Mid-year Outlook 2026

Making hay while the sun shines

The first half of the year has certainly lived up to the title of our optimistic 2026 outlook publication: Sunny with blustery showers. Despite a particularly severe and blustery 'shower' in the form of a hugely disruptive war with Iran, the past six months have been characterised by a series of records and firsts. While around 20% of oil and gas supplies were stranded in the Gulf, the global economy has continued to prosper. Trade is robust as societies are doing what they always do: finding ways to overcome obstacles. One of the largest synchronised capital spending cycles in history is being driven by a scramble to increase investment in defence, renewable energy and, of course, AI. Despite the spike in energy prices, capex is bolstering economic growth and has pushed financial markets to record highs while the largest IPO in history, SpaceX, made founder Elon Musk the world's first trillionaire! Although there are still risks, and record corporate issuance, higher policy rates and geopolitical disruption will ultimately have consequences, we believe the current economic and market environment is one for making hay while the sun shines.

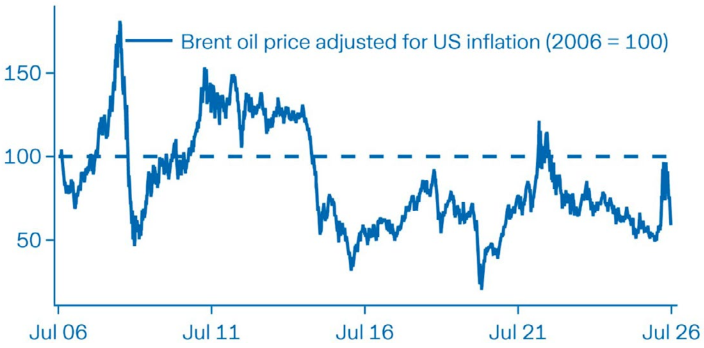
Growth drivers remain

Of the three key drivers of growth that we identified at the start of this year, namely capital investment, fiscal spending, and policy easing, only the latter has changed direction given the jump in energy costs and headline inflation. Indeed, while the Iran war has been a major disruptor of what was once a benign economic narrative, it is perhaps surprising how little impact the surge in energy costs has had on both financial markets and economic prospects.

The world overcomes obstacles

A number of factors have been at play to limit the impact of the closing of the Strait of Hormuz. It should not be forgotten that the USD 60 a barrel price of Brent oil at the start of the year was a depressed level as the result of a global oil glut and was uneconomic for most producers. The fleeting surge to a USD 126 intra-day peak in April was a huge percentage move, but in real, inflation adjusted terms, this only took the price close to its 20-year average. In addition, most developed economies have dramatically reduced their oil dependency, meaning that oil consumption per unit of output has slumped since the 1970s to only around a quarter of what it was.

Real price of oil is low

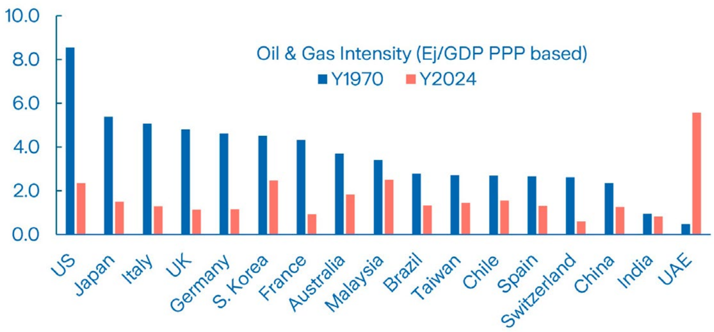


Adjusting for inflation, the spike in the price of oil is relatively modest

Source: Bloomberg

All of that noted, experts opined that should the Strait of Hormuz remain closed until the end of June, oil prices could surge to USD 150 per barrel or more. A key factor in why this has not been the case is China. Not only did China stockpile oil when it was cheap, filling its strategic reserves and building cushions into its supply chains and satellite country operations, it also increased the process of extracting gas from coal. In addition, a dramatic shift to electrification also played a part in allowing China to cut its oil imports by more than a third without causing disruptions in production. This reduced global demand and eased some supply pressures.

