its growth rate to slow slightly in 2026, but a pace around 2% looks achievable. The numbers are flattered by continued immigration-driven population growth, but rising non-tourist services exports are particularly positive. Germany, France and Italy all have a similar, slower, growth outlook. Germany's fiscal impulse is the key driver of its 2026 outlook. France's economic outlook remains particularly concerning, with tax increases weighing amid continued political instability. Italy's politics are remarkably stable, but growth is likely to remain at low levels next year as Covid EU recovery funds provide less support than previously. In line with the recent north-south convergence, the outlook for countries like Finland and Austria remains

Germany's budget deficit to rise sharply yet remain below France's.



Source: Bloomberg

weak with rising unemployment, while Portugal and Greece are likely to continue growing at their recent elevated trajectory.

Inflation banished?

We see a high probability of Eurozone HICP inflation averaging under 2% for 2026. This is a welcome development for consumers and corporates alike. Yet, real purchasing power is only just back to 2019 levels. Variance in core inflation across countries is currently limited, but divergences are growing. While services inflation remains uncomfortably high, disinflationary progress was made in 2025 and should continue. Wage growth, which is closely related to underlying services price pressures, has clearly slowed. Forward indicators, such as the ECB's negotiated wage tracker, strongly suggest this will continue in 2026. Goods inflation, quicker to fall in 2023, remains comfortably below 2%. On the input side, PPI measures are currently subdued and consistent with limited inflationary impetus to be passed on to consumers.

Despite this benign central projection, there are clear longer-term upside risks to inflation. Growing geopolitical distrust is reversing the gains of global integration. Trade protectionism and security policy are being prioritised at the expense of textbook economic efficiency and comparative advantage. This is not bad in of itself, but simply a reality. Subsidising domestic EU steel production, building critical material refining and secure energy infrastructure, and blacklisting foreign communications technology providers from EU networks are all likely to boost input costs.

The ECB refuses to fully release the handbrake

The ECB is currently telling us they are in 'a good place', and there is justification for this assessment. The deposit facility rate stands at 2%, from a peak of 4% in 2024. Inflation has fallen from a peak of 10.6% in 2022 to close to the 2% target currently. Their assertion is that the risks to both growth and inflation are broadly balanced. Related to potential structural upside risks, many ECB voters remain concerned about inflation. This is particularly true given economic agents are likely more sensitive to price increases given recent experienced.

While we understand this assessment, we think the risks are skewed towards further ECB easing in the near term. We see a higher probability of disappointing growth and slower inflation data, which would tilt the balance towards easing. Lastly, the ECB has a lesser-known secondary mandate to 'support the general economic policies in the Union'. We believe it is currently being under emphasised. With economic growth still underwhelming and base-case estimates of sub-2% inflation, it would be justifiable for the ECB to lean towards easier policy.

Through the Looking-Glass, and what bond investors found there

We see European bond yields continuing to trade within their post-2022 range next year, which has been 2-3% for 10yr German paper. Slowing inflation and our assessment that ECB will lean towards easing should help bonds, while structural changes will pressure yields up. The environment for

Eurozone government debt has changed significantly over recent years. Towards the end of the past decade, the market priced almost permanent negative yields and perpetual QE. That world is gone. What has replaced it is much closer to the traditional textbook: fiscal sustainability assessments and price-sensitive private investor demand now influence yields. The ECB is committed to run down its QE programmes in full, and any structural reserve portfolio is expected to hold only short-dated government debt.

In other ways, the bond market is turning upside down. Germany's abandonment of the debt brake has coincided with an upgrade cycle in EU nations at the epicentre of the sovereign debt crisis. Italian, Portuguese and Greek debt are examples of issuers that now trade at their tightest levels to Germany since the 2008 financial crisis. This is welcome. However, we are wary of valuations, particularly as the Next Generation EU funds will be less supportive next year, and demographic issues weigh on highly indebted and low-growth sovereigns. France is an exception to the otherwise positive story, with yields now above those of Italy. There, we see downside risk given ongoing political gridlock and fiscal concerns.

As central banks have moved from buying bonds to selling them, other buyers are needed to step in. We note that the market is not concerned about future inflation, despite the recent experience. Rather, it is the real yield component of bond prices that are repricing higher. This likely reflects the fact that the private investors do demand an attractive real return, unlike price inelastic central bank QE programs. Lastly, long-maturity debt should come under further pressure from Dutch pension reform. These funds will begin selling some of their long-dated bond holdings next year. Conversely, we expect debt management offices will shift issuance shorter to reduce supply at the long end.

European credit markets preferred

We prefer European Investment Grade credit relative to the US. Spreads have compressed versus the US credit market in 2025 but we still think there is further upside as European credit has historically traded at tighter spreads to the US. Furthermore, supply is likely to be

less of a headwind as both AI driven debt issuance as well as M&A is likely to be milder than in the US. European High Yield credit is more vulnerable with weaker credits facing refinancing pressures. European covered bonds are likely to remain well supported as supply/demand technicals should be strong, while we expect supply of municipal bonds to rise from Germany but spreads are unlikely to widen meaningfully given solid investor demand and robust credit quality.

Equities turn inward

Eurozone equities had a strong 2025, although an initial surge of optimism gave way to underperformance versus global peers in the latter part of the year. We expect this underperformance to continue into next year. While we expect positive excess returns, recent gains have primarily been the result of multiple expansion rather than earnings growth. For our outlook to be more positive, we need to see a truly sustained economic upswing delivering earnings growth, an acceleration of EU regulatory simplification, and/or a growing culture of equity investing among EU citizens. We are not there yet. An IPO pipeline would help, but we continue to see a pull towards US listings for many successful private EU-founded firms. In contrast to some of the breathless commentary, we do not expect a structural reallocation out of US equities towards European.

Aggregate index earnings growth still looks challenging into 2026. The earnings outlook is highly dispersed across sectors. Export-oriented firms in traditional areas of European strength, industrial and consumer alike, are likely to continue to struggle. Conversely, many domestic industries stand to benefit from EU and national support. European financials, and banks in particular, had a stellar 2025. This significantly aided both Spanish and Italian indices, where this industry features prominently. Long-term valuation metrics suggest there is still further upside to both regional indices. The German DAX and French CAC are more exposed to export weakness and waning international consumer tastes for some European goods. The French equity outlook is weighed down further by the political situation, with risks skewed to further increases in corporate taxation measures.

Spanish and Italian equities have significantly outperformed French and German



Source: Bloomberg

Germany

Outlook

- We expect German economic growth to be meaningfully positive for the first time since 2018
- Enormous fiscal spending will be the primary driver of next year's economic boost
- Previous reliance on trade surpluses that are now structurally reversing will weigh on the economy

Implications

- German equity market dispersion to continue, with beneficiaries of the domestic fiscal plans to outperform
- German bond market supply will surge, but slowing inflation and possible ECB easing to keep yields in check

Risks

- Hard-won fiscal leeway used to fund social transfers rather than infrastructure
- A continued slowdown in manufacturing outweighs the positive impact of fiscal stimulus
- A breakdown of the CDU-SPD coalition squanders Germany's necessary reform agenda

Where we are

2025 was another forgettable year for the German economy. It is important, however, that Germany does not forget it. For the sixth year in a row, real GDP has flatlined. We expect this to change in 2026 and forecast a long-awaited year of clearly positive growth. The primary driver is historic fiscal loosening that will begin in earnest. In March of 2025, the new CDU-SPD coalition announced a stimulus plan that unlocks over EUR 1tn of additional spending over 12 years. While most Eurozone governments are tightening fiscal policy, 2026 will see Germany's spending accelerate considerably. There is enormous uncertainty around whether this plan will lead to a permanent boost to potential economic growth, but it is a genuine reason for optimism.

The Mire

Offsetting this is the current difficult environment. The old German economic model is struggling. A heavy reliance on growing net exports is increasingly unrealistic in the current global environment. Domestically, production costs have risen considerably faster than those of international competitors, driven by higher energy and labour input costs. Industrial production levels have fallen consistently and now stand 16% lower in real terms than the peak year of 2017. Looked at from another angle, manufacturing as a proportion of Germany's economy has fallen from 22.6% in 2017 to 19.6% in 2024.

Export growth to China and the US, two key markets, is clearly reversing. Germany's current account surplus remains positive but has fallen to a percentage of GDP last seen 15 years ago. The extent of the impact from US tariffs is unclear, but risks are clearly skewed towards a further reduction in exports to the US next year. The China situation is even less ambiguous and is impacting Germany negatively on two fronts. Firstly, China's rapid ascent up the value-chain in industry and technology, at relatively

low costs, is usurping Germany's competitive advantages in international exports. Secondly, demand from China for German exports is being hit both by general Chinese consumer weakness and changing tastes away from European products.

The German labour market is also changing. Although still low in absolute terms, the unemployment rate is rising. At the same time, wage growth is slowing, with clear evidence of new wage negotiations falling significantly from those of the past three years. While this should theoretically improve the competitiveness of firms, social security costs for employers continue to rise. The behaviour of German consumers will be key to watch this year. Savings rates remain elevated and confidence indicators weak. Our estimates are relatively downbeat, and we expect any rise in consumer spending to be the lagged effect of public and private investment efforts. In line with the fiscal positives discussed below, there are upside risks here. Next year's budget brings increased social spending, a VAT cut on

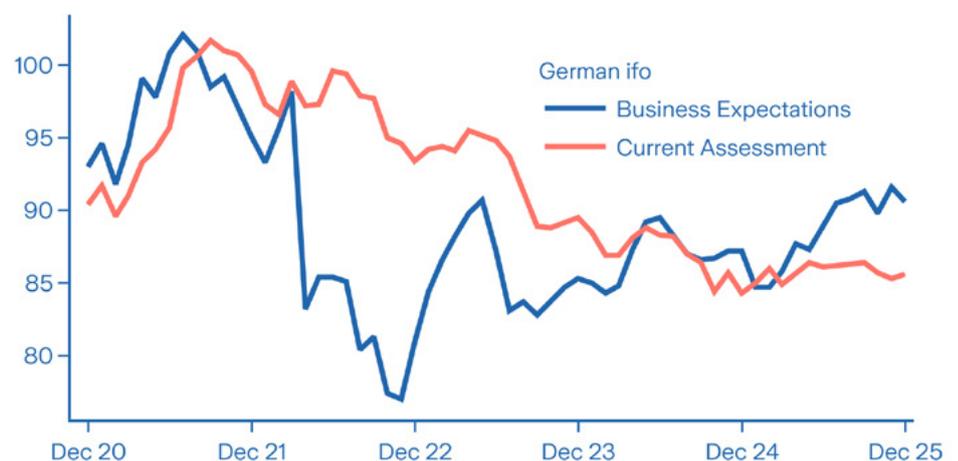
restaurants, and an 8.4% increase in the minimum wage. Increased demand for labour should also be a natural consequence of the spending plans, particularly in areas like construction and engineering.

The Escape

So much for the gloom. Germany recognises the severity of its malaise and is using a very strong government balance sheet to accelerate a necessary economic transition. In an unprecedented move, the incoming government negotiated with the previous parliament to pass a reform of its constitutional debt brake. The resulting fiscal stimulus is historic in size. This is playing out in German economic data through rising expectations indicators for future activity. The contrast between optimistic forward-looking sentiment and weak actual current data is stark.

