Macro Readings 2026

V Thiagarajan

31 Dec 2025

SYFX
TREASURY FOUNDATION

Disclaimer

- As nothing in this document should be taken to be advice, we encourage you to seek independent advice on these matters and you should reach your own conclusions and decisions, in consultation with your own advisors.
- The information in this document might change and we are not undertaking to update it.
- This information is published solely for information purposes. It is not to be construed as a solicitation, an offer or recommendation.
- As this information has been prepared without considering your objectives, financial situation or needs, you should before acting on the information, consider its appropriateness to your circumstances.
- It must not be relied upon as investment research.
- SYFX Treasury foundation believes that the information is correct and any opinions, conclusions or recommendations are reasonably held or made, based on the information available at the time of its compilation, but no representation or warranty, either expressed or implied, is made or provided as to accuracy, reliability or completeness of any statement made

Preamble

- In the 1940s, while working on long-range weather forecasts, a team of statisticians realized that their predictions were no better than chance.
- When asked to be relieved of their duties, they were told, “The Commanding General is well aware that the forecasts are no good. However, he needs them for planning purposes.”
- The objective of the presentation is to be more right than wrong and adding value through wise decision-making over time. We aren’t simply producing a forecast because the commander demands it.
- We are utilizing a vast trove of macro reasoning to make calls which consensus hesitates to make .
- We believe good decisions are formed from macro analysis and refined with judgment
- <u>This combination of art and science yields the insights., which could prove useful.</u>

Executive Summary

- Anyone expecting 2026 to be a calm year after the turbulence of 2025 is likely to be disappointed. The notion that everything will “return to normal” overlooks the structural shifts currently underway driven by new rules in trade and investment, with the US as the dominant player and China aiming for technological supremacy.
- Fiscal activism is universal , as governments prioritise spending over austerity, resulting in expansive policy - significant paradigm shift from the neoliberal era where fiscal stimulus was used only to smooth out economic downturns.
- Hence Fiscal dominance triggers higher interest rates and inflation - less economic integration and more activist fiscal policy will not only put structural upward pressure on long-term bond yields but also lead to more compressed and more volatile cycles and more steep yield curves.
- The accelerating innovation Supercycle in AI, disrupts incumbents. Innovation differentials to drive the sentiment .
- US growth will outperform the consensus by some margin and US economic exceptionalism will not end in 2026, and will likely continue. Despite an expanding economy, unemployment remains the same or worsens.

1. Looking Back and thinking Ahead

In a world of multi-trillion dollar deficits and persistent geopolitical tension, the traditional definitions of "risk" and "safety" have merged

Looking Back 2025

- Despite geopolitical uncertainty, global growth proved resilient in 2025, thanks to accommodative monetary and fiscal policy alongside a sharp pickup in AI capex.
- The year was a "perfect storm" of loose monetary policy, fiscal expansion, and geopolitical risk forced both speculative "risk-on" traders and conservative "safe-haven" seekers into the same trades, creating the current consensus that all assets must go up because the value of the currency is going down.
- While economic growth exceeded expectations during 2025, the benefits were unevenly distributed, creating a two-speed global economy.
- 2025 was a year marked by uncertainty, yet risk assets delivered strong returns, culminating in what could be described as an “almost everything” bull market.
- In most major economies, the corporate and household sectors have not taken on excess leverage and have cash buffers. These conditions helped them weather 2025’s huge swings in policy uncertainty. Healthy balance sheets help set the stage for an improvement in growth.

Thinking Ahead for 2026

- 2026 should see a ‘breather’ on the policy front as short-term focus returns to macro fundamentals. But 2026 will still be “the year of delayed policy impact.”
- The world is only just starting to grapple with the full impact of US trade, migration, and defense policies.
- The shifting sands of global macro and geopolitical relationships will continue. Building resilience is the task at hand in this new ecosystem, whether for countries or individual firms.
- The US, and global, economies are set to enjoy continued growth in the coming year, albeit growth that is accompanied by a continuing sense of anxiety.
- AI adoption and targeted fiscal support as meaningful tailwinds in 2026
- Demographic headwinds that once seemed years away have accelerated, exerting an outsized influence on everything from the labor market to consumer spending and even inflation.
- Like medieval alchemy that failed to turn lead into gold, today’s monetary policy of central banks will fail to keep the long term yields under check.

Wall of Worry

- In a year defined by fiscal profligacy and geopolitical upheaval, safe-haven assets and high-risk equities have abandoned their historical inverse correlation to reach all-time highs in tandem.
- This simultaneous surge suggests that investors are no longer choosing between growth and safety; instead, they are afraid of a common enemy: the mix of expansionary monetary policy in the midst of fiscal profligacy.
- The key takeaway is that the old correlations are broken; in a world of multi-trillion dollar deficits and persistent geopolitical tension, <u>the traditional definitions of "risk" and "safety" have merged.</u>
- The current market behavior is a significant departure from historical precedents. Typically, a soaring S&P 500 indicates economic confidence and low inflation, while soaring gold indicates fear and high inflation.
- The fact that they are rising together suggests we are in a "Wall of Worry" market that is ignoring traditional signals.
- This event fits into a broader trend of "fiscal dominance," where central bank policy is increasingly dictated by the need to service massive government debt rather than just controlling inflation.

Two Scenarios

- There are two primary scenarios. The first is a continuation of the "melt-up," where the Fed is forced to continue easing to prevent a debt crisis, aiding the sentiment for pushing gold toward $5,000 and the S&P 500 toward 7,500.
- In this scenario, the primary risk is hyper-inflationary pressure that could eventually lead to radical policy shifts.
- The second, more volatile scenario involves a "violent correction."
- If the Fed is forced to pause or reverse its rate cuts due to a resurgence in tariff-induced inflation, the overstretched valuations in both tech and metals could face a rapid deleveraging event.
- Investors should watch for a strong upmove in the dollar that would be the "tripwire“ which could cause a simultaneous sell-off in both risk and haven assets as liquidity is sucked out of the system.
- The key message is that In this market where everything goes up, the eventual return of gravity is often sudden and unforgiving.

2. Policy dynamics

- All pervasive fiscal Policy
- Monetary Policy ‘s diminishing efficacy
- Inflation Outlook
- Growth –Employment nexus

Understanding the interplay between monetary and fiscal policy isn’t just academic. It’s essential for understanding where growth, risk, and rates may be headed

Back towards the Past…

- Markets don't move in a vacuum—and neither does policy..
- Between 1950 and 1980 , Tighter alignment between monetary and fiscal policy prioritized shared prosperity across business, labour, and government. As a natural consequence, central bank independence lessened. saw positive gaps and labor-friendly policies. Political influence contributed to delays in tightening and encouraged premature easing in the 1970s, contributing to a sustained period of high inflation.
- From 1980sto 2020s the capital takes the lead as the social and policy priorities shifted towards the same Acknowledging the inflationary risks resulting from political interference, central banks were empowered to operate independently. Price stability became the mantra. Manufacturing sector dominance was supplanted by growth in technology and services. Globalization and overseas competition drove the outsourcing of labor and manufacturing to lower-cost countries.
- Where are we today? Deficits are rising. Populism is ascendant. As policy tilts toward labor and growth—even at the cost of inflation running hotter, The erosion of central bank independence is a logical consequence of these dynamics resulting in Lower short-term rates, Structurally higher inflation and Steeper yield curves -

Key Challenge

- Restoring sustainable debt dynamics and rebuilding fiscal space is the key fiscal policy challenge of our time.
- Multiple recurrent crises have largely exhausted the available fiscal space worldwide.
- However , Political appetite for fiscal restraint is minimal. With little political will to address the problem directly, the temptation may be to "inflate away" the debt burden. <u>While not actually that easy to do, politics are aligning to promote employment and wage growth at the expense of lower inflation or price stability.</u>
- Some governments are prioritizing growth and strategic investment, particularly in defense and strategic sectors linked to AI. Others are constrained by rising debt burdens which are amplifying sovereign-yield pressures and limiting fiscal flexibility.
- France and the UK's fiscal woes have been a regular theme in the financial markets news cycle in recent years. If the various headlines- and bouts of bond market stress - are taken at face value, both are in a dire fiscal situation, perhaps even a doom loop of low growth and unsustainable debt.