Oil intensity improves



Most economies have become much more efficient in their use of oil

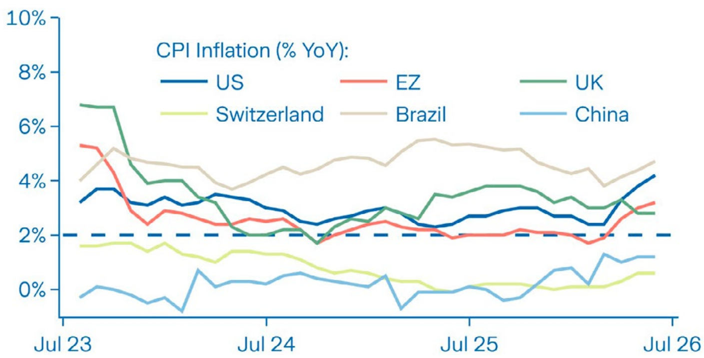
Source: The Energy Institute; World Bank

More broadly, Asian economies found ways of accessing alternative supplies—most notably from the US where shale production was again economic and exports surged. While a Pandora's box of geopolitical challenges has been opened in the Middle East as a result of the war, and there is no robust and lasting agreement as yet, risks from higher oil prices have receded. Importantly, with gasoline prices in the US peaking 61% higher than at the start of the year, the US administration has become intent on finding a pragmatic resolution to the war as the mid-term elections loom. With oil prices now down by 40% to USD 72 per barrel on news of the ceasefire and desire for resolution, economic conditions are certainly brightening.

Inflation rebounds, but is it different this time…?

It is not only US fuel prices that have been impacted by the war with Iran, but global inflation more generally. CPI inflation had been fairly well behaved in recent years, moving sideways close to central bank targets in most regions. Clearly the jump in energy costs derailed this, with headline inflation rebounding. Unlike post Covid, however, this is a supply shock without the demand shock to amplify the effects. Consequently, this time, inflation is likely to be temporary and we expect that month-on-month inflation prints will soon start to decline given the fall in energy costs. Importantly, supply chain disruptions have been avoided. Central banks cannot afford to be complacent, however, despite only limited evidence of any pass-through to core prices.

Inflation back in focus



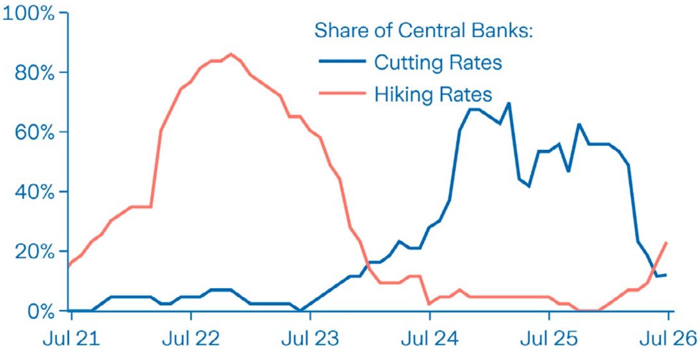
Headline CPI inflation is rising but there are few signs of pass-through from energy costs

Source: Bloomberg

Central banks take precautions

The memory of dovish policy mistakes post-Covid loom large and the ECB has been quick to hike rates to demonstrate its focus on its inflation mandate. This hike could well turn out to be another mistake, given the weak and fragile growth environment in Europe, but the ECB is not alone. Our central bank tracking shows that over the past three months more central banks have been hiking rates than cutting, with Indonesia, Japan, Australia, and Sweden notable examples. Most importantly, the Fed has remained on hold. That noted, the new Chair, Kevin Warsh, made it clear that the Fed has failed in its inflation fighting credentials, having missed its target for five consecutive years and that this needs to change. Certainly, the US economy is in better shape than most, but elevated services prices and a still tight labour market give cause for attention. Market pricing has jumped to imply two rate hikes, which we interpret as too aggressive despite the hawkish tones from Warsh, but that risk is certainly real.