The stimulus package focusses on three main areas of support. Firstly, a EUR 500bn 'Special Fund for Infrastructure and Climate Neutrality', representing 11.6% of 2024 GDP,

Business optimism is rising, but the present situation remains challenging



Source: Bloomberg

was established with a spending timeline of 12 years. This is split between federal projects (60%), climate (20%), and individual state spending (20%). The government intends to spend EUR 58bn of this in 2026, mainly on transportation, hospitals and digitalisation efforts. Secondly, defence spending in excess of 1% of GDP is now exempt from the debt brake. This effectively offers open-ended optionality. Germany plans to raise defence spending from around 2% of GDP in 2024 to 3.5% by 2029. For next year, this will increase to 2.8%, with procurement looking to heavily favour domestic firms. Lastly, the government announced an ambitious reform agenda, from bureaucracy overhaul, to support for early-stage start-ups and energy infrastructure build out.

Watch what I do, not what I say

The fiscal impulse, measured by the change in deficit levels from one year to the next, will be particularly large in 2026. This is partially related to a slow ramp-up of spending in 2025, which is an ongoing risk for large infrastructure projects. The second reason is that the planned loosening places a heavy emphasis on social spending, subsidies and tax cuts at the expense of infrastructure ambitions. While this has the benefit of ensuring that the money is injected into the economy quickly, these are areas in which the fiscal multiplier is likely to be lower. German think-tanks, like the IW, have raised legitimate questions about whether the government is thwarting the spirit of the fiscal reforms by using hard-won debt leeway to fund pensions and general expenditure rather than additional infrastructure.

The Politics

The coalition between the CDU and the SPD is increasingly fractious and threatens

the ambitious reform agenda. Until recently, the market's positive case for the Merz-coalition has been based on the strength of conviction and action, as opposed to the infighting and policy stasis of the Scholz era. Currently, however, a pension reform bill is dominating political discussion and exposing ideological fissures both within the coalition and the parties themselves. While pension reform is important for long-term public financial health, there is a risk that this debate will reduce the focus on other important priorities.

The government's draft budgetary plan for 2026 comes with a list of planned reforms. A case in point is the much needed "Annual Bureaucracy Reduction Act", which stipulates that each ministry streamline its interactions with the general public and businesses. Ironically, it is unclear whether this act itself is mired in bureaucracy, as the government's stated date of implementation is Q4 2027. Other areas are faring better, including laws on defence procurement and accelerated housing construction.

From Scarcity to A-Bund-ance

There is no one that doubts the structural shift underway in the German debt markets. The government's decision to abandon the debt break with gusto, all while the ECB continue to run their own balance sheet down, is flooding the market with German paper. The days of Bund scarcity leading to extreme valuations are over. This is reflected in the yield on 10yr German debt, now trading close to that of Euro interest rate swaps, as opposed to an average of 0.4% lower over the past 15 years.

This doesn't necessarily mean yields will only move higher. This repricing already reflects future expectations of supply. Despite

volatility, particularly following Germany's fiscal announcement, Bunds remain within their post-2022 yield range of 2-3%. Crucially, bond yields also reflect an expectation of future ECB policy. We favour positioning for lower yields in the near-term in anticipation of the market pricing in a higher expectation of ECB rate cuts amid growth and inflation disappointments. Longer-term, the ECB's quantitative tightening and higher supply will continue to weigh on bonds, particularly in long-dated maturities.

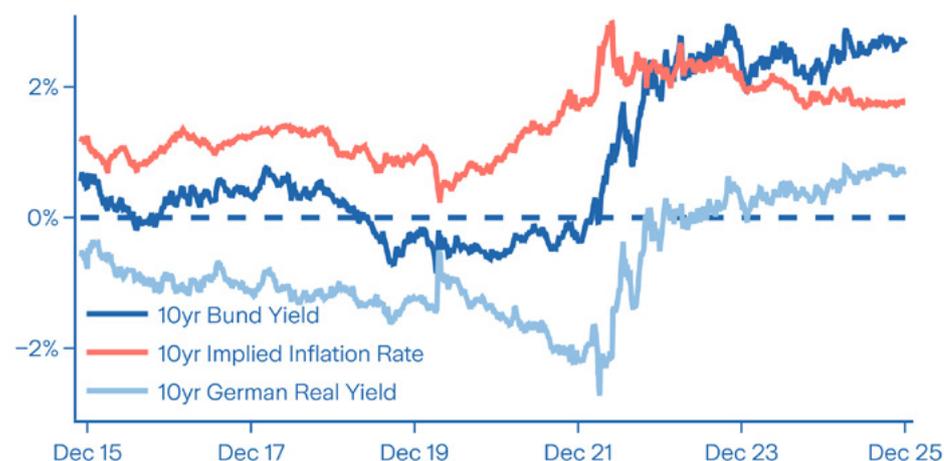
Equities reformed

Despite the economic malaise, it has been a good few years for German equity markets. 2025 was no exception. The year began particularly strongly on surging optimism of a German and European economic renaissance, before investor enthusiasm was significantly tempered by the deteriorating global trade environment. We expect this tone of caution to continue into next year initially, consistent with persistent trade headwinds. This is still consistent with outright positive market returns. Furthermore, we expect tactical opportunities to position for the fluctuations of investor sentiment towards Germany, most likely in the latter portion of 2026.

A significant portion of the strong performance is due to a clear rotation within the major large-cap DAX index. This is testament to the design of market-capitalisation weighted indices. The high-profile auto sector now constitutes only ~7.5% of the index, while technology (~17%) and financials (~23%) have been rising as part of a global theme. The same is true for firms involved in defence capabilities, as well as energy infrastructure.

The valuation story is nuanced. Recent performance has been driven by margin expansion rather than earnings growth. Looking ahead, the earnings outlook is brighter for 2026. This is helped by favourable annual comparisons vs a particularly weak 2025 for certain sectors, including automobiles. At an index level the DAX is now somewhat expensive relative to its own history. When comparing internationally, however, it screens more favourably. The median stock trades much more closely in line with historical averages, and dispersion is high. The MDAX, Germany's more domestically oriented mid-cap index is a useful barometer to assess investors' expectations around Germany's domestic growth. Having surged on the fiscal pledges, recent pricing suggests enthusiasm has almost fully unwound. Any positive surprises within the economy would likely see this index significantly outperform.

Investors are demanding a higher real return from German bonds



Source: Bloomberg

Switzerland

Outlook

- The economy is likely to experience subdued growth, given external headwinds
- Inflation should remain weak as deflation pressure broadens out
- The SNB is expected to keep rates unchanged at zero while maintaining a dovish outlook

Implications

- Bond yields to remain low given weak inflation and policy rates at zero
- The Swiss franc should remain in strong demand, but near-term upside to the currency is limited

Risks

- The labour market deteriorates further, leading to a broader-based decline in sentiment and activity
- Renewed tariff and global trade disruptions triggering a deeper slump in the export sector
- Geopolitical risk leads to a sharp further appreciation of the Swiss franc

Growth is slowing, alongside inflation

The Swiss economy grew at a trend-like pace in the first half of 2025, led by the front-loading of exports, resilient consumption, and solid government spending. But the economy stumbled in Q3, with GDP declining -0.5% on the quarter, in large part reflecting a sharp contraction in the pharma sector. The labour market has moreover weakened, with stalling job growth and a pickup in the use of the government's short-time working compensation, and survey data show that the services sector is also facing headwinds, with falling new orders and downbeat sentiment. Meanwhile, disinflationary pressures have intensified as tariffs and the strong franc drive renewed focus on keeping costs and prices in check, with rent inflation also slowing, leading the SNB to cut rates to zero in mid-2025.

A tariff agreement has been reached with the US

Looking forward, prospects for exporters have improved as Switzerland signed a declaration of intent with the US in mid-November. This aims to reduce the Swiss trade surplus with the US, and in return the US will cut the reciprocal tariff from 39% to a maximum of 15%, which is aligned with EU tariffs. The agreement is positive for Swiss exporters, reducing the risk of a more persistent drag on competitiveness and activity and decreasing uncertainty. Tariffs are still elevated compared to the past though, and Swiss companies are under pressure to increase investment and production in the US. This was demonstrated by the agreement, which includes a commitment by Swiss companies to make investments in the US of USD 200bn over the next five years. In addition, the Swiss franc remains highly valued, which is a headwind for exporters.

The economy should remain resilient, despite external headwinds

We expect growth to be subdued near term, with quarterly growth likely to stay negative in Q4 before conditions stabilise in early 2026. While the tariff agreement is positive,

we anticipate annual GDP growth of around 0.8% in 2026 (sport events adjusted GDP), down from an expected 1.3% in 2025.

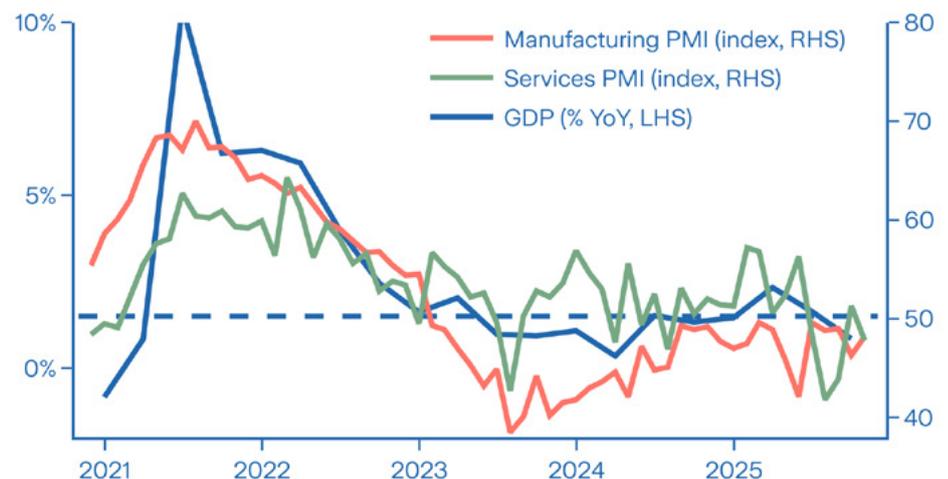
While this is well below the historical average of around 1.9%, a deeper downturn is not expected. The highly diversified economy, both with respect to sectors and trading partners, should limit the overall impact of US tariffs. The niche nature of Swiss exports—which tend to be highly differentiated and high value add goods—should also cap the negative impact, as demand tends to be sticky. Households also benefit from a favourable financial position, with one of the highest savings rates globally at close to 20% of disposable income, which should underpin resilient consumption despite the weakening labour market and downbeat sentiment. On the investment side, construction activity is tentatively improving as borrowing costs have come down, while tech-related capex spending should prevent a deeper drawdown in equipment investment. The upshot is that domestic demand should be resilient, despite external headwinds.

There is additionally ample fiscal space, should support be needed. This includes the government's short-term working arrangement, which has already been extended further, likely limiting spillover from weaker export performance into the broader economy. That said, the labour market poses a key risk, and a further deterioration would be concerning.