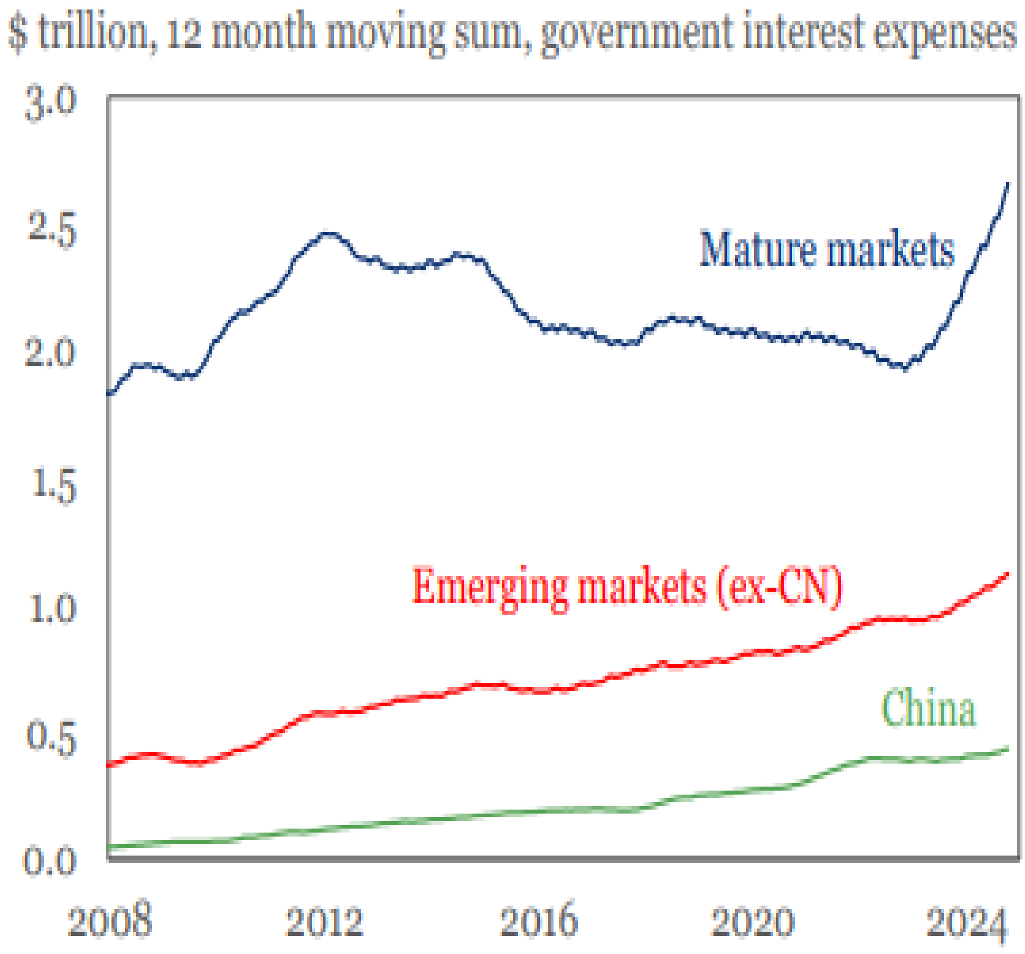
Deficit Bias stays

- Fiscal policy is about the role of the state in the economy.
- The active fiscal policy reflects an ad-hoc belief legated by the 1930's Chicago Economics asserting that fiscal policy can play an important role during business cycles, especially in contractions, when the instruments of monetary policy have outlasted their purpose and usefulness.
- Fiscal policy was supposed to accommodate asymmetric shocks and monetary policy was supposed to deal with symmetric shocks. But , Since GFC , fiscal policy has played a more dominant role in shaping global economic dynamics.
- <u>The spending initiatives started during a crisis have now become entrenched, thus the so-called "deficit bias" of fiscal policy. This trend is expected to persist.</u>
- The sharp increase in public debt around the world to previously unknown levels has induced a new debate about a possible trade-off between the stabilisation and sustainability of public debt.
- The persistently high global fiscal deficit, averaging around 5% of GDP, is the main driver of rising public debt. Global public debt could increase to 100 % of global GDP by the end of the decade if current trends continue,

Interest Burden

- Pursuing expansive fiscal policies in an era of rising geoeconomic fragmentation may prove challenging.
- Heightened trade tensions could undermine growth prospects and trigger mini boom-bust cycles in sovereign debt markets, particularly as inflationary pressures resurface amidst a potential escalation in supply-chain disruptions and tightening public finances.
- Soaring government interest expenses could exacerbate fiscal strains, making debt management increasingly difficult in a volatile environment .
- With significant amortizations due in 2025 and 2026, particularly in emerging markets, rising volatility could leave some sovereigns vulnerable to sudden shifts in investor sentiment, underscoring the risk of liquidity crises

<u>Government interest expenses have reached record highs globally, with big surges in mature markets</u>



Source: IIF, Bloomberg

Fiscal Impulse

- Fiscal policy faces political and budget constraints, and supply-side reforms take longer than the electoral cycle to bear fruit. Hence Monetary policy has nowadays become the focal tool to guide economies .
- The investor and media buzz around each central bank decision and economic data release inadvertently imbues rate-setting with a strength it doesn’t possess.
- In contrast to the last century or more of monetary theory, which has focused on central banks' liabilities, the basis for the effectiveness of central bank asset purchases turns on the role of the asset side of the central bank's balance sheet.
- Complicity of Central banks in fueling the inflation that was largely driven by excessive government spending in recent years appears to have rendered monetary officials leery of economic activity—to the point of leaning toward restrictive interest rates at the expense of productive economic growth.
- Hence loose monetary policy is unlikely to be an effective strategy for countering a recession, which contradicts the working assumption of the central banks around the world.

Monetary Policy trajectory

- In all the major advanced economies, the scope for cutting interest rates in 2026 is limited. <u>Policy rates are already close to what is considered the "neutral" rate – the level that neither stimulates nor restrains economic growth .</u>
- In the US, the range of estimated neutral rates remains hotly disputed but we doubt the Federal Reserve will reduce rates given strong real growth and inflation which is still sticky. There remains, of course, the big question surrounding whether Fed 's decisions become more politicised, with pressure for a large cut even if inflation remains above target and growth and unemployment remain resilient. On balance, the risk of that as small. It is not reflected in current market pricing, such as inflation break-even rates, or the expectations of current Fed
- In the Eurozone, interest rates are already close to neutral. The scope for UK rate cuts will be constrained by relatively sticky, above-target inflation, notably in the services sector. The Bank of Japan is expected to struggle to raise rates – at least until the middle of 2026. In Switzerland, rates are already at zero and Swiss National Bank President Schlegel has signalled the bar for reintroducing negative interest rates is higher than in the past.

Nexus between Unemployment and Growth

- The type of economic growth (extensive or intensive), is considered as an important factor that determines the rhythm of job creation in relation to economic growth. Thus, the economic growth (GDP growth -aggregate production) as reaction to the aggregate demand growth, can be achieved in different ways: either the quantity of inputs (labor force, capital, etc) increases and then the extensive growth, or the productivity of production factors increases (intensive growth), or a combination of the two possibilities. There has been a structural change in the post pandemic era.
- In 2025, labour markets presented a complex story of divergence and transformation . A low jobless rate paired with weak participation rate in major economies implied a smaller pool of available workers, amplifying skills shortages and higher wages. The relationship between growth and employment is getting blurred in these times.
- And while there are implications for government finances in putting taxpayers out of work, there are also those who argue that this time could be different. A hit to humans' earning power, through job losses or downward wage pressure, would indeed reduce the ability of those affected to fund consumption. However, richer members of society would experience a wealth effect as AI-driven efficiency boosts the value of their stock portfolios, potentially mitigating the effect on GDP.