Central banks turn hawkish



No longer broad-based rate cuts, but a protracted tightening cycle seem unlikely

Source: Bloomberg

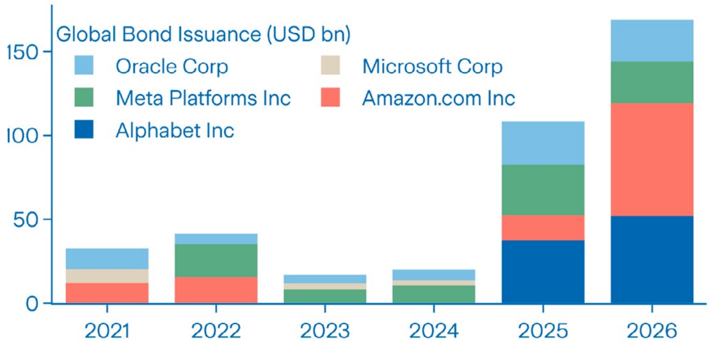
Fiscal fades, but capex is hot

Although monetary stimulus has shifted course, the two other drivers of global growth this year, fiscal spending and capital investment, remain. Government spending initiatives in Germany, Japan, and of course the One Big Beautiful Bill in the US helped during the energy shock but are likely to fade in aggregate over the remainder of the year. This leaves the capex boom as a key driver of growth and an agent of change for both economic activity and financial market returns. The scale of this is unprecedented, with the synchronised and global nature of the build-out justifiably leading to talk of a ‘Supercycle’, in terms of both scale and duration. Certainly, there has been an awakening on the part of both governments and corporates for the need to change, spurred by a technological inflection point and the shifting tectonic plates of geopolitics and climate change.

The triple vortex of spending

Spending on defence, renewable and more robust energy infrastructure, and the AI build-out is now ramping up, though total capex is still below historic boom periods, implying notable upside ahead. The common feature of all is technology. From semiconductors and memory chips to electronic componentry and wiring looms, the demand is currently insatiable. For now, at least, development begets development, with inter-linkages across sectors and geographies, while the financial markets are willing and able to provide the capital. The circularity is clearly evident, with the funds being raised by some providing the revenue for others.

Funding is flowing

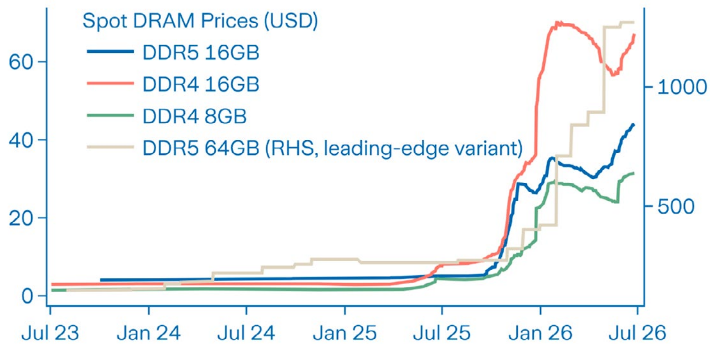


The hyperscalers are taking advantage of market conditions to optimise capex funding

Source: Bloomberg

Many Asian economies are prime beneficiaries having the manufacturing capabilities, but lack of capacity in semiconductors is leading to major bottlenecks. This will be resolved over time but is resulting in skyrocketing prices for memory chips and other key components and supernormal profits for the providers. There is also a trickle-down effect with many global manufacturers benefitting, while the building of data centres is also helping construction and the utility industries. While the assumption is that productivity will be dramatically boosted, which we agree with, this will take time to manifest while in the meantime soaring component prices add another dynamic to the inflation challenge.

Memory prices soar



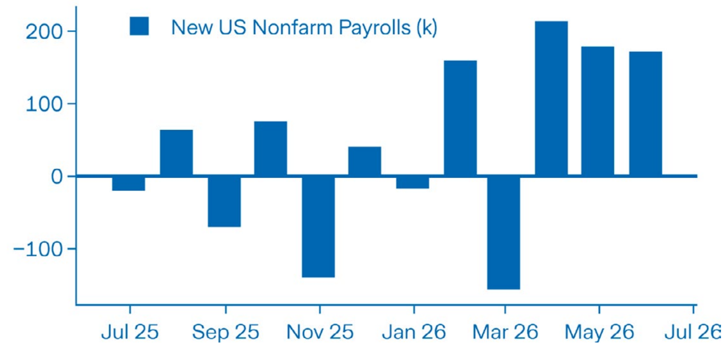
Dramatic jump in electronic components with memory chip prices skyrocketing

Source: Bloomberg

Global growth to remain trend-like, with key regional deviations

US growth above trend with risks to the upside this year

Payrolls have recovered



US economy is in good shape, with payroll growth recovering

Source: Bloomberg

Growth differs notably between the three key regions. As noted, the US has been impervious to the energy shock despite the surge in gasoline prices and growth is robust. Following the labour market concerns at the start of the year, jobs growth has recovered, though we characterise this as a low hiring and low firing environment, and survey data point to growth ahead in both the services and manufacturing sectors. That noted, it is not all clear cut. Small business surveys are less cheerful, and anaemic job creation at a time of technological change is fuelling labour market anxiety. In aggregate, however, the economy is strong, and we see growth a bit above trend at 2.2% for the year. This is a tad lower than our forecast of 2.5% at the start of the year, but risk is tilted to the upside. This will be important in determining potential Fed hikes should inflation prove more persistent than expected.