Longer-term challenges remain as the world trade environment is changing

While the tariff agreement improves the near-term outlook for the export sector, longer-term challenges remain. Pressure on the pharma sector, in particular, to potentially move some activities to the US would have significant impact on the broader economy, should it materialise. The chemicals and pharma sector makes up around 10% of GDP, contributing to close to 50% of exports, and has been a key driver of growth, with sectoral real value-added growing at an average pace at 12% annually over the past decade, compared to 1.9% for the whole economy.

Slowing growth amid tariff headwinds



Note: Sport events adjusted GDP

Source: Bloomberg

More broadly, Switzerland has been one of the beneficiaries from the globalisation trend that has prevailed over past decades, given its track record in producing goods and services that are in strong demand globally. The persistent trade surplus is a testimony to this, and Swiss exporters have prospered despite headwinds from the strong currency. We expect the successful export model to remain in place going forward, given our conviction that world trade will remain relatively open. However, it may become challenged more frequently, highlighting the importance of domestic demand as a driver of economic resilience.

The weak labour market is weighing on sentiment and growth dynamics

The unemployment rate has risen from the trough in 2023 and is now slightly above its long-term average at 3%. The KOF labour market indicator suggests that overall job growth has stalled, down from an elevated level in mid-2022. While the latest data show a slight improvement, led by positive developments in the construction sector, manufacturers are clearly under pressure, indicating further weakness to come. Consistent with this, uptake of the government's short-term working arrangement has risen significantly. While this means that job losses remain low, it also implies a slowdown in hiring. In Switzerland, household sentiment is closely linked to job security and unemployment, and a further labour market deterioration would be concerning as it could trigger more broad-based weakness. We anticipate conditions will stabilise, in part reflecting the reduction in tariffs, but this will be key to watch going forward.

With a weakening labour market, immigration is set to slow, which would be an additional headwind to growth over the coming year. This will amplify the structural demographic headwinds that are already underway, with a shift lower in population growth and a rapidly ageing population.

Inflation set to remain close to zero

Inflation has fallen sharply and is tracking at around zero, with headline CPI briefly dipping into negative territory in early 2025. Looking forward, we anticipate inflation to remain close to zero, averaging 0.2% in 2025 before picking up slightly to around 0.4% in 2026. Downward pressure on import prices is set to persist while producer price deflation is broadening out as businesses focus on maintaining competitiveness. In addition, rent inflation is falling, with further declines anticipated given past cuts to the regulated reference rate for rents. Services prices are still rising as domestic demand is holding up, however, and this is a key difference compared to the pre-pandemic period, when Switzerland saw persistent deflation. This partly reflects stronger wage dynamics, with a range of wage surveys indicating wage growth averaged 1.6% in 2025, down from 1.8% in 2024, and projected to slow further towards 1.3% in 2026. While the trajectory is downward, this nonetheless marks a clear break from the five-year period before Covid, when annual wage growth was muted at 0.5%. Unless wage growth slows sharply, which is unlikely in the absence of a deeper economic slowdown, we anticipate domestic

price pressures to remain in positive territory. As a result, we do not expect a return to persistent deflation over the coming year. Risk to inflation is to the downside, however, and both the labour market and wage growth will be key for the trajectory for inflation.

Further SNB rate cuts are not expected

The SNB has cut rates to zero but signalled that the hurdle for cutting rates into negative territory is higher compared to the past. An important development was the statement on foreign exchanged matters, jointly issued by Switzerland and the US, which confirmed that foreign exchange interventions remain an important monetary policy tool for the SNB. The SNB also released data showing some FX interventions around the 'liberation day' tariff announcements.

We maintain our view that the SNB will keep rates at zero over the coming year. While inflation has weakened further in recent months and is currently tracking slightly below the SNB's forecast, the tariff agreement with the US reduces downside risk to economic activity and inflation. Given the higher hurdle for cutting rates into negative territory, we anticipate that the SNB will increasingly rely on FX interventions, should renewed currency pressure emerge. That said, risk to the rate outlook is to the downside. Should inflation continue to surprise to the downside relative to the SNB's forecast, further policy easing is justified.

The Swiss franc will remain in demand given strong underlying fundamentals

The Swiss franc strengthened sharply against the US dollar in 2025, in part reflecting broad-based dollar weakness, leaving the franc only slightly stronger against the euro. The real effective exchange rate has strengthened further, however, and is now trading close to historical highs. At these levels, the currency is a headwind for both economic activity and inflation, and we expect that the SNB will intervene in FX markets should the franc strengthen meaningfully further. As a result, we see limited further upside to the franc over the coming year.

At the same time, the Swiss franc is set to remain in strong demand, given the persistent trade surplus. While higher US tariffs may reduce the surplus somewhat, underlying fundamentals are set to remain strong. Safe-haven demand for the Swiss franc is also likely to be a tailwind for the currency, given the fraught geopolitical backdrop and its role as an inflation hedge. As a result, any downside to the currency is likely to remain limited.

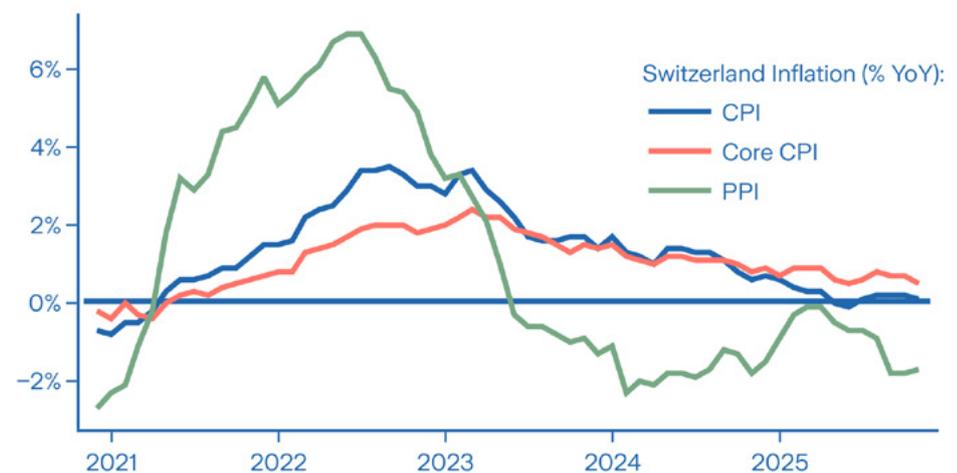
Over a longer-term horizon, we should anticipate further upside to the nominal value of the currency, given the persistently lower inflation rate in Switzerland compared to its key trading partners. This inflation differential also explains a significant part of the upward trend in the value of the franc over past decade.

Government bond yields to remain low

Swiss government bond yields have fallen in line with the SNB policy rate, with the 10yr yield trading below 20bp through Q4. We expect yields to remain flat over the coming year as the SNB keeps rates on hold. Risk to the yield outlook is however tilted to the downside given growth and inflation headwinds.

Swiss yields have decoupled further from other markets, with the spread vs Bunds rising above 250bp for the 10yr yield, which marks a multi-decade high. The relative outperformance can be explained by the weaker inflation backdrop, lower policy rates, a strong fiscal position, and tight demand/supply dynamics in the government debt market. That said, Switzerland is an open economy with close economic and financial links to Europe and the rest of the world, and there are limits as to how far economic fundamentals and yields can decouple. Going forward, we maintain our view that spreads should narrow, particularly relative to Bunds.

Inflation set to remain weak



Note: PPI shows the combined producer and import price index

Source: Bloomberg

Japan

Outlook

- Japan's economy is poised for decent growth in 2026, boosted by fiscal spending
- Core inflation is likely to remain firm at around 2%
- Rate hikes are likely to be measured, with the BoJ's policy rate on track to reach 1%

Implications

- The rally in equities has further to run amid robust earnings and ongoing corporate reforms
- Bond yields are set to rise amid BoJ expected rate hikes and ongoing fiscal expansion
- Corporate bonds should continue to be supported by positive fundamental trends

Risks

- Inflation may accelerate, compelling the BoJ to tighten policy more aggressively
- Fiscal overreach could push long-term yields higher and trigger further yen depreciation
- Sharp swings in the USDJPY and a rapid rise in yields could destabilise financial markets

A renewed optimism

2026 could bring renewed optimism for Japan after a period of political instability, rising inflation, and the shock of 25% US auto tariffs. Signs of light are breaking through the clouds with US tariffs reduced to 15% and bilateral US-Japan relations improving. While the election of PM Takaichi revives Abenomics-inspired fiscal expansion, the key challenge for the new PM is that Japan is now grappling with inflation rather than the deflation that defined Abe's era. However, if fiscal stimulus is executed carefully, without spooking markets or interfering with the BoJ's independence, it could usher in a new atmosphere for Japan's economy. Overall, Japan's 2026 outlook appears favourable, with real growth expected to be around 1%, supported by fiscal spending, improving consumption, and reduced tariff uncertainty.

All eyes are on the fiscal front

The government's newly unveiled JPY 21.3tn stimulus package (3.4% of GDP), is its largest since the pandemic. JPY 17.7tn is earmarked for direct spending, while JPY 2.7tn has been allocated to household-focused tax cuts. Around half the package will be channelled into strategic investments in sectors such as AI, semiconductors, shipbuilding, and a significant ramp-up in defence spending to 2% of GDP. PM Takaichi has emphasised that the package will be funded primarily through stronger fiscal revenues, with only limited new borrowing.

From a growth perspective, the fiscal package is unequivocally supportive. Increased direct fiscal spending, improving consumption as household income gets a boost from tax cuts, and strategic government investments encouraging private capital expenditure are all expected to stimulate the economy. Over the long term, strategic government-driven investments are highly positive for Japan's capital spending trends, especially after a prolonged period of domestic

underinvestment during which Japanese companies preferred to invest abroad.

A new inflation mindset takes hold

Japan's long-awaited inflation didn't stem from years of Abenomics stimulus or negative interest rates. It arrived after pandemic-era supply shocks and a sharply depreciating yen. What began as transitory price pressure has evolved into something more persistent, with a healthy feedback loop between wages and prices. Japan has recorded the strongest wage gains in three decades, and firms no longer hesitate to pass higher costs onto consumers. Despite negative real wage growth, household spending is resilient, signalling a shift away from the old habit of delaying purchases in anticipation of falling prices. Looking ahead, headline inflation may be tempered by high base effects and waning impact of previously sky-high food prices. But underlying inflation is likely to remain firm at around 2%, improvement in household spending.

Wage growth set to be strong

Japan's shrinking population has put persistent pressure on labour supply, but rising participation among women and seniors, together with a low-growth environment, has masked the problem until recently. With both groups now near peak participation and immigration tightly controlled, the scope to boost labour inputs is reaching its limit. Resilient domestic demand and strong corporate profits have spurred hiring but also deepened labour shortages. The latest Tankan Survey on Employment Conditions points to synchronised chronic shortages across sectors and firm sizes. Since 2023, Japan has logged three consecutive years of strong wage gains, highlighted by a 34-year high, 5.2% increase in Shunto wage negotiations in 2025. The wage outlook for 2026 remains positive, with labour unions pushing for at least a 5% increase next spring. While current real wage growth is negative at -1.4% YoY, it is expected to turn positive in 2026 as wage gains play catch up and inflation eases.