Inflation Dynamics

- For decades, low and stable inflation has served as a bedrock of economic policy in advanced economies. This has been a long, hard-learned lesson. From the hyperinflation traumas of the Weimar Republic to the stagflation shocks of the 1970s to the global pandemic inflation, policymakers have been reminded time and again that price stability is not merely a technocratic objective on paper but a prerequisite for sustainable growth and public trust in economic institutions.
- Globally, price level growth in CY 2025 has been put in check by China's continued manufacturing largesse, not withstanding the attempts by Beijing to tackle 'excessive' competition, or involution as it has come to be known and hence it's tempting to think that inflation is waning now. However, this headwind is expected to fade in its impact in this year .
- The policymakers as well as markets consider higher inflation as "transitory,"- the reality however is that the economy is, in fact, entering a new era of higher-for-longer price pressures. A period of higher-for-longer inflation could mark a turning point for an investing landscape defined for the past 16 years by low inflation, low rates and the dominance of passive U.S. equity investing.
- That's why the markets want to own "real assets" like precious metals, which can help to hedge inflation and policy-related risks and stay cautious in long-duration bond exposure, Although monetary policy is typically considered more effective in fighting inflation, fiscal consolidation only can help bring down this inflation spiral.

3. Financial Markets

- Bond Markets
- Fx Markets
- Equity Markets
- Learnings from 2025

- A cardinal rule of macroeconomic analysis is to never reason from a price change.
- Price changes are endogenous responses to fundamental changes in the economy that may have multiple implications.

Term Premium

- Interest rates are determined as the sum of expectations for short-term rates plus the term premium for holding a bond until maturity. After more than a decade of subdued risk compensation in sovereign bond markets, the return of term premium is reshaping the landscape. This term premium is demanded by investors to compensate for the risk that monetary policy might have to follow a different path.
- In years of historically low rates, pension funds and insurers absorbed long-dated bonds to meet duration targets and hedge liabilities. As rates rose, those structural needs diminished (the convexity effect), and investors began to demand a larger premium for holding long-dated risk.
- This has direct implications for debt management, portfolio construction, and the design of derivative structures. In equities, the democratisation of derivatives transformed market functioning. Fixed income is now undergoing a similar inflection point: the bridge between cash bonds, repo financing and derivatives is becoming a defining feature of the market architecture rather than a peripheral activity
- Globally ,The spread between government bond yields and funding costs has widened, reintroducing a meaningful term premium into yield curves and enabling the monetisation of forward carry.

Bond Vigilantes

- The bond market has a history of punishing fiscally irresponsible governments, sometimes costing politicians their jobs. Most recently, in Japan, Prime Minister Sanae Takaichi has grappled with keeping bond investors happy while trying to further her agenda.
- When Trump began his second term, several indicators watched by bond traders were flashing red: total U.S. government debt stood at over 120% of annual economic output. Those worries flared after April 2 when Trump imposed massive tariffs on dozens of countries.
- Bond yields saw their steepest weekly rise since 2001, as bonds sold off alongside the dollar and U.S. stocks. Trump backed off, delaying the tariffs and ultimately imposing them at rates below what he initially proposed. As yields retreated from what he described as a queasy moment, he hailed the bond market as "beautiful."
- Since then, 10-year Treasury yields have fallen over 30 basis points, and a measure of bond market volatility has recently fallen to its lowest in four years. On the surface, it seems that bond vigilantes have gone silent.

How long the silence will last

- One reason for the silence is the resilience of the U.S. economy, with massive AI-led spending offsetting the drag on growth from tariffs, and with a Fed in easing mode because of a slowing job market; another is the steps the Trump administration has taken that signal to the market that it doesn’t want runaway yields.
- On July 30, the Treasury said it was expanding a buyback program that will reduce the amount of long-dated, illiquid debt outstanding. The buybacks are meant to make it easier to trade bonds, but because the expansion was focused on 10-, 20- and 30-year bonds, some market participants wondered whether it was an effort to cap those yields.
- The Treasury Department has also taken other steps to support the market, such as leaning more heavily on short-term borrowing through Treasury bills to fund the deficit instead of increasing supply of long-dated bonds.
- We're in this age of financial repression with governments using various tools to artificially keep a lid on bond yields which we can be called as uneasy equilibrium.
- The question for market participants, however, is how long it can last.

Placid FX

- Currency markets have been so placid in 2025 is that it's difficult to distinguish and differentiate among the various fiat currencies as the underlying macroeconomic, monetary and fiscal conditions are so similar. <u>This can make global diversification look pointless</u>
- Much of the US dollar move has been versus the euro, helped by the rotation towards European companies .But the ECB cannot easily sit on its hands and watch EURUSD rise. <u>By contrast, many of the major EM currencies are priced more for crisis than current realities: there is more room here to run.</u>
- In a nutshell, in most countries, the macro economic dynamics are almost similar.
  - Core inflation is running above targets
  - Nearly all central banks have cut rates despite above-target core inflation
  - Most countries are seeing rising unemployment rates and soft economic growth
  - Importantly , there is a universal streak of Fiscal dominance: many countries are running large fiscal deficits and have no plan to rein them in.
- While this makes it difficult to distinguish among the various fiat currencies, it has sent investors hunting for assets that central banks cannot print. over the course of 2025, many investors concluded that the value of fiat currencies in general is falling relative to precious metals. This trend could continue into 2026 if budget deficits widen further and if central banks continue to ease policy in the face of above-target inflation.

Equity Markets

- Global Stock markets had a stellar run in 2025. While Wall Street achieved a third straight year of heady returns, non-US stocks did even better as investors sought out alternative markets amid the tumult
- S&P 500's 18.7% doesn't look far off the MSCI World Index's 21.8%.
- The MSCI World Index has 23 constituent countries. Of these, the US is 20th on the leaderboard. It is beating only Denmark ,New Zealand and Australia.
- All other 19 countries are well ahead of it, some absurdly so. And it isn't just the dollar: Even in local currency terms, US stocks are behind the pack, leading only six other countries.
- Leadership rotates, usually when few expect it. No one country (or sector or style,) leads for all time.

Learnings of 2025 : Regime shift

- High valuations, rising long-term bond yields and elevated public debt point to a system that looks stable on the surface but is increasingly stretched underneath.
- The traditional stock-bond offset is not broken, but it is less predictable. Periods when both move in the same direction, as we saw in 2022, can happen again.
- If 2025 taught investors anything, it's that they need to think actively about how they preserve capital through a period of global fragmentation and, consequently, increased market volatility.
- The old rules for doing so have been challenged. A 60/40 portfolio split between equities and bonds, for instance, serves little purpose when both asset classes perform similarly in the face of market disruption.
- One of the main takeaways from this regime change is that interest rates are not going back to where they were in the previous cycle. The rest of the global central banks cannot deviate that far from what the Fed is doing, even if the US has faster growth and higher inflation.
- The rules that worked for 40 years may not guide through the next five.

Learnings of 2025 : Perverse Inverse

- Whenever there is a political change or big policy shift, there would be hypes buying the perceived "winners" of said change. That can happen. But, normally it doesn't—and the very reverse occurs.
- Either the policy never plays out as hyped or the excitement among investors just proves excessive which results in a twist called as the perverse inverse—and 2025 has quite a few examples.
- For instance, many presumed the Trump administration's "crypto-friendly" agenda would be bullish for the cryptocurrency industry. Coins initially surged on optimism. The government also passed legislation (e.g., the GENIUS Act), but reality hasn't met expectations—and the flagship crypto, bitcoin, is in the red.
- Early in 2025, headlines cheered the spending plans of new Chancellor Merz, arguing plans for much higher public investment would turbocharge Germany's stagnant Growth. Now ,Bundesbank predicts government spending will have only a limited impact on the "potential output" of the German economy.
- In general, the learning of 2025 is to question assumptions about how a given policy or politician will influence the markets .Very often, they do something perversely inverse to what you expected.