Eurozone flirts with recession before regaining a foothold

Citi surprise indices

Economic data in the Eurozone continue to surprise negatively

Source: Bloomberg

The Eurozone is more challenged than the US. Growth has again disappointed, and the optimism that German fiscal spending would translate into robust regional activity faded as another energy shock hit. Sentiment has been dire and economic surprises very negative. Industrial activity is particularly vulnerable, and we have seen Chinese car exports continue to dominate and squeeze out incumbent European players. The region still suffers from a lack of competitiveness and a 'single voice', with different vested interests disrupting reform, but it should not be forgotten that change, albeit slow, is afoot. Unfortunately, the Eurozone is once again flirting with a technical recession, though we would categorise activity as 'dull not dead'. There is cause for more optimism towards the end of the year, with the proviso that the ECB does not try to fight the inflation battle it lost back in 2022 by hiking rates further. This still leaves GDP up only 0.9% this year compared to our expectations of 1.3% at the start of the year.

Car exports tell an important story

China now dominates car exports with incumbent producers under severe pressure

Source: Bloomberg

China overly dependent upon exports, with domestic recovery slow

As mentioned earlier, China has been a major factor in oil prices not moving as high as expected for many positive reasons, but also because domestic activity has been lacklustre. Apart from some tentative signs that Tier 1 housing markets are bottoming, consumption, fixed investment and sentiment continue to disappoint, and China is now massively dependent upon exports for growth. This is helping in the short term but creates a dependency on others given that net export growth now account for more than 30% of real GDP. At the margin, growth has deteriorated, and we continue to forecast underlying growth of only 4.3% for this year, largely unchanged from our expectations at the start of the year.

China surplus is staggering

China runs a vast trade surplus, making it increasingly dependent on global growth

Source: Bloomberg

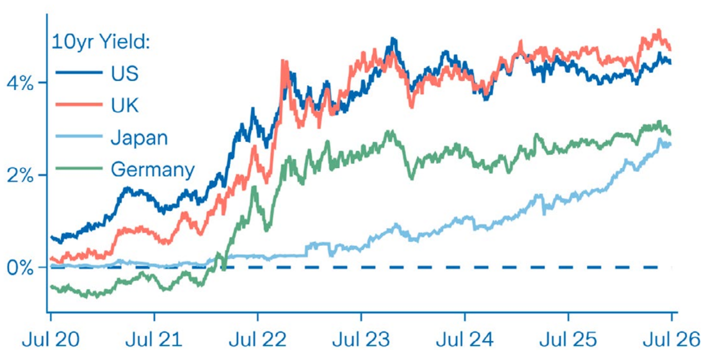
Financial markets

Government bonds shepherd policy makers

With so many cross currents on the economic and geopolitical stage, bond markets have been under pressure as both inflation and fiscal spending have risen. The move has been contained within an established range for most markets. Indeed, what volatility we have seen is deemed to be a welcome reminder to governments that there is a cost to fiscal largess, and there have been further examples this year of policy constraint as a result.

Japan has been an outlier, though the surge higher in yields has been in line with our expectations at the start of the year. The combination of lax monetary policy to anchor inflation expectations at a higher level, along with the new prime minister's stimulative fiscal initiatives, has lifted 10yr JGB yields to 2.7% from 2% at the start of the year. Our view is that there is likely to be an upside cap at around 3% and a pain threshold will influence policy were we to approach it.

Bond trading range



Government bond yields are curbing profligate government spending

Source: Bloomberg

Bond yields to range trade

More generally, the outlook for bonds is fairly benign. We see further range trading, with yields slipping modestly lower towards the end of the year if inflation moderates as we expect. One problem for governments is that with large and still growing deficits in many cases, issuance is increasingly competing with corporate debt issuance, which may put some upward pressure on yields. The changes at the Fed could also add some volatility, as less forward guidance and communication require more price discovery in markets, which we see as a good thing.