Inflation has exceeded the BoJ's 2% target for the last four years



Source: Bloomberg

A weak yen and fiscal expansion strengthen the case for BoJ tightening

Despite inflation remaining above target for nearly four years, the BoJ has raised policy rates only gradually by 50bp, leaving real rates deeply negative. While one could argue the BoJ is significantly behind the curve, this deliberate stance reflects the Bank's priority of ensuring that inflation becomes firmly anchored after decades of undershooting its objective. With underlying price pressures now showing clearer signs of persistence and fiscal policy set to become more expansionary, conditions are aligning for the policy rate to move to 1% in 2026.

Japan Inc. seems to no longer be sleepwalking

Corporate governance reform has long been on the agenda, but only saw concrete actions in 2023–2024 when the Tokyo Stock Exchange pressed firms to improve ROE and capital efficiency, addressing persistent issues such as cash hoarding, and cross-shareholdings. Firms have responded with record buybacks, larger dividends and further unwinding of cross-shareholdings. Despite tariff-related pressure in autos, overall corporate profits have held up, supported by a weaker yen and improved pricing power. Improved profitability coupled with reform momentum have spurred appetite for capex investment. Going forward, wage pressures and capacity constraints should continue to push firms toward automation and productivity upgrades while the global wave of investment in AI will keep appetite for tech investment strong in 2026.

Exports to turn a corner

While exports have become less dominant as a growth engine for Japan, the country's extensive overseas operations and deep integration into global supply chains, especially in high value-added intermediate goods, make it highly sensitive to global demand and geopolitical developments. Between April and August 2025, for example, Japan's exports contracted for four months in a row on the back of elevated US tariff rates. However, recent monthly data show stabilisation as US tariff rates on Japan came down to 15%. Looking ahead, we think there is more room for exports to recover from the current weakness.

10yr JGB yields set to edge higher

2025 has been a turbulent year for Japan's bond market. 30yr yields have climbed 120bp to 3.4%, while 10yr yields have surged 80bp to 1.8%. Notable moves in bond yields pose two critical questions. First, with debt-to-GDP at 235% and ongoing fiscal expansion, will rising bond yields threaten Japan's fiscal sustainability? Second, will Japanese bond investors repatriate from overseas markets, triggering a sell-off in global bonds?

On fiscal sustainability, we think the risk of sharp deterioration appears contained in 2026. Deficits have narrowed, tax revenues are robust, and the effective interest rate on fiscal debt is still very low, thanks to an average maturity of 10 years. With real GDP growth expected to be at 1% in 2026 and

inflation around 2%, nominal growth should be comfortable at around 3%, providing a decent fiscal buffer even if 10yr yields rise further from here. Nonetheless, this balance is delicate. The ongoing demographic decline remains a burden and unexpected external shocks could unsettle growth at a time of elevated inflation. Most critically, sustaining market confidence hinges on the BoJ maintaining its independence and credibility, ensuring inflation remains anchored and investor risk premia stay contained.

On the repatriation risk, it has been a talking point for years but there is little evidence of a widespread pullback of Japanese investors from overseas markets, especially as US Treasury yields remain compelling. Near-term, we think repatriation is not yet a material threat. In fact, Japanese investor appetite for domestic bonds, especially at the super long end like 30yr and 40yr, has diminished. Life insurers have stepped back from the market, scaling down duration exposures while grappling with increased unrealised losses on their balance sheets. Japan's well-capitalised insurers should mitigate systemic risk, but the demand for long-duration bonds is clearly fading. Looking ahead, the government's reduction in super-long issuance should help stabilise yields in the long-end, but upward pressure is likely to remain concentrated in the 10yr segment. With potentially increased issuance and further BoJ tightening expected, 10yr yields could reach 2% in 2026.

Regarding the JPY, further weakness from current levels could trigger FX intervention and may force the hand of the BoJ to accelerate rate hikes in 2026. These will act as stabilising factors for the currency to settle within the 150–155 JPY/USD range.

High credit quality appeals to global credit investors

We expect Japanese corporate bonds to continue to be supported by positive fundamental trends, although there could

be some volatility through the year. Issuance has surged to record levels in 2025 as companies have aimed to lock in funding ahead of the expected interest rate hikes by the Bank of Japan, which has begun normalising policy after years of ultra-loose conditions. Spreads are still tight thanks to strong demand from domestic institutions, though foreign participation has eased amid yen volatility and higher global yields. Looking ahead, issuance will likely remain strong in early 2026 as firms continue pre-funding. However, risks such as persistent inflation, currency swings, and global trade uncertainty could introduce more volatility. Overall, Japanese corporate bonds remain a high-quality option and a good diversifying play for global credit investors.

The rally in equities has further to run

Japanese equities are expected to offer an attractive trading opportunity in 2026. Fiscal pro-growth policies and corporates' ability to pass on inflation will continue to support earnings while momentum in governance reforms is boosting shareholder returns, with Japan leading the world in net buyback yield at around 2% of market capitalisation. Valuations remain compelling, trading near book value and at a deep discount to global peers. Meanwhile, MSCI Japan delivers broad sector exposure, including financials which benefit from higher interest rates, and industrials, and technology capitalising on strong global demand for energy security, defence, and semiconductor infrastructure.

That said, yen volatility poses a near-term risk. After a sharp decline in late 2025, ongoing depreciation might trigger currency intervention by the finance ministry, and a reversal in which the JPY strengthens sharply could weigh on equity sentiment, given the historical negative correlation between the JPY and Japanese stocks.

Bond yields are set to rise amid BoJ expected rate hikes



Source: Bloomberg

China

Outlook

- Growth is expected to slow in 2026 as exports normalise and consumption remains muted
- Inflation will likely remain subdued, driven by weak demand and persistent excess supply
- Policy support will continue to be modestly accommodative and remain targeted

Implications

- Equity markets are poised to benefit from China's ambitious AI initiatives and stimulus
- Bond yields are likely to remain low in response to sluggish growth
- Credit spreads should remain tight amid negative net supply

Risks

- A resurgence in trade tensions with the US, potentially leading to higher tariffs
- A deeper collapse in the property sector, which could trigger new waves of defaults
- Employment pressure arising from production cuts related to anti-involution campaigns

Muddling through

2025 has been the year of 'muddling through'. Real GDP growth loosely tracked the 5% target, largely supported by robust export performance. Domestically, consumption remained sluggish. Investment stalled in the second half of the year as local governments prioritised deleveraging over new investment. Beneath the weakness of the old economy, however, a vibrant new economy is emerging, driven by high tech, advanced manufacturing, and green energy, all showing impressive growth. Meanwhile, elevated US tariffs on Chinese goods proved less disruptive than initially feared. China was among the few that played hardball in negotiations with the US, leveraging its near-monopoly position in rare earth supply to secure a trade truce.

New wine in old bottles

The Year of the Horse in 2026 symbolises energy and independence, a sentiment mirrored in China's policy orientation. China is expected to continue its pursuit of technological advancement and self-sufficiency as outlined in the 15th five-year plan (2026–2030). In line with this, China appears to be doubling down on its current growth model, focusing on investment over consumption. The key difference is a shift in emphasis toward advanced manufacturing and high-tech industries. As a Chinese proverb goes, it is "new wine in old bottles," signalling China's ambition to transform into a modern, high-tech economy using a similar growth model. Moving into 2026, we expect headline growth to moderate to around 4.2%, reflecting normalising exports alongside persistently weak domestic demand. This is despite strong growth in tech-driven sectors, evident in robust investment and industrial production. Overall, the economy appears set to muddle through another year.

Export strength will remain

The biggest surprise of 2025 was China's exports. At the start of the year, consensus expected a 1-1.5ppt hit to China's GDP from

a collapse in exports. Instead, China defied the odds with exports tracking a solid 5-6% YoY growth. In 2026 and beyond, exports are expected to remain the primary engine of growth. First, China has diversified its export markets, with the US accounting for less than 3% of GDP, mitigating the impact of targeted tariffs. Second, China retains a strong grip on various critical supply chains, from raw materials such as rare earths to intermediate and capital goods, making decoupling costly and disruptive for trading partners. Third, the country's competitiveness is rising, not only through cost advantages but also via improvements in quality, exemplified by the growing success of the EV industry, which is reshaping and elevating the perception of what 'Made in China' stands for. Although the export momentum of 2025, driven by stockpiling, is unlikely to be fully repeated, underlying forces should sustain steady growth. Following the drop in tariffs to 30% post US-China trade truce, bilateral trade could experience a second wind.

Consumption to take a back seat

While consumption is formally acknowledged as a policy priority in the latest five-year plan, it continues to play a secondary role compared to technology and self-sufficiency. Retail sales growth is expected to remain in the 3-5% YoY range in 2026. Policymakers are likely to prevent a sharp decline in household spending through targeted subsidies, possibly shifting support toward services rather than goods. That said, the crux of the issue is that China is still tackling a deep, structural challenge with mostly short-term fixes. Consumer spending is stuck in low gear due to weak sentiment, with a large portion of household savings tied up in depreciating real estate assets. Weak income growth, especially with elevated youth unemployment (close to 18%) further restrain spending. Deflation, a lack of social safety nets, and an aging population reinforce household savings.

Some policy measures, such as the gradual easing of the 'hukou' system (which restricts access to public services for people living outside their registered locality, often affecting migrant workers) as well as new childcare subsidies and free pre-school education, have been introduced. However, their scale has been too timid to move the needle. Bold reforms remain elusive, held back by their hefty fiscal price tag, especially when local government balance sheets are already under strain.

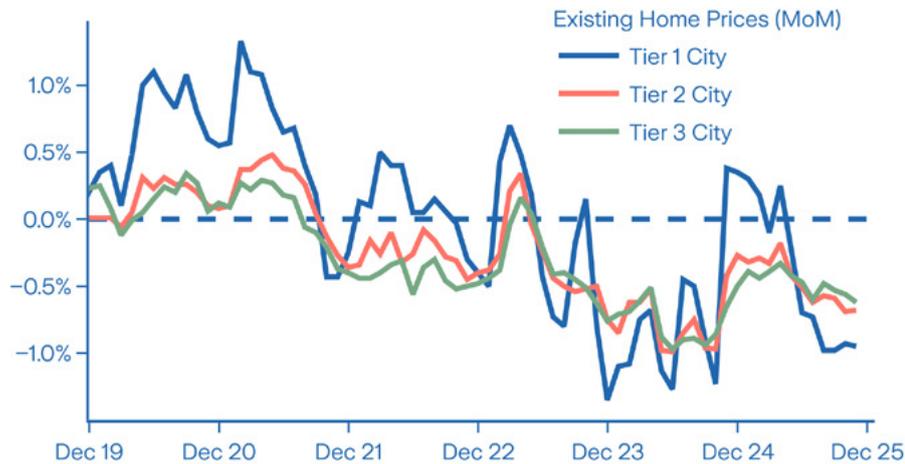
The housing market not yet out of the woods

The property market downturn, now in its fifth year, continues to weigh heavily on the economy. The Evergrande default exposed the intricate links between developers, banks, local governments, and household finances. While China avoided a systemic collapse, the pain has persisted for years and it leaves the whole system paralysed with debt overhang. While policy interventions finally stepped up in late 2024, they have not been sufficient to stabilise the property market. By mid-2025, prices resumed their decline. New home prices and existing home prices are down 12% and 20% from their respective peaks in the second quarter of 2021. Home sales have collapsed by 75% from their late 2020 highs, with the decline particularly pronounced in Tier 2 and Tier 3 cities. Looking forward, high inventory levels and weak demand are likely to continue suppressing prices. The number of unsold homes remain elevated with little improvement from 2024, highlighting the need for further policy support to reduce inventory.