4. Artificial Intelligence

What distinguishes the current super cycle conjuncture is its pace and breadth of technology leading to severe disruption: Artificial intelligence

AI Race to supremacy

- The prize in the AI Race is valuable, and the competition is intense. New capabilities are attracting massive amounts of capital investment from a range of players, especially in the U.S. and China.
- Given the size of each domestic market and links to all regions and countries, Dan Wang, author of Breakneck: China's Quest to Engineer the Future, said of the global tech competition, "It is Americans and Chinese—Silicon Valley, Shenzhen, Wall Street, and Beijing—that will determine what people everywhere will think and what they will buy."
- <u>**This race will continue at a fast pace for the foreseeable future.**</u>
- One immediate problem is that the sheer amount of demand in the space creates difficulties in assessing timelines, which in turn can suppress rates of return. In recent weeks, several stories have highlighted issues with accessing power to operate data centers, and other supply chain concerns may also make it difficult to gauge the time to completion for some projects accurately.
- For context, an investment that would return twice over a three-year time horizon generates a compelling 26.0% internal rate of return (IRR). If the same project were to take five years, the IRR would drop to a more pedestrian 14.9%, not to mention that assumptions and technologies would further evolve over a longer horizon.

Adoption

- Generative AI adoption is expected to accelerate in 2026. The next phase of AI integration is set to extend well beyond the technology sector, where most of the activity has occurred so far.
- At the macro level, these changes could reshape labor demand and growth dynamics as technology augments many roles. At the company level, they are likely to produce wider differences in performance, reflecting how effectively firms integrate and scale new AI capabilities.
- While there has been little evidence so far of AI-induced layoffs, companies appear to be finding success in enhancing their existing workforces with new technology — effectively doing “more with the same.”
- Some academic studies have emerged that show how AI is disrupting early career hiring in exposed occupations like software engineering and customer service, where the technology is profoundly benefitting productivity.
- As adoption broadens beyond the technology sector, these labor and productivity dynamics are likely to play a larger role in shaping both economic growth and corporate performance.

Payoff

- The benefits to economy-wide productivity and profitability to ramp up in 2026.
- Importantly, the productivity cycle from new technologies often mimics a "J-curve" pattern of initial negative results followed by eventual long-term gains.
- This is because companies face upfront costs from purchasing new systems and experimenting with how they can deploy them effectively while workers must learn new routines.
- Surveys conducted by consultants, hyperscalers, and asset managers generally show companies are starting to see a positive return on investment from their generative AI deployments.

Surveys Show AI investments begin to pay off

View	Survey	Date	Finding
	Morgan Stanley / AlphaWise	June 2024	90% of respondents see ROI at or above expectations
	IBM / Harris Poll	April 2024	2/3 of respondents see an improvement in profits greater than 25%
	Ernst & Young	April 2025	97% of organizations see a positive ROI
	Google	June 2025	74% of businesses report a ROI within the first year
	IBM / Oxford Economics	April 2025	ROI of +14% but only 25% of initiatives delivered expected ROI
	Snowflake	January 2025	80% see material improvement in financial performance. Average ROI of 41%
	MIT / Nanda	June 2025	95% of organizations report zero ROI
	Enterprise Tech Research	January 2025	38% see ROI between 1-25%, 9% see ROI above 25%, 26% aren't measuring ROI
	Boston Consulting Group	December 2024	Most see ROI of between 5% and 20%, fewer than 10% see no ROI.

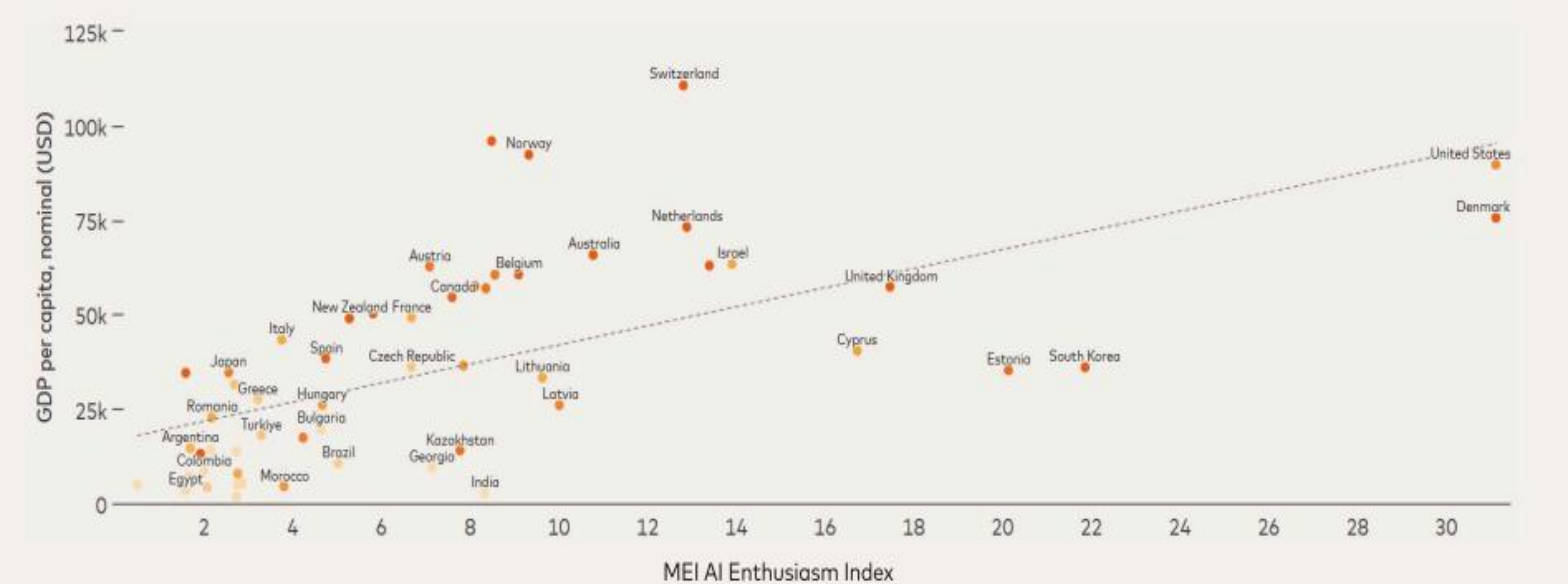
Key:

- Positive
- Neutral
- Negative

Optimism

- The Optimistic scenario for AI is that it unlocks some trillions of dollars, tens of trillions of dollars in present value in terms of future GDP growth uplifted.
- If the top AI-related stocks, capture even 20% of that value created, then their valuations are entirely justified.
- And that’s, again, not even to mention a scenario of artificial general intelligence, where the lid’s blown off in terms of economic growth.
- But then, on the flip side, there is obviously a downside scenario where that value isn’t captured.
- But on the basis of full range of outcomes, one can’t rule out the valuations that we see right now from an economic fundamental standpoint.
- While AI-related capital expenditures and the data center buildout are already contributing to growth in the US and China, they also pose important risks to economies and markets.
- Importantly , the scale of capital required to build AI could pressure funding markets. For now, this capex is overwhelmingly funded by internal cash flows, but by 2030 financing needs could be more than $1 trillion.

- MEI Enthusiasm Index is based on consumer and corporate spending on AI tool providers (ex: generative models, chatbots, enterprise software, developer tools, excluding large diversified tech companies and free AI usage tools).
- The index aggregates total spending on these providers per country, spending per capita and the AI share of software spending. The countries presented represent the top 57 based on the index.
- MEI AI Enthusiasm Index vs. GDP per capita: top right quadrant reveals countries with greatest AI enthusiasm and largest GDP per capita



Whether it’s a Bubble ?