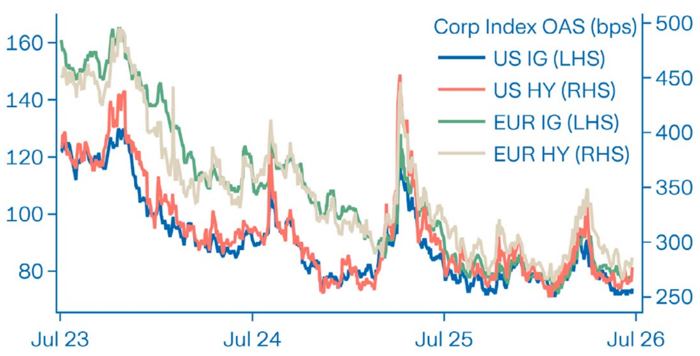
Credit markets are in high demand from both borrowers and lenders

Credit markets continue their remarkable run, with the Iran war and equity market wobbles being easily absorbed. Spreads have crept even lower, with investors prepared to overlook the modest but persistent deterioration in speculative grade defaults in both the US and Europe. Debt issuance from the hyperscalers in the US has been lapped up, whatever the duration or base currency, with even the biggest deals being multiple times oversubscribed. These companies have been managing their books by appealing to a wider global investor base and, by doing so, have also helped build out the sector exposures within credit benchmarks, notably in the US and European markets. We see this as healthy and note that in most cases these US mega-cap companies are high quality and are issuing debt smartly to optimise their financings.

With abundant liquidity in markets and an almost insatiable appetite from investors, this is a golden period for corporate financing. Total funding costs are rising with underlying government bond yields, but the compression in spreads for the best companies still makes an attractive proposition for both borrower and lender.

Credit spreads are running out of steam as the lower bound caps gains

Credit



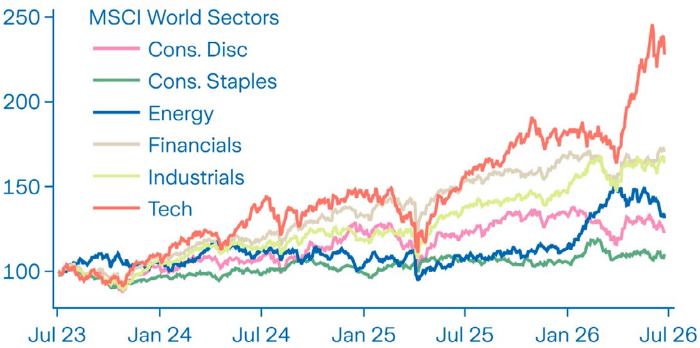
Credit spreads are very low, with limited potential for further gains

Source: Bloomberg

Given the stage of the cycle, and the scale of pending issuance, we believe that the direction of travel for spreads is ultimately higher, though likely in an orderly manner. Recession is not expected and while defaults are rising for small and medium sized companies, this is manageable. We maintain however, that despite a constructive backdrop, the risk reward balance continues to favour equity investors for the remainder of the year.

Equities play harder for longer

Equities



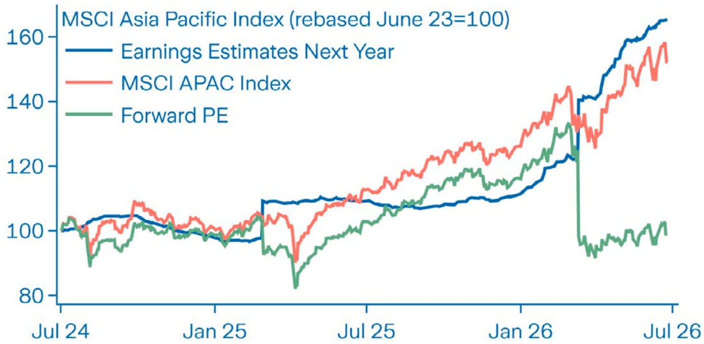
Bull market in stocks continues to be driven by the tech sector

Source: Bloomberg

Equities remain our favoured asset class despite the strong move higher this year. The rally, taking most markets to record levels, has not been without challenges. Indeed, the outbreak of war with Iran saw global stocks sink and our own view shift as the unpredictability and lack of clarity on outcome demanded caution. Despite the war having an impact on both growth and corporate input costs, investors were loath to sell, and the drawdown proved modest and short lived. The S&P 500 only fell 9% peak-to-trough, significantly less than the 19% drop last year following Liberation Day. Investors have learned to stay invested, particularly with a US administration so sensitive to financial market fluctuations in influencing policy. Despite the modest pull-back, the subsequent rally has been extremely sharp and supported by strong fundamentals.