Deflation is here to stay

China has been in deflation for close to three years, with CPI near zero and PPI deeply negative. Producers, unable to offload excess goods domestically, have increasingly targeted overseas markets. The 2025 anti-involution campaign aims to curb destructive competition and excess capacity in industries such as solar, EVs, and steel.

Elevated unsold inventory continues to put pressure on existing home prices



Source: Bloomberg

This may modestly support PPI and industrial profits, but a meaningful rebound is unlikely without measures to boost consumption and stabilise the housing market. We expect inflation to remain muted. Moreover, overly aggressive production cuts could exacerbate employment challenges. So far, this has largely manifested as reduced working hours rather than widespread layoffs, and we expect policymakers to proceed with caution.

Further stimulus is warranted

With growth momentum faltering, additional stimulus is expected early in 2026, primarily through fiscal measures. Consumer support may take the form of service-oriented subsidies. Infrastructure investment, particularly in AI, advanced manufacturing, and energy projects, will remain a priority. Fiscal efforts will also support local government deleveraging through debt-swap programs and possible bank recapitalisation. Monetary easing is likely to be forthcoming, with an expected 20bp cut to the LPR and 50bp cut to RRR. While stimulus will support growth, it is unlikely to be a 'bazooka', as local governments retrench under debt pressures and declining revenues while the central government appears to prefer an incremental approach, fixing broken parts as they arise rather than pursuing an overhaul.

Innovation the Chinese style

While China's old economy struggles, a new growth engine is firing. High tech now accounts for roughly 18% of GDP, nearly double its share a decade ago. Contributions from high-tech manufacturing have cushioned the ongoing drag from the property sector. Half of the world's industrial robots are now installed in China. The country leads globally in patents and accounts for 70% of AI-related grants. Indeed, AI sits at the heart of China's transformation. Unlike the US, which focuses on developing the most powerful AI models, China is prioritising rapid

adoption across industry and consumers. Its five-year plan envisions AI integrated into key sectors by 2027, driving growth by 2030, and shaping an 'intelligent society' by 2035. Leveraging a vast digital economy, open-access labs, and tech-savvy users, China is scaling AI quickly, positioning it as a powerful player.

Room for government bond yields to compress

Following the property market collapse, Chinese government bond yields have fallen roughly 100bp. We anticipate a further compression of 10-20bp to around 1.6% in 2026, driven by expected slower growth, renewed central bank purchases, and expectations of additional monetary easing. Policy rate cuts of around 20bp are increasingly likely, and a softer US rate environment may help limit FX volatility, making long-duration bonds attractive.

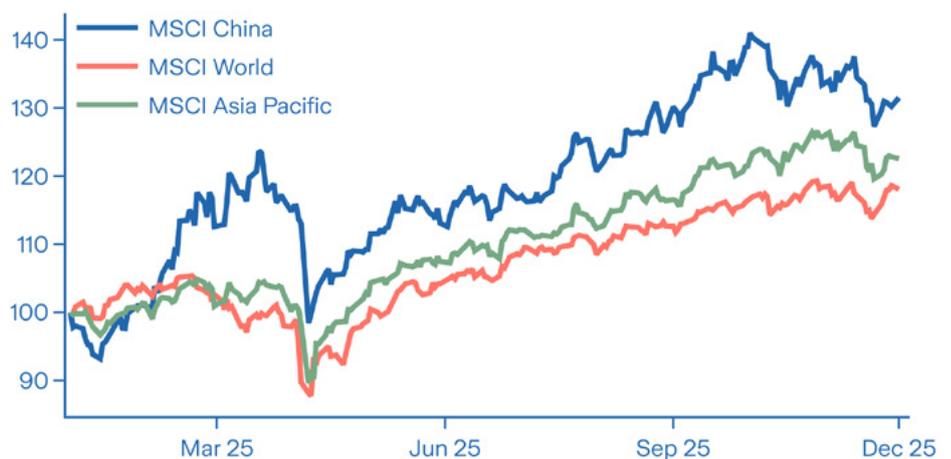
Tight credit spreads limit upside while negative net supply limits downside

We believe credit spreads are tight but are likely to stay supported by strong supply/demand dynamics as net supply is expected to stay negative. While net supply is likely to remain negative, but the shrinkage is likely to be less severe than in 2025. This trend reflects subdued GDP growth and the continued advantage of cheap RMB funding, which discourages issuance in USD. The cost differential between USD and RMB funding is expected to remain significant, reinforcing the preference for onshore financing. Despite these headwinds, several factors are likely to mitigate some of the impact of negative supply making the conditions less severe next year. A notable driver is the anticipated capex boom in China's technology sector. This should support some USD issuance from leading tech names.

The bull market in equity has further to run

Despite subdued macro growth, China's equity markets have performed strongly. The MSCI China Index, weighted toward technology, have gained around 30% YTD in 2025. Looking ahead, we think a mid-teen upside is achievable for China's stocks, supported by valuation rerating, robust southbound inflows, and renewed foreign investor interest. Earnings growth is likely to be modest, constrained by soft e-commerce activity and competitive pressures in food delivery, but cloud services and AI adoption present strong growth opportunities. Tencent, for instance, is experiencing double-digit earnings growth through AI integration across WeChat and gaming. Policy tailwinds, particularly the new five-year plan's commitment to AI infrastructure, will further support equities. Elevated volatility remains a key risk, alongside US-China trade tensions and the fragile property sector.

The MSCI China has outperformed global stocks in 2025



Source: Bloomberg

India

Outlook

- Above trend growth is expected despite the impact of US tariffs
- With inflation moderating, the RBI will have room to cut its policy rate further
- Expected economic reform will be positive for long-term growth ambitions

Implications

- Stocks should perform well amid better earnings despite high valuations
- Bond yields will likely trade lower thanks to the inclusion in the global bond index
- With most rate cuts already priced in, the INR is likely to trade rangebound

Risks

- Retaliatory measures by the US should India continue to buy Russian oil
- A stronger USD that weighs on the INR and intensifies capital outflows from India
- Inflation accelerates from either adverse weather impact or oil price shocks

Strong growth will continue

After a very strong first half of 2025, economic growth for India remained on track to exceed 7% for the full year, a view reinforced by recent PMI sentiment data from manufacturing and services surveys. This implies strong growth momentum going into next year. For 2026, we expect that India's economy will grow slightly above trend, between 6.5-7%, driven by stronger domestic demand. Consumption, which accounts for 70% of Indian GDP, should continue to benefit from the recent sales tax reforms that reduced overall effective tax rates. This impact will potentially add an annualised 0.1-0.3% increment to GDP, more than offsetting the negative impact of US tariffs.

Inflation should bounce but remain benign

Headline inflation has slowed dramatically from the 6% level of mid-2024 to 0.25% YoY and is now significantly undershooting the RBI's long-term target. Aided by a favourable monsoon season, a significant decline in the price of food, which comprises just under half of the overall inflation basket, has underpinned a reduction in headline inflation. Core inflation, however, remains at 4%, with the largest contributor being the cost of housing.

With low base effects, headline inflation is expected to bounce back from these recent lows. The unpredictability of weather factors could also result in unexpected volatility in headline inflation. That said, we think underlying inflation should trade within the RBI's range as supply-demand dynamics appear to be balanced.

More rate cuts ahead

The RBI has cut its official interest rates for the third time in the current cycle, taking rates to 5.5%. The rate cuts were in response to the relative slowdown in economic growth through H2 2024 and reflected a significant decline in inflation levels.

As inflation is expected to trade within the target range of the RBI for the immediate future, we expect the central bank will deliver between 25-50bp in rate cuts in 2026. With growth expected to pick up next year, the need for rate cuts exceeding 50bp appears limited given that the central bank does not want to unnecessarily weaken the INR due to compressed rate differentials with the US and other markets.

With rate cuts coupled with sales tax cuts, fiscal and monetary policy are well coordinated to support growth going forward.

US tariff headwinds are manageable

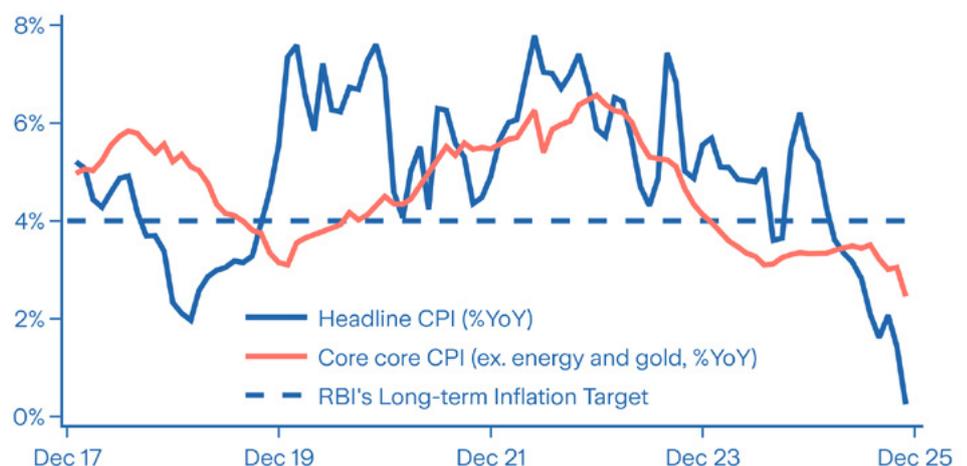
The tariffs applied by the US to India currently remain amongst the highest in the world at 50%, with an effective rate closer to 34%. However, India is currently negotiating with the US, and tariffs are likely to be reduced significantly as India is scaling down oil imports from Russia—a root cause of the recent trade escalation. Regarding sectoral

US tariffs, while the 200% tariff on branded pharmaceuticals poses some risk to India's exports, the impact is limited, as around 90% of India's pharmaceutical exports to the US are generics, which remain unaffected.

From a macro perspective, net exports have typically comprised a small, and from time to time even negative, contribution to economic growth. In this context, the seemingly high US tariffs have not impacted growth in a meaningful way. Moreover, the negative impact of tariffs has been further mitigated by a weakening rupee.

For 2026, we expect this trend to continue. Rather than directly causing significant harm to the broader economy, US tariff costs are likely to be seen as more of an opportunity cost, as they are prompting global producers to reconsider shifting operations to India if the country continues to be subject to tariff rates as high as the current 50%.

Benign inflation paves the way for further rate cuts



Source: Bloomberg

Navigating trade tensions: India's balancing act

Recent trade escalations are challenging the widespread view that India will be the primary beneficiary of the trade war given the need for global companies to diversify manufacturing away from China. Taking into consideration India's advantages as a large economy with abundant labour and its close geopolitical alignment with the US, we believe India is nonetheless still well positioned to benefit from the global trend toward trade diversification. However, in the short-term uncertainty remains high and depends on how India balances its respective relationships with both the US and Russia.