- To put a finer point on the concerns over investments today in the AI revolution, it is useful to compare the current capex investments to those of the TMT (Tech-Media – Telecom) bubble from the mid-1990s to 2000.
- The TMT bubble, to a large degree, represented a major mismatch in terms of the timing of investment and the realization of demand. A significant portion of the nearly $1.5 trillion invested in capex during the TMT bubble ultimately was utilized, much of it in the form of fiber optic cables and other infrastructure that had a long useful life.
- The problem was that the cash flows from these investments were realized much later than expected, which depressed their present value.
- In the case of the current investment, data centers are being built with an assumed useful lifespan of 15 to 25 years in many cases, but the technology inside the data centers might have a lifespan as short as one to three years depending on intensity of use.
- If the infrastructure ends up being overbuilt, and the cash flows are realized too late, the hardware itself might be obsolete before there is demand for i

AI is technological inflection

- Economists often categorize bubbles into two types.
    - Inflection bubbles are driven by genuine technological breakthroughs and ultimately transform the economy, even if they involve excess along the way, like the internet or transcontinental railroad.
    - Mean-reversion bubbles, by contrast, are fads that inflate and collapse without transforming the underlying industry. Some examples include the subprime mortgage crisis of 2008 and The South Sea Company collapse of 1720.
- If AI represents a true technological inflection – and early productivity gains and rapid cost declines suggest it may – then the more important questions center on how this investment is being financed.
- Debt is best suited for predictable, cash-generating investments, while equity is more appropriate for highly uncertain innovations.
- While ,in most cases, the cost of investment-grade debt remains attractive relative to the cost of equity., the more important question is what this wave of issuance means for credit markets. In the near term, such lumpy supply can pressure spreads wider. Indeed, tech sectors spreads have widened from 69bps in mid-August to 88bps, currently.
- For now, caution, not panic, is warranted.

5.US Economy

As headwinds fade and tailwinds build, the balance of risks are shifting from <u>resilience to reacceleration</u> and a potential for above-trend real GDP growth

US : Exceptionalism is inherent

- In 1831, the French political philosopher and historian Alexis de Tocqueville embarked on a journey across the United States, seeking to understand the nascent nation's unique character. His observations culminated in his work 'Democracy in America', in which he described the country and its position as 'exceptional.
- De Tocqueville highlighted how America's development is fundamentally different from European nations, including political, social and economic structures.
- Unlike many of these nations, the country has not been shaped by centuries of aristocratic class structures, which allows for greater social mobility and an emphasis on meritocracy and individualism as defining features of American society.
- In addition, a free-market economy encourages competition, innovation, and entrepreneurship.
- While major economies faced stagnation and even contraction in 2023 and 2024, the U.S. maintained a post-pandemic upswing, with strong real growth rates of 2.9% and 2.8% respectively . Since 2010, U.S. real GDP growth has averaged at around 2.4%, compared to 1.3% for the Eurozone.

Grand Macro Strategy

- In 2025, the US demonstrated its willingness to embed economic statecraft deep into the fabric of policy.
- When viewed through a strategic lens, the torrent of headlines on tariffs , subsidies, mandated investments, and military actions reveals not a set of isolated measures, but an integrated strategy -aimed at ensuring the US retains its position as the world’s leading power in an environment where China is gaining influence.
- Besides import tariffs designed to bolster domestic production, investments in AI, quantum technologies, and defense, This Grand Macro strategy operates on multiple layers.,
- Within its own continent, Washington is shaping the USMCA to its advantage and pressuring Canada and Mexico to align with its anti-China agenda. Gas exports serve as a lever of pressure on Europe, while the Federal Reserve faces political pressure to keep the economy running amid heightened uncertainty.
- At the same time, it is reasserting influence – akin to a renewed Monroe Doctrine – over countries such as Argentina and Venezuela to block external powers from gaining a foothold in the Americas.

Reverse Marshall Plan

- U.S. Secretary of State George C. Marshall formulated Marshall Plan in 1947 which was a massive program of financial assistance to help rebuild war-torn Europe.
- Perhaps most striking development of 2025 is the so-called “Reverse Marshall Plan”: allies such as Europe, Japan, South Korea, and the UAE have pledged to invest hundreds of billions in US industry over the coming years – from shipyards to semiconductor plants.
- Trump has extracted pledged investments of at least US$1.5 trillion from America’s trading partners. This amounts to the Marshall Plan in reverse.
- Whether this “geopolitical contract” will be honored remains to be seen, but what is clear is that access to the US market is being granted in exchange for capital and loyalty.

Simpson’s Paradox

- Simpson’s paradox describes a situation where a relationship can appear in multiple groups but not in the aggregate. The themes of AI and private investing are exerting a powerful influence over business activities
- In the US, economic activity remains resilient but increasingly reliant on three pillars: affluent consumers, AI-fueled capital investment and elevated asset valuations. These dynamics form a virtuous cycle and highlights the complexity of Fed’s dilemma and their difficulties in navigating this tricky stretch
- The economy and markets are showing some duality as well. The Growth is strong but the labor market is seeing minimal hiring with few layoffs. While employment growth has slowed significantly, American wages continue to rise at a reasonably fast pace. The stock market is making new highs, but with fewer stocks participating. Interest rates are being influenced by “hot” inflation and easing policy. This dynamics
- As headwinds fade and tailwinds build, the balance of risks are shifting from resilience to reacceleration and a potential for above-trend real GDP growth of 2.25% to 2.5% in 2026. Building upon the resilience theme from 2025, we believe solid economic fundamentals should support strong earnings fundamentals and protect against a layoff cycle.

Productivity Boom

- Interplay—a surging economy and a soft labor market—is likely to be the major economic narrative in 2026
- K-shaped economy at work: Household consumption driven by higher-income consumers and AI-related investment accounted for just under 70% of total growth during Q3.
- While the economy and financial markets will increase at a strong clip, job creation will continue to be tepid, and inflation will remain elevated at or near 3%,
- If one asks how the U.S. can grow so fast even as hiring slows, the answer is productivity. With productivity increasing at 2.7% year over year, the American economy is experiencing its best gains in that area since the boom from 1995 to 2004.
- That is why wages are rising above inflation, corporate earnings and profits are increasing and the U.S. continues to outperform its peers. This means that the overall amount of compensation going to the labor force continues to grow at around 5% per year, slightly above the 4-5% pace that dominated the 2010s.
- While U.S. productivity, measured by output per worker, has been higher compared to other G7 countries over the last 15 years, the cumulative productivity gain from AI has been estimated by the IMF and JPMorgan to contribute an additional 17.5% of total economic growth in the U.S. over the next 20 years

Dilemma of Dual Mandate

- Inflation has moderated but remains sticky, with renewed tariff pressures and tight labor markets likely to push prices higher. Consumer and corporate balance sheets remain healthy .
- Combined with growing pressure from the US administration, an increasing number of Fed officials to argue that rates should shift lower from what they perceive as still restrictive levels. The Fed closed out 2025 by slashing its benchmark interest rate by a quarter of a percentage point – the third cut in a year.
- The move reopened a familiar debate: Is the Fed’s easing cycle coming to an end, in as much as Fiscal support from the One Big Beautiful Bill Act, deregulation, and robust AI-driven capital investment have offset cyclical softness .
- In the near term, the market will need to internalise the risk that the Powell Fed may be done with cutting rates, with the FOMC themselves perhaps forcing that conclusion ahead of the market becoming comfortable with the pathway due to lingering concerns over the incoming official data.
- This is the reality of a central bank that appears to be now placing a more equal weight on its inflation mandate rather than focusing single-mindedly on employment.

Fed Independence -1/2

- The biggest uncertainties for 2026 relate to government policy. The most immediate question related to IEEPA will likely be answered in early 2026. A longer-term question relates to Fed independence.
- In late August, President Trump posted “Lisa Cook must resign” on social media before announcing her termination from the Federal Reserve Board. Cook has been allowed to remain at the Fed pending a Supreme Court hearing on 21 January.
- If Cook loses her case and is removed from the Fed, that would be seen as a significant blow to Fed independence. Even if Cook wins her case, markets will be watching the appointment of a new Fed Chair when Powell’s term ends in May 2026.
- The announcement of Powell’s designated replacement will likely occur soon, and investors will want to see a candidate who is free of political influence when making monetary policy decisions.
- Despite significant discussion to date about Fed independence, meaningful market concerns are hard to find with the exception of gold, which has rallied by as much as 30% since the day before President Trump’s first social media demand that Lisa Cook resign. Uncertainty surrounding Fed independence is likely not the only driver of the gold price move, but it was a meaningful contributor.
- The term premium for US Treasuries has not moved meaningfully over the same period. If it appears Fed independence is being diminished, steepening of the US yield curve would become more likely.