It's not all about momentum, fundamentals matter

Super-normal profits in parts of Asia



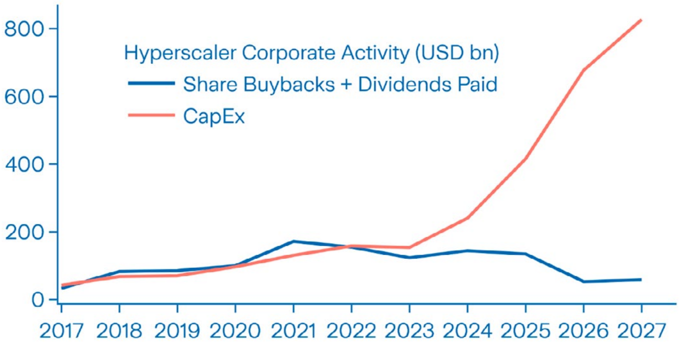
Asian equity markets have seen huge gains, but earnings are keeping pace for now

Source: Bloomberg

Trend-like economic growth, accompanied by record capex, has been a recipe for very strong earnings and margin growth. The unusually unbalanced supply and demand dynamics within the tech space has generated super-normal profits for key companies, which in turn has driven indices higher in an uneven manner. Nowhere exemplifies this more than the 95% gain in Korea's Kospi index since the start of the year. While that is remarkable, perhaps more remarkable is the 217% rise in earnings expected for next year, meaning multiples have actually fallen to single digit levels. Historically, it has paid to sell cyclical names when they are cheap and buy when they are expensive on a P/E basis due to that cyclicality in earnings. Currently there is reason to believe that, due to the nature and visibility of supply demand imbalances, this window for rising profitability could last for longer.

There are bumps in the road…

Buybacks and capex



Analysts forecasts for 2026 & 2027

Companies are investing in their future rather than simply buying their stock back

Source: Bloomberg

Earnings expectations for the S&P 500 for 2026 are more modest but have been shifting progressively higher to +26% YoY currently. The road ahead still has many potholes, however. These earnings estimates show that a lot of good news has already been factored in, and an offset to companies spending so much on capex is that there is less free cash flow to spend on buying back stock. For more than twenty years, there has been a tailwind for stocks of de-equitisation, whereby the number of listed stocks has been in a structural decline. This year could see a change in that. Not only are the hyperscalers in the US likely to reduce stock repurchases by around 65%, but net issuance is starting to shift. Alphabet issued USD 85bn in stock, while the USD 75bn in SpaceX IPO and likely listings of Anthropic and OpenAI will add to supply and also increase the concentration and market multiple of US indices. It is fair to say that companies generally only issue stock when they see valuations as rich rather than cheap, which is another reason that suggests periods of volatility and price adjustment should be expected.

The Kool-Aid is still being served

To us, time is still on the side of investors. With stocks well bid and the combination of earnings momentum, liquidity, rising M&A and a technology story that is in full swing, it seems that this bull market has further to run. Consequently, we continue to favour markets that have exposure to not just high-end AI, but also to broader technology and equipment producers in parts of Asia and the US. While other markets, including Europe and LatAm, are likely to offer trading opportunities from time-to-time, they are less exposed to the structural drivers of change.

Conclusion:

As we hit mid-year, we remain of a sunny disposition with regards to economic activity and financial market returns. Moderating energy costs and the continuation of potentially one of the largest capital spending booms in history across defence, energy and AI, bode well. Downside risks are omnipresent, with higher inflation forcing higher policy rates, or financial market exuberance resulting in a sharp drawdown, key threats to our views. However, the potential for truly profound technological breakthroughs, or a ceasefire in Ukraine are more positive risks to our outlook. In the meantime, resilient economies and abundant liquidity in financial market suggest making hay while the sun shines.

Disclaimer and cautionary statement

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