That said, there is a clear need for India to hedge its geopolitical risks in response to the current unpredictability of US trade policy. The India-China relationship has become warmer recently as demonstrated at the Shanghai Cooperation Organization (SCO) summit in Tianjin. Moreover, India is very engaged with the remaining BRICS countries and has been signing more trade agreements with other countries such as the UK. Historically, India has been known for having relatively higher trade barriers compared to its regional counterparts. Therefore, India's willingness to open up during a period of trade tension is an encouraging shift.

Reform momentum is picking up pace

Intensifying external headwinds and India's ambition to increase structural growth while positioning itself as an attractive destination for capital flows have encouraged further reforms, including sales tax reforms, banking and financial market reforms as well as labour reforms.

While tax reforms, which effectively reduces tax rates, will boost consumption over the medium term, banking and financial market reforms will add a further positive tone to the investment thesis for foreign institutional investors, potentially driving flows into bond and equity markets. Meanwhile, labour reforms that allow companies greater flexibility to hire and lay off employees will improve productivity and labour mobility, areas that have long been significant obstacles for businesses seeking to grow and adapt to changing market conditions.

The sovereign bond yield curve expected to flatten

The Indian sovereign bond yield curve steepened by around 100bp in 2025, as the long end remained effectively anchored with a yield just above 7% while short durations declined over 100bp.

In the last two years, several major index providers have added India into their emerging market investable universe, notably increasing demand for Indian sovereign bonds. In September 2024, JP Morgan added India with a 10% weight to their Aggregate EM Index. In March 2025, Bloomberg made the inclusion to their EM Govt. Bond Index; as did FTSE in September of 2025. Meanwhile, S&P raised their Indian sovereign credit rating one notch to BBB flat. We think inclusion to these various indices will continue to drive positive flows and support the bond market.

With the short end of the sovereign yield curve likely to be driven lower by rate cuts and the long end similarly under downward pressure given the increased foreign demand for Indian bonds, the curve will flatten as the

long end reduces faster than the shorter end. Ultimately, we think a bull flattening in the yield curve over 2026 is likely.

Upside potential in equity remains despite high valuations

Indian equity investors, conditioned to expect 15% annual returns, faced a challenging 2025 as the Nifty 50 started at nearly an all-time high, with a high P/E ratio and low dividend yield relative to sovereign bond yields. Despite increased volatility, the market has delivered modest positive returns year-to-date. While pharmaceuticals lagged due to US tariff uncertainties, and IT firms underperformed amid visa issues and lower growth guidance, financials, especially life insurers and retail banks, outperformed due to sector rotation. Foreign outflows have been notable through 2025 as foreign investors rotated towards more tech heavy markets in Asia.

Looking forward, we expect appetite for equities to improve as the macroeconomic environment should remain supportive. Corporate earnings are likely to be underpinned by lower inflation and interest rates. Whilst valuations remain high by historic standards, there have been numerous positive developments with respect to the pace of retail broker account openings and there is now less pessimistic foreign sentiment towards Indian equities thanks to robust growth. All of this bodes well for strong performance in 2026, but elevated valuation levels and a low absolute tech exposure, suggest limited regional relative outperformance.

The rupee is likely to be rangebound

The Indian rupee (INR) has weakened this year, largely due to heavy equity outflows and a wider trade deficit, driven by strong demand for gold and silver imports. As a major global oil importer, India has benefited from lower oil prices, which have supported the trade balance. The central bank has responded to currency weakness by intervening in FX markets.

Looking ahead, the INR is likely to remain rangebound, with most rate cuts already priced in and trade balance pressures easing slightly. Stable oil prices should help prevent unexpected shocks. As corporate earnings strengthen, Indian equities are expected to become more attractive again. However, a stronger USD in 2026 could pose risks to the currency. The RBI is well-positioned to defend the INR, supporting its stability going forward.

Equity momentum has gradually returned



Source: Bloomberg

Australia

Outlook

- Growth should be around trend, aided by rate cuts and improving consumption
- Inflation to remain elevated short-term before easing into the RBA's target range
- The central bank is likely to cut its cash rate moderately in the coming year

Implications

- Bond yields should track lower, though there is limited scope for further curve steepening
- The equity market will be supported by a rebound in corporate earnings
- The AUD will likely appreciate further, but remains below its long-term average

Risks

- Inflation remains above the RBA's 2-3% target range, delaying rate cuts
- Housing market supply-side issue remains substantively unaddressed
- A further slowdown in China drags on exports

Growth to return to trend

2025 has been a year of anaemic growth, with GDP tracking below 2%. Comprised of a mix of social security payments and increased defence spending, the public sector has been the key pillar for growth over the past eight quarters and more recently has contributed 22% to overall GDP versus historic levels of 17%. Fiscal spending has helped to cushion some of the weakness in consumer spending. Consumer confidence is improving but remains subdued. For the younger cohort, high levels of household debt and high interest rates continue to consume a significant portion of their overall spending, limiting further discretionary consumption. The remaining cohorts appear less stressed, and their spending remains healthy.

We think economic growth will move back towards trend growth of around 2%-2.5% in 2026, supported by strong public spending in the pipeline and an ongoing recovery in household consumption. This consumption effect should be aided by a gradual decline in inflation and lower interest rates.

The RBA's next rate move will be highly data dependent

Against the RBA's 2-3% inflation target, headline inflation is showing reluctance to decline materially lower into the target range. A major component of the inflation basket, housing, has been distorted by elevated rent, as well as property rates and charges. Electricity prices have also jumped in recent months as rebates have rolled off.

Despite this, we expect inflation to continue trending downward, supported by several factors in the coming year. First, as a result of the 'base effects' of the unwinding of government energy subsidies and the large one-off annual adjustment in local government levies for services, headline inflation is likely to ease further. Second, wage growth continues to show a steady trend, hovering between 3-3.5% YoY, which is consistent with core inflation rates within the RBA's target range.

While we expect the RBA will deliver one more rate cut in 2026, taking the cash rate to 3.35%, the timing of the next rate move will be highly data dependent given recent signs of inflation stickiness.

Home prices to remain stretched

Australian house prices have continued to remain 'severely unaffordable', defined as a median salary-to-price ratio of 9x or higher. The fundamental issue for housing in Australia remains that of the supply-demand imbalance. There is simply an insufficient number of homes being constructed to address the level of demand. Pressure on the demand side is exacerbated by immigration to Australia, whilst the supply side faces headwinds from increasing construction costs, amid a prevalence of fixed priced contracts, which have sent many construction companies into default. More recent initiatives such as lowering the deposit rate from 20% to 5% for select first home buyers are creating further upward pressure on house prices.

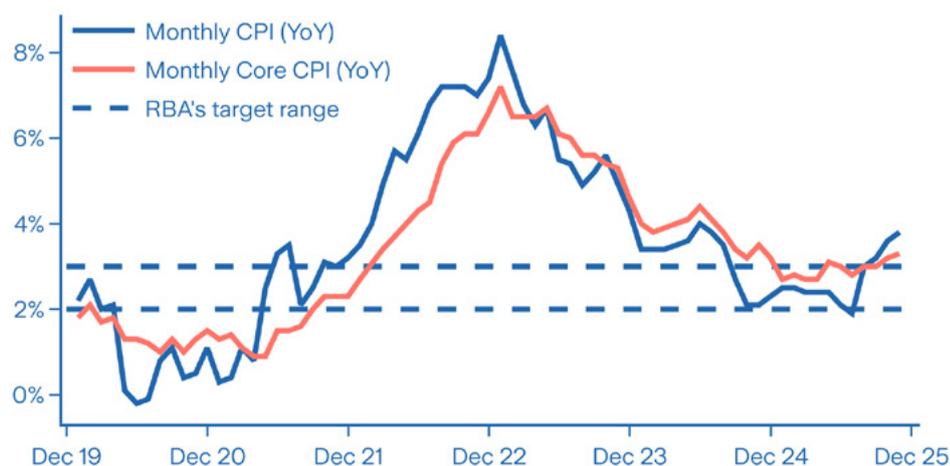
Looking forward, we expect house prices will continue to trend higher stemming from a confluence of factors outlined earlier. Until there is material resolution with respect to the supply side, various other factors and policies will continue to exert pressure on aggregate demand. Potentially lowered interest rates will boost housing affordability, if judged by monthly interest payments alone, but will not address the structural imbalance between supply and demand.

Australia's exports to navigate opportunity beyond China

China remains Australia's largest trading partner, but its influence is declining. Commodity exports to China have weakened due to ongoing Chinese domestic challenges, particularly in the property sector. That said, beyond China, Australia will have opportunities to capitalise on the ongoing supply chain diversification for two reasons.

First, Australia faces the lowest US tariff rate (10%) among commodity-driven economies, which has helped boost Australia's export

Signs of inflation stickiness to delay the RBA's next rate cut



Source: Bloomberg

competitiveness. Second, China's revision of rare earth mineral export licenses has prompted a global rethink of supply chains. In this context, Australia emerges as a potential alternative to China for rare earth mining, given its substantial rare earth reserves. The US and Australia recently agreed to invest USD 8.5bn to expand Australia's mining capability in this regard. However, progress will take time, and much of the processing may still depend on China, which currently handles 90% of rare earth mining, processing and manufacturing.

Overall, while Australia's export growth is expected to remain limited by muted demand from China, this should be partially offset by increased opportunities in other markets.

Limited scope for further steepening in sovereign bond curve

The Australian government bond curve has steepened by 150bp as the short end priced in several interest rate cuts and the long end remained relatively anchored around the 4.8-4.9% level.

Looking ahead to 2026, we see limited scope for further steepening of the sovereign yield curve. As inflation appears sticky, the RBA may be forced to adopt a relatively more hawkish stance than its global peers, limiting further downward pressure on the short end of the curve. Nevertheless, uncertainty persists, particularly regarding the potential impact of US tariffs on global growth and inflation expectations. This could drive continued volatility in bond yields throughout the year.

Credit spreads are likely to be steady

Issuance in the Australian credit market exceeded AUD 215bn in 2025, marking the third largest year on record. Kangaroo issuance (i.e. non-domestic entities issuing in AUD) was circa 27% of the total issuance, the strongest market in five years, whilst domestic retail banks took advantage of a rule change in regard to hybrid debt issuance, with attractive yields for subordinated and longer dated issuance. With interest rates expected to edge lower, we anticipate many corporates will seek to term out their debt and capitalise on relatively low funding costs. While debt issuance is expected to increase, we think

that a significant widening in overall spread levels is unlikely, as we see demand to stay supported, with foreign investors taking advantage of alternatives to USD exposure. Overall, while risk reward in global credit seems skewed to the downside, AUD credit appears to be a good diversification play for global investors.