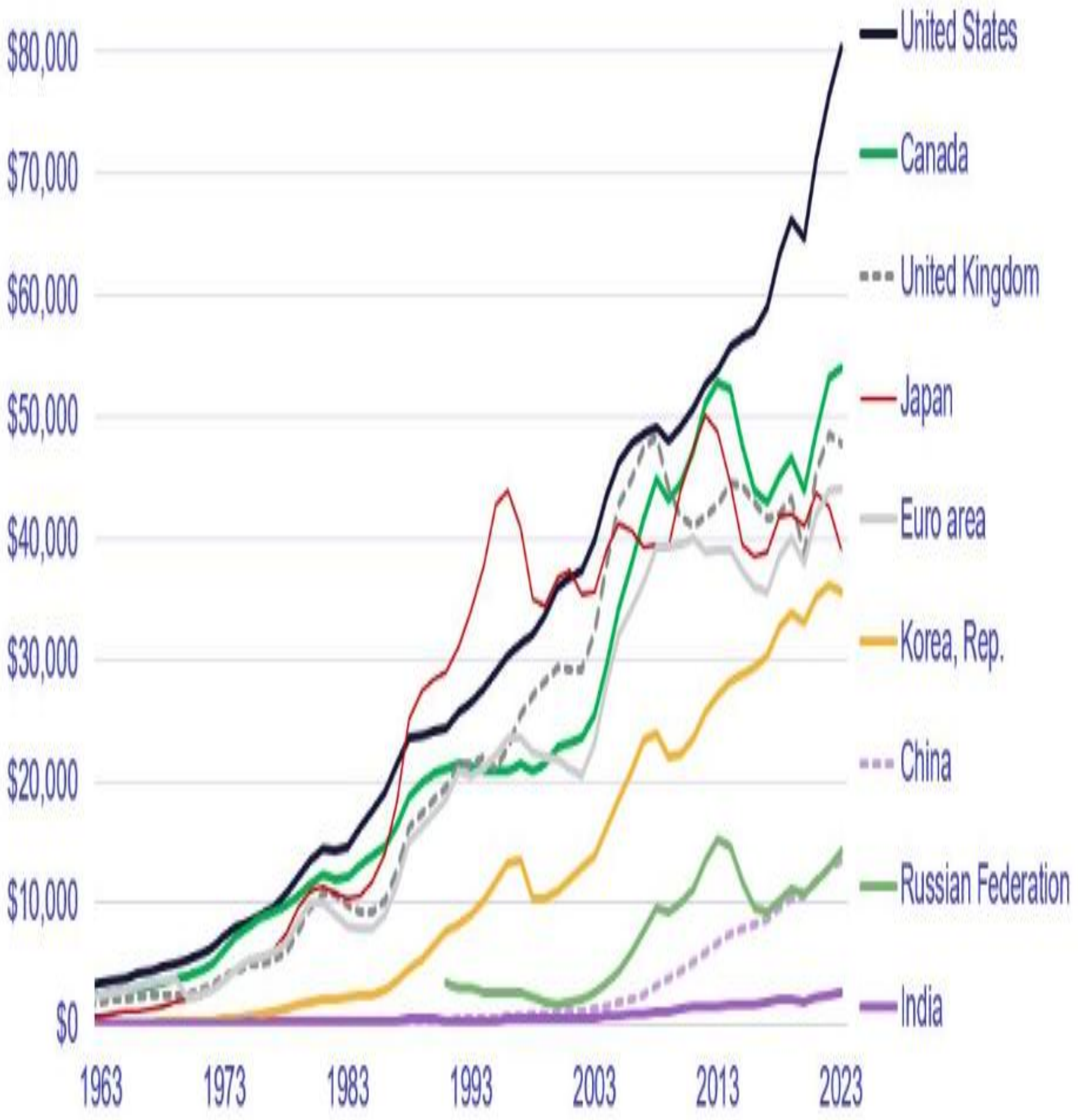
Fed Independence -2/2

- The Fed anchors the world’s reserve currency and the most liquid safe asset: US Treasuries.
- A loss of confidence in the Fed’s independence would undermine these pillars, triggering market volatility, weaker investment, and ultimately tighter financial conditions worldwide.
- In a severe scenario, erosion of trust in US assets could be a significant threat to the global financial system, echoing the instability of the 1970s.
- In short, an “over-easing” Fed risks not only US overheating but also a destabilised global monetary order.
- While the Fed Chair wields significant influence, their power is not absolute. As shown by Stephen Miran’s experience, a single vote cannot override the technocratic FOMC members without strong economic justification.
- If Powell decides to stay on the board, he might serve as somewhat of a Shadow Chair, and potentially quite an influential one.

Rate cuts amidst Resilience

- Monetary easing by Fed at this stage of the cycle will certainly prove counterproductive. Indeed, the backdrop is hardly one that screams for stimulus.
- Equities are at record highs, credit spreads are very tight, and the economy is already running above potential at a time when fiscal policy is set to add more fuel in the months ahead.
- In this environment, rate cuts are more likely to stoke inflation than employment. There's a material risk inflation becomes unanchored.
- Structural constraints – especially a shrinking labour supply – mean the economy's potential growth rate is falling.
- That raises the odds of a tighter labour market, faster wage growth, and stickier inflation.
- Long-dated bonds won't like that, especially given the already troubling debt dynamics.