Positive equity performance expected, even if trailing regional peers

Including dividends, the Australian market has risen around 10% YTD. Materials proved to be one of the best performing sectors. The traditional engines of BHP, RIO and Fortescue were relatively muted in the wake of China's significant slowdown in demand for base metals. However, it was the demand for rare earth, minerals and gold that drove the sector higher. Additionally, the financial sector performed strongly, with most of the big four banks generating double-digit returns. Consensus earnings for FY26 have bounced back to a mid-single digit range, aided by interest rate cuts as well as a rebound in earnings after the decline in H1 2025, which was attributed to lower commodity prices, weaker Chinese demand, and rising input costs.

Looking to 2026, expected looser financial conditions and an improving earnings outlook should provide support for equities despite richer valuations. That said, the lack of tech exposure within the ASX200 index means Australian equity performance is likely to lag regional tech-heavy markets such as Taiwan, Korea and China H-shares, which continue to benefit from the AI boom. With the aforementioned backdrop, the Australian equity market is expected to generate positive total returns for 2026 in the range of 5-10%, however will lag regional peers.

The AUD is likely to strengthen further but remain below long-term averages

The Australian dollar has firmed modestly this year from AUD/USD 0.62 to 0.65, though it remains below its long-term average of 0.75. If domestic inflation proves stickier than expected, the RBA may need to adopt a more hawkish stance than other major central banks, widening the interest rate differential and supporting further AUD appreciation. However, weaker Chinese growth and softer commodity demand will partly offset this support. Overall, we expect AUD/USD to strengthen but remain below the USD 0.75 level.

Commodity stocks have cushioned the weakness in financials



Source: Bloomberg

LatAm Ex-Brazil

Outlook

- Recent positive political developments are likely to boost investment prospects, especially in Chile and Argentina
- Mexico's economic activity is expected to accelerate next year, though still below trend
- Inflation pressures should continue to ease

Implications

- Central banks are expected to steer policy rates towards a neutral stance
- Local assets retain upside potential, contingent on pro-investment reforms and trade deal outcomes
- The CLP is likely to strengthen further, driven by REER undervaluation and a favourable copper price outlook

Risks

- A deterioration in global financial conditions triggers capital outflows, FX pressure, and weaker commodity prices
- Adverse USMCA terms are agreed between Mexico and the US
- Argentina and Chile fail to secure legislative consensus to advance their pro-investment agenda

Argentina: The mid-term election outcome has shifted structural reforms and investment opportunities, with FX reserve build-up still lagging

Despite financial distress and political uncertainty ahead of the polls, President Milei's party (LLA) delivered a decisive mid-term victory last October, securing 40.7% of the national vote versus 31.7% for the Peronist bloc, well above market expectations. This outcome grants LLA control of over one-third of congressional seats for the second half of Milei's term, a critical threshold to block veto overrides and impeachment attempts. While the party still lacks an outright majority, its stronger position should foster broader cooperation, improving prospects for legislative coalitions to advance structural reforms. Near-term priorities include approval of the 2026 budget bill—potentially Milei's first approved budget—and progress on labour and tax reforms.

On the economic front, activity is expected to regain momentum in 2026 after the contraction observed since late Q2 2025, when election-related financial stress derailed the early-year rebound. Our baseline scenario projects GDP growth of 3.3%, driven by investment recovery, looser financial conditions, and stronger net exports.

The disinflation process stands out as one of the most notable achievements in Milei's macroeconomic normalisation strategy. After surpassing the 200% annual inflation threshold when taking office at the end of 2023, the country has drastically reduced the pace of price increases to just 31% as of last October. Inflation is expected to continue decelerating next year, with projections below 20% by December 2026.

Fiscal discipline remains the cornerstone of the program. Following the first surplus in 15 years in 2024, data through October 2025 suggest another surplus is likely this year, strengthening the administration's credibility on fiscal consolidation.

However, the persistent lack of meaningful FX reserve accumulation remains the weakest link in the current macroeconomic framework, critical for meeting hard-currency debt obligations and IMF targets. Seasonal factors, such as weaker USD inflows from tourism and front-loaded agricultural settlements, compound this vulnerability. On the positive side, post-election optimism has triggered a surge in corporate and provincial debt issuance abroad, which could support FX reserve buildup. Nevertheless, the government's decision to maintain the current moving exchange-rate band, where the BCRA intervenes only at extremes, limits scope for significant FX accumulation.

Chile: A constructive outlook, supported by private investment revival and improved political stability

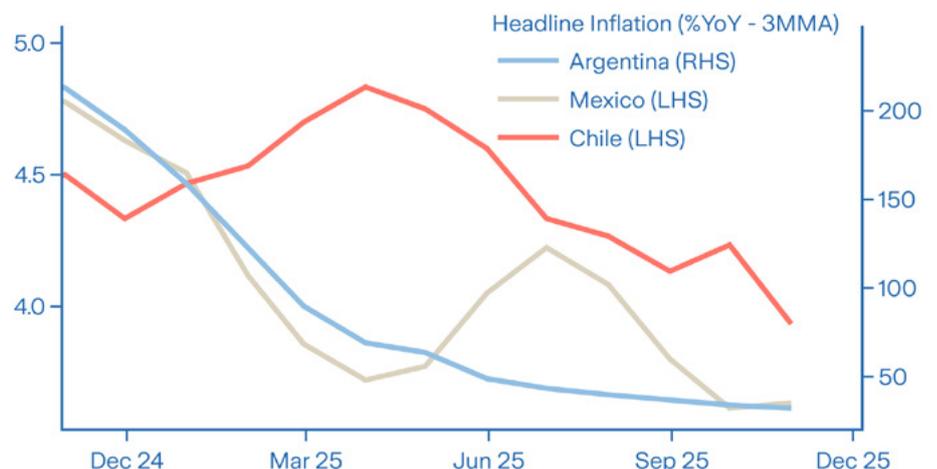
Domestic demand has remained robust throughout 2025, supported by sustained real wage gains and a strong rebound in private investment. Combined with an

acceleration in government spending during the first half of the year ahead of elections, these factors more than offset the mining sector's underperformance caused by supply constraints. As a result, 2025 GDP growth is expected to be near 2.5%, outperforming early-year expectations of 2.0%.

Looking ahead to 2026, we anticipate GDP growth of 2.3%, above Chile's estimated long-term trend. This outlook is underpinned by improving investment prospects, a favourable copper price environment, and lower financing costs. However, fiscal consolidation measures likely to be implemented by the incoming administration could introduce some headwinds.

The disinflation process has advanced significantly, with headline inflation falling from 4.9% at the start of the year to 3.4% as of October. The cautious stance of the Central Bank, with just one 25bp MPR cut in July versus 325bp in 2024, alongside a modest CLP appreciation and relatively contained

Inflation pressures are expected to continuing easing



Source: Bloomberg

fiscal spending, has supported this outcome. In this context, we expect inflation to converge to the 3% target in 2026, creating room for further monetary easing.

Regarding the local currency, we see further scope for appreciation, as it has lagged regional peers year-to-date, remains undervalued relative to its historical REER average, and benefits from a favourable outlook for copper prices.

On the political front, the November first-round presidential election points to a highly probable victory for right-wing candidate José Antonio Kast in the December 14 runoff. While the result fell short of the market's most optimistic scenario, right-wing parties failed to secure a simple majority in Congress (76 deputies, two short of 50%, and 25 senators, exactly 50%), a Kast presidency would likely prioritize security, fiscal discipline, and pro-investment policies. Constitutional reforms appear unlikely under the current congressional configuration, though consensus with centrist legislators remains possible for specific initiatives.

This backdrop reinforces a constructive outlook for Chile's economy. After years of elevated uncertainty following the 2019 social unrest and two failed constitutional reform attempts in 2022 and 2023, greater stability combined with an agenda focused on reviving private investment could lay the foundation for renewed momentum. Positive signals are already evident in 2025, with increased approvals of investment projects and a notable acceleration in capital goods imports. Ultimately, the ability of the incoming administration to build consensus will be critical to fully deliver on this pro-investment agenda.

Mexico: Navigating economic headwinds while USMCA renegotiations intensify

Mexico's economy continues to face headwinds, with Q3 GDP data confirming a quarterly contraction of 0.3% (vs +0.2% in Q1 and +0.6% in Q2). The slowdown is becoming increasingly uneven as services outperform while industrial output remains in contractionary territory.

Investment is still weak, reflecting the fiscal drag from the completion of major public infrastructure projects begun under former president AMLO's administration, heightened uncertainty surrounding USMCA renegotiations, and a recent judicial system reshuffle, which all weigh on private investment dynamics.

Private consumption remains a relative bright spot, supported by low unemployment, real wage gains, and resilient consumer confidence, though risks persist from slowing job creation and declining remittances. We expect GDP growth to reach around 0.5% in 2025, an improvement versus early-year consensus that anticipated a sharp contraction amid US trade policy disruptions. Front-loaded exports in H1, growing above 10% annually, helped cushion activity but have faded in H2. Looking ahead to 2026, growth is projected to accelerate to 1.6%, though still below trend.

Inflation dynamics remain favourable, with headline CPI running below the 4% upper bound of Banxico's target range, driven by easing non-core components such as food and energy. Core inflation, however, remains elevated amid rising real wages and a resilient labour market. We forecast inflation at 3.8% for 2025 and 3.7% for 2026, both within the tolerance band.

On monetary policy, Banxico has maintained a dovish tone and is expected to continue easing amid a weakening economic backdrop. We anticipate a 25bp cut by year-end to 7%, followed by an additional 50bp in 2026, moving the policy rate toward a neutral stance. That said, risks to this path arise from uncertainty around the Fed's next moves as the MPR rate differential approaches historical lows.

USMCA renegotiation remains a key uncertainty. The official review deadline is July 2026, but preliminary talks have intensified. A positive development was the delay in raising tariffs on non-USMCA-compliant goods from 25% to 30%. Meanwhile, Mexico's Congress is considering a 50% tariff hike on imports from

non-FTA countries (most notably targeting China), which could be used as leverage in negotiations, but potentially carries one-off inflation risks.

Mexico retains a competitive edge in US market access, with current US tariffs on Mexican goods standing below the 10% baseline applied to other major trading partners. Given exports to the US account for roughly 30% of Mexico's GDP, maintaining USMCA preferential terms is critical. The Sheinbaum administration is expected to prioritize securing a deal, though uncertainty will weigh on sentiment until negotiations conclude.

Latin American markets shone in 2025, driven by favourable tariff treatment and political tailwinds

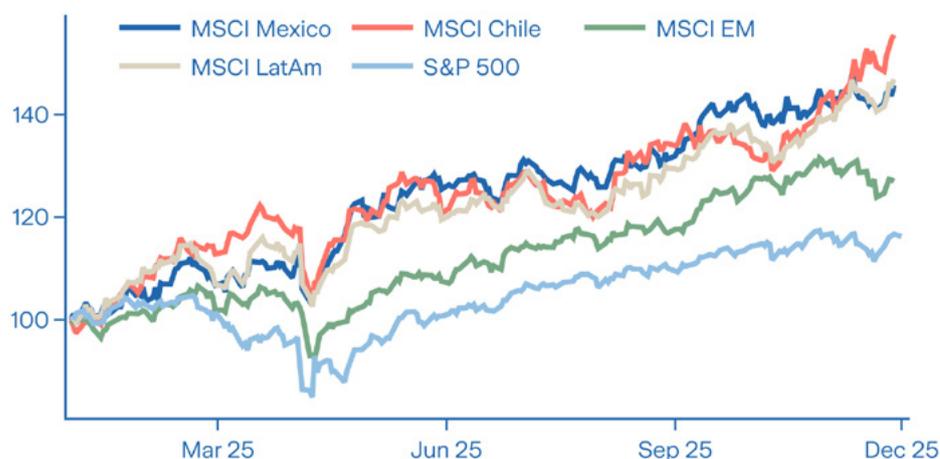
Equity markets in Latin America have delivered an extraordinary performance this year, with the MSCI LatAm index up more than 40%, outperforming most developed and emerging markets. Despite a volatile start to the year, driven by disruptive US trade policies, the region benefited from relatively favourable trade treatment. Additionally, a weaker US dollar provided a tailwind, boosting USD-denominated total returns.