Per-capita Income indicates economic resilience



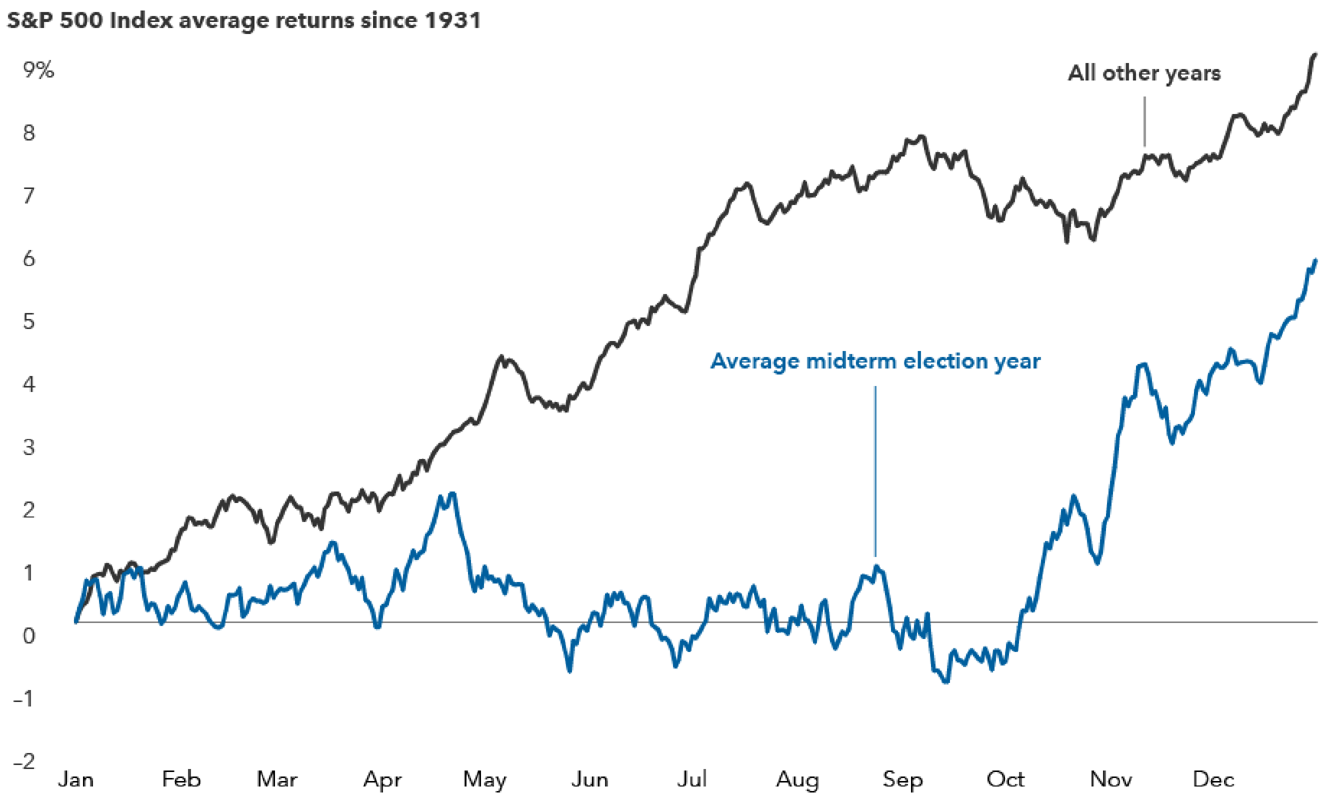
Fiscal Dominance

- Through multiple rounds of quantitative easing, including vast new purchases of Treasurys during the 2020 pandemic, the Fed has become the largest single holder of U.S. national debt.
- According to CBO estimates, the Fed won't be reducing its holdings of Treasury securities over the next decade. Instead, it will increase them significantly.
- The Fed owns $4.2 trillion in U.S. government debt in the form of Treasury bills, notes and bonds. The CBO projects the Fed's holdings of Treasurys will climb to $9.9 trillion in 2035—more than double today's amount.
- For perspective, FED owned less than $500 billion in Treasurys before the 2008 global financial crisis.
- Federal Reserve remittances have been a significant source of revenue to the federal budget, providing more than $835 billion from 2013-22. and Fed officials portray this fiscal bonanza as an incidental consequence of monetary policy,

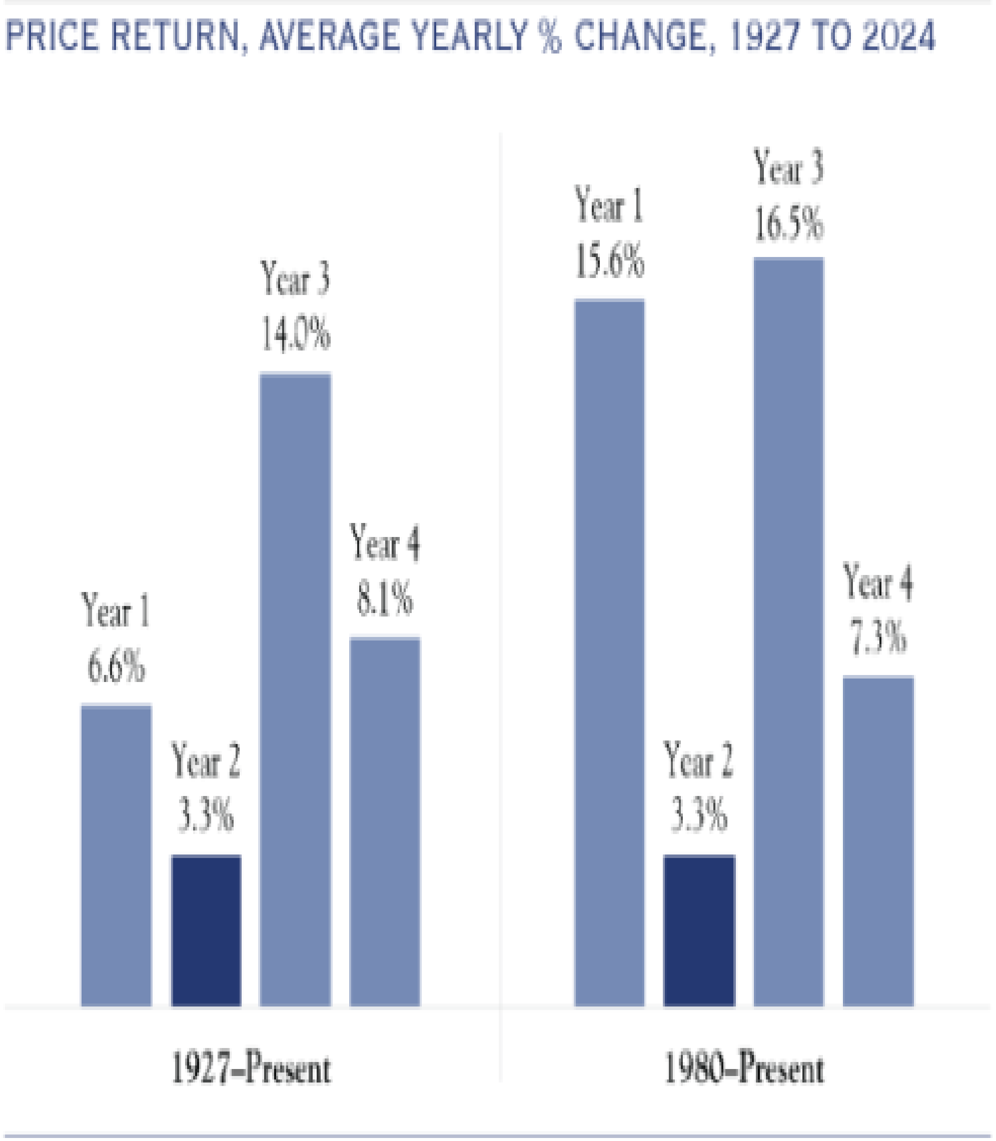
Key Risk : Mid-term Elections

- The mid-term elections could change the US policy trajectory by limiting the Administration's ability to legislate.
- While it is too early to forecast election results a year in advance, if history is any guide, the Democrats are heavily favored to win control of the House of Representatives in November 2026. Over the last 65 years, the party in control of the White House has lost seats in the House of Representatives in every election except 1998 (Bill Clinton) and 2002 (George W. Bush one year after 9/11).
- On average, in every election since 1960, the party in control of the presidency has lost 26 seats versus the current six-seat Republican majority. In the US Senate, 35 of the 100 seats will be up for election in 2026 with 22 seats currently held by Republicans and 13 held by Democrats.
- Despite the higher number of Republican Senators up for reelection, the GOP appears likely to hold onto its majority given that many of the states voting in 2026 either lean or are solidly Republican.
- It is prudent not to expect any meaningful legislation in the next two years, as a divided Congress is likely to revert to gridlock

- However , CY 2026 falls in the worst year of a presidential cycle for stocks, which historically means equities struggle leading into the midterm election and then experience a clearing-the-deck reset with better results in the late part of the year



S&P 500 in Presidential Cycles



US Inflation Outlook

- If tariffs remain near current levels, the US CPI inflation rate is likely to top 3.5% in the first half of 2026 . Many goods being delivered to US customers today were not subject to tariffs when they were ordered by the importing company. For example, in September, the average tariff charged on US goods imports was 11.1%, meaning that only half of the announced increase in tariffs was being charged.
- As importantly, importers have taken advantage of the various tariff pauses in 2025 to front-load purchases and build inventory that is now in the process of being depleted.
- After pre-tariff inventories have been depleted, the cost of goods sold will be higher, and merchants will have to decide whether to protect their profit margins or insulate their customers. I expect most companies to opt to preserve their margins while cutting other expenses to avoid raising prices too meaningfully. One potential mitigating factor could be decreased rent inflation.
- The Zillow Observed Rent Index has historically led US shelter CPI by about one year. For the two years ended in June 2025, year-on-year (y-o-y) rent inflation ranged between 2.9%–3.5% during each month . However, by October, rent inflation slid to only 2.3% y-o-y. If rent increases remain at this new lower level or even slow further, reduced shelter inflation could offset some portion of the impact of tariffs on CPI.