Within LatAm, Chilean equities led the rally, surging over 50% year-to-date, even though the Chilean peso (CLP) was the least appreciated currency in the region (+7% vs +13% for MXN and +16% for BRL). The market's strong performance reflects expectations of a right-wing victory in the presidential runoff scheduled for December 14, a key catalyst for investor sentiment. Looking ahead, we maintain a constructive view on Chilean equities, supported by a pro-investment agenda under a potential right-wing administration, political stabilisation after years of uncertainty, favourable copper price prospects, and still-attractive valuations. That said, the key risk for the incoming administration will be its ability to build consensus in Congress as no coalition secured a simple majority in either chamber.

Mexican equities also posted solid gains, up 42% YTD, driven by discounted valuations, currency appreciation, and robust company earnings results. While Mexico's stock market offers scope for further upside, valuations now appear more stretched relative to its regional peers, while ongoing USMCA negotiations continue to weigh on the investment outlook. Accordingly, we maintain a neutral stance at this juncture.

In Argentina, the positive outcome of the October 26 mid-term elections triggered a sharp rally in bonds and equities. On the fixed-income side, the EMBI country risk index plunged 428bp in a single day to 660bp. Since then, spread compression has been modest, around 40bp through end-November, leaving current levels still 60bp above the Milei-era low reached last January. We see room for further tightening, with sovereign bonds trading near 70 cents. However, for this to materialise, investors should monitor early signs of legislative wins in Congress, tangible progress on FX reserve accumulation, and renewed access to international debt markets in the near term.

LatAm equity markets outpaced global peers



Source: Bloomberg. Note: Indexed to 100 at December 31, 2024

Brazil

Outlook

- Economic growth is expected to remain subdued
- Inflation will continue to decelerate but remain above the Central Bank's target
- The BCB is likely to initiate a gradual easing cycle as soon as Q1 2026

Implications

- Financial assets should benefit from the anticipated BCB easing cycle
- Local investors are expected to rotate from fixed income into equities
- Scope for bond yield compression is likely to be limited due to the unsustainable public debt trajectory

Risks

- Rising political uncertainty erodes market confidence, triggering capital outflows
- Fiscal slippage in an election year
- Global financial deterioration pressures FX and inflation expectations, delaying the monetary easing cycle

Economic activity data confirm a broadening slowdown

Recent data confirm that Brazil's economic deceleration is deepening and becoming more widespread. The monthly economic activity index IBC-Br fell 0.2% MoM SA in September, following a +0.4% MoM SA gain in August. This print was in line with consensus and points to a Q3 GDP contraction of -0.9% QoQ SA, reversing Q2's modest +0.3% expansion. On the supply side, industrial production declined 0.4% MoM in September, while October PMIs remained in contractionary territory. These indicators underscore that restrictive monetary policy is weighing heavily on rate-sensitive sectors, particularly credit-driven consumption and investment.

We expect 2025 GDP growth to hover near 2.0%, down from the strong performance in 2024, as tight financial conditions continue to constrain domestic demand. For 2026,

growth is projected to slow further to around 1.7%, even as the monetary easing cycle begins. Despite expected rate cuts, real policy rates will remain highly contractionary, partially offset by a stronger fiscal impulse that should provide some support for activity.

Disinflation gains momentum, paving the way for a monetary policy pivot

Brazil's disinflation trend has gained traction, supported by global tailwinds, a softer US dollar, and the Central Bank's restrictive policy stance. After peaking near 6% early in the year, core inflation metrics have moderated meaningfully, with the three-month annualised rate now hovering around 3%, while headline CPI eased to 4.7% YoY in October. We expect inflation to close 2025 at around 4.5% YoY and continue decelerating into 2026 until it reaches approximately 4.0% YoY, within the BCB's tolerance band ($3\% \pm 1.5\%$).

The latest BCB minutes acknowledged progress on disinflation and inflation expectations but reaffirmed its commitment to maintain the Selic at 15% for a 'prolonged period'. This guidance effectively rules out a December cut and aligns market pricing with our base case of a first rate cut likely at the late-January meeting, though a March scenario remains plausible. The key risk to earlier easing lies in services inflation, which remains stubbornly high at above 6.0% YoY in October, reflecting a still-resilient labour market.

Overall, we expect the Selic reference rate to end next year at 12%, implying a cumulative 300bp reduction. Even after this adjustment, real rates will remain firmly contractionary, though easing from the two-decade high of above 10%, converging toward 2023-24 averages.

Recent fiscal prudence will be tested as the election cycle begins, while the debt trajectory remains unsustainable

Contrary to the previous few years, fiscal developments have been relatively stable in 2025. This reflects a clearly more prudent stance on government spending, following the significant fiscal impulse observed in 2024. The financial distress caused by unsustainable fiscal policy late last year led to a more cautious budget execution in 2025. Accordingly, the public sector's primary balance improved from -1.9% of GDP in October 2024 to -0.3% in October 2025.

Looking ahead, this constructive fiscal picture may begin to deteriorate as the electoral season approaches. The expansion of social programs, such as new credit lines for low-income household renovations and the recently approved income tax overhaul for workers earning less than BRL 5K are expected to weigh on fiscal accounts, with a combined impact of roughly 0.6% of GDP. Risks to budget execution are further

Weakening growth and falling inflation expectations to pave the way for monetary easing



Source: Bloomberg

compounded by the reversal of one-off revenues, as Congress recently rejected the proposed tax hike on financial industry and fixed-income instrument revenues.

In this context, the approval of the 2026 Budget, currently under discussion, will be critical. The proposal includes additional revenue measures and spending cuts, which will need close monitoring. Overall, the primary fiscal deficit is expected to widen slightly in 2026 compared to the 0.5% of GDP deficit projected for 2025. Importantly, President Lula's improved approval ratings reinforce the view that he is unlikely to resort to drastic populist measures to boost electoral prospects. The stability achieved in 2025 has proven to be more effective in improving approval ratings than risking financial distress. Nevertheless, fiscal slippages cannot be ruled out as the election cycle enters full swing.

Finally, it is worth emphasising that the public debt trajectory remains unsustainable, with gross public debt projected to surpass the 80% of GDP from 2026 onward (up from around 70% in 2022). High interest rates contribute significantly to the debt burden. The current near-equilibrium primary balance is insufficient to stabilise debt dynamics. This implies that the next administration will need to address this structural vulnerability before it continues to deteriorate further.

Lula confirms 2026 bid as the election landscape remains fluid

President Lula has officially confirmed his candidacy for a fourth term in the October 2026 elections, reinforcing his position as the dominant figure in Brazilian politics. At this stage, Lula appears well-positioned to win the election given a recent rebound in popularity. Public surveys now place his approval rating near 50%, up from the low 40s in mid-2025. This recovery has been supported by strong public backing for his nationalist stance amid escalating US–Brazil tariff tensions with President Trump, as well as by the recent disinflation trend, particularly in food prices, and legislative wins that have advanced Lula's agenda (e.g., the income tax overhaul).

On the opposition side, São Paulo Governor Tarcísio de Freitas is widely viewed as the strongest challenger. However, his candidacy still hinges on securing an endorsement from former President Jair Bolsonaro—recently sentenced to 27 years in prison for his role in an attempted coup—who remains undecided and may instead back a family member. While Tarcísio enjoys credibility among local markets, foreign investors remain cautious about his prospects without Bolsonaro's support. In this context, Tarcísio recently stated that a final decision on his presidential bid will be confirmed in February. That said, with 11 months to go, these dynamics remain highly fluid. Lula's advantage today does not guarantee the outcome, and the race could shift significantly as campaigns intensify.

A constructive outlook for Brazilian equities, but not immune to external and fiscal risks

In line with broader emerging market trends, Brazilian equities delivered a strong performance in 2025, recovering from the sharp 35% sell-off in 2024, which was driven by mounting financial distress amid loosening fiscal policy, and rising 40% YTD. A weaker USD backdrop further supported

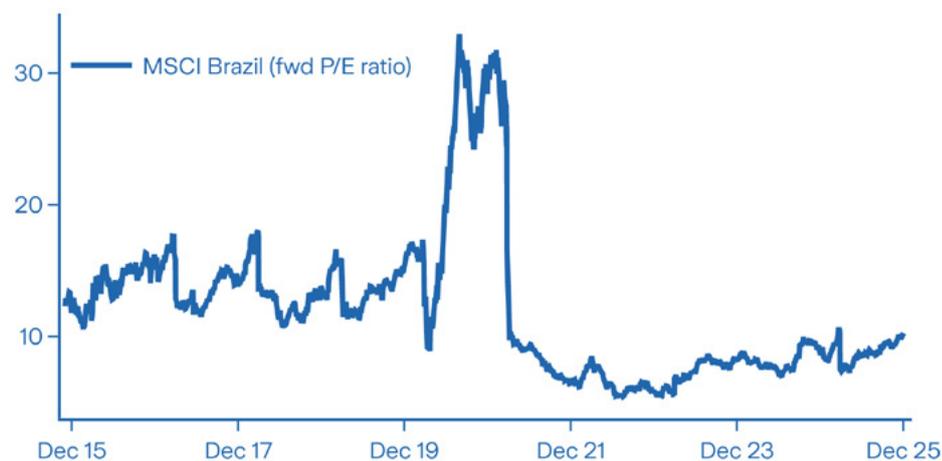
dollar-denominated returns as the BRL appreciated roughly 16%, which couple with record-high Selic rates.

We maintain a constructive outlook for Brazilian equities heading into 2026. Despite a significant rerating in 2025, valuation multiples remain historically discounted and lower than EM peers. More importantly, the current high-interest rate environment and expectations of an imminent monetary policy pivot provide a substantial easing cushion ahead, historically a strong tailwind for equity performance.

While foreign investors have steadily increased their exposure to Brazilian equities YTD, large local institutional investors have favoured fixed-income assets given attractive carry, leaving equity positioning relatively light. A gradual reallocation toward equities is expected to support performance going forward.

Despite these constructive factors, continued momentum in Brazilian equities will depend not only on a benign external backdrop but also on fiscal policy prudence continuity, a lesson underscored by last year's drastic sell-off.

Brazilian equity valuations remain discounted



Source: Bloomberg

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Economic and market implications of the US election outcome on the US, Eurozone and China

Thomas Liebi, Håkan Hedström, Ross Hutchison, Guy Miller
34:31



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