Inflation overshoot and impact on yields

- US inflation is likely to exceed the market expectations priced by inflation-linked bond breakevens, at a time when the economy, though resilient, is beginning to slow.
- This divergence will have meaningful implications for bond markets.
- The sustained US fiscal deficit has injected lots of money into the economy, but, unlike the programmes of quantitative easing in 2009 and 2020, it is possible for this supply of money, ultimately from the 'kindness of strangers', to run out or alternatively seek higher return.

Source: LSEG

Higher Growth need not imply higher employment

- Historically, approximately 140,000 new jobs per month were required to maintain a stable US unemployment rate.
- From May to November 2025, US payrolls only grew by an average of 17,000 jobs per month while the rounded unemployment rate rose from 4.2% to 4.6%.
- Unemployment might have increased more meaningfully were it not for the fact that the number of foreign-born workers in the labor force fell by more than 500,000 over this period.
- Deportations only explain a small part of the decrease and are likely to increase materially in 2026, suggesting that the breakeven job growth level might fall even further next year, perhaps to 50,000 or below, reducing the impact of demand weakness on the unemployment rate.

Elevated Debt to GDP

- The current US economic expansion—which began after the brief but severe contraction at the start of the pandemic in 2020—is now approaching its sixth year.
- That's long by historical standards, and this economic cycle has been anything but typical.
- It has traversed the path from pandemic lockdowns to massive stimulus, then to inflation and rising interest rates, and now to an AI-driven investment surge.
- With deficit spending still in place, debt levels continue to climb.
- The debt-to-GDP ratio has been around 125%, but has remained stable as economic growth has been solid. Tariff revenues are chipping away at the deficit, though the longer-term outlook for that revenue is unclear.
- Tariffs have brought an important shift in tone to the discussion as they have helped reduce the size of the problem.
- Nonetheless, with debt-to-GDP at elevated levels, we anticipate continued political pressure to keep the focus on stability in this metric.

Normalisation Signal

- First, the spread 10*30 is back to pre-financial crisis levels.
- The average spread stands at 48 basis points, just below the long-term average of 51 after briefly inverting in 2023. That points to normalization in the relationship between financial markets and the economy following an extended period of unorthodox monetary policy that suppressed rates at the long end of the curve.
- Second, that normalization <u>has not been well received by a generation of investors that grew accustomed to low interest rates.</u>
- What makes it more challenging is the disruption caused by U.S. trade policy, which seeks to rebalance the global economy.Under current conditions, the widening spread tells investors that they may not be adequately compensated for duration risk associated with holding long-dated financial instruments.
- It is natural that information will in turn influence both pricing and hedging strategies around long-term debt, mortgages and pension liabilities.

6.Europe Economy

Structural dependencies, Constrained finances, and Outdated defence and Industrial capabilities

High stakes Challenge

- From global diplomacy and trade to defence and rapid technological development, Europe has to navigate the transition into a year of high-stakes challenges.
- Factors that limit its autonomy : <u>Structural dependencies, Constrained finances, and Outdated defence and Industrial capabilities.</u> However , Europe has strong pieces on the board: a robust internal market, a network of reliable treaties, regulatory capacity and reputation, and a currency that is gaining weight as a safe haven.
- It is perhaps not surprising, therefore, that in his September 2024 report, Mario Draghi highlighted the need for Europe to close the innovation gap with the U.S. and China, and wrote that 'Europe faces a choice between exit, paralysis, or integration', when he spoke of the future of European competitiveness.
- The stakes are high for 2026 as Russia's war of aggression shows no sign of easing and Europe finds itself in an unprecedented relationship with US. EU's decision-making processes bend and creak under internal and external threats to its sovereignty, while it tries to tackle an ongoing competitiveness crisis.
- Faced with this fragmented global landscape, Europe faces a choice: it can either consolidate its position as a regulatory, commercial and technological power, or be relegated to a reactive role if it does not act quickly and coherently.

Euro Zone : Growth Dynamics of 2025

- The Eurozone economy outperformed expectations in 2025, supported by resilient household consumption and frontloaded trade flows.
- This resiliency is despite the headwinds from US tariffs and intense competition from China – even if that performance is exaggerated by outlier Ireland, which contributed a massive 0.6pp to 2025 growth so far. Put another way, eurozone growth would have been a much less impressive 0.8% in 2025 were it not for Ireland.
- There is also real underlying strength in southern Europe - For years, these countries underwent an 'internal devaluation' following the eurozone sovereign debt crisis, i.e. wages were held down while they surged in northern Europe (in Germany and the Netherlands in particular). This factor may also yet help France dig itself out of a fiscal hole.
- Growth is projected to soften over the course of 2026 as southern European outperformance is expected to wane on the end of the EU's Recovery & Resilience Facility. The scale of AI investment in Europe still lags behind the US, and overcoming regulatory hurdles remains key
- Importantly , Ireland was one of the chief beneficiaries of the spike in exports to the US ahead of the tariffs in April, but what has surprised is how gradual the post-tariff unwind has been, and how little this has impacted growth. The risk remains of a more substantial pullback in Ireland that could hit eurozone growth in Q4. There is a perceptible risk that some of this year's growth may have been a mirage (Ireland's GDP surges are often corporate tax planning balance sheet transfers).

Europe Growth Outlook

- For the longest time, Germany has suffered from a tight labour market and, more recently, high energy costs.
- But with the car industry undergoing a painful restructuring, slack is being gradually released. Whether that slack can quickly retool to meet the demands of higher defence and infrastructure spending remains an open question.
- If the German economy proves flexible, growth could surprise to the upside. If it does not, more of that spending will leak out in the form of higher imports, or – worse – the extra spending might be inflationary.
- Another growth driver to watch next year is the end of the EUR650bn Recovery and Resilience Facility. Just 57% of the funds have been utilised since the RRF started in mid-2021 and the deadline for disbursement is 31 August 2026.
- There is likely to be a rush of spending ahead of that deadline with probably some leniency for projects under construction/in progress. Thereafter, growth in the periphery is likely to slow as that spending dries up again.

Political Challenge

- Politics will also continue to be a key driver of the eurozone outlook.
- While not in the Eurozone, Hungary's general election in April could be a pivotal moment for the EU, given that PM Orban is currently trailing in the polls, and given his historic obstruction of many EU initiatives.
- A more pro-EU government there - coming alongside a new pro-EU could give new momentum to integration initiatives such as completing the capital markets union, the multi-annual budget or even Eurobonds .
- Further ahead, the signs are less positive, with the French presidential election in 2027 potentially heralding a far-right presidency.
- While much can happen between now and then, centrists and those on the left are currently on the back foot politically in France. This will make dealing with France's deficit problem in a growth-friendly manner all the more crucial,

Rare Earth challenge

- Rare earths have gone from being rare to being ubiquitous, at least in geopolitical conversations. For its part, the European Union is terrified by its own lack of leverage.
- EU currently sources most of its critical raw materials from outside the bloc. For example Türkiye provided 98 percent of the EU's boron as of 2024, and China a whopping 100 percent of the EU's supply of heavy rare earth elements, such as europium, terbium or yttrium. The EU has tried hard to diversify its sources, but has met with mixed success
- As a huge net importer of rare earths and with no valuable rare-earth compounds to export – like the US – European companies are left exceedingly exposed to the rare earth threat.
- Major employers like Airbus, Vestas, Volkswagen, and other electric vehicle manufacturers are all vulnerable. So too is Europe's embryonic military industry, which European leaders and the Commission are so keen to support. And although the EU managed to land the same one-year truce as the US, that's where the good news ends.
- While the Critical Raw Materials Act, approved in 2024, sets clear goals on paper, the targets for self-reliance by 2030 (10% extraction, 40% processing, and 15% recycling) are just not realistic.

Higher for longer yields

- From mid-2024 to mid-2025, ECB reduced its key lending rates by 200 bps, with deposit rate ending Nov 2025 at 2%.
- ECB has continued to communicate that it is in a ‘good place’ with regards to interest rates, though President Lagarde augmented this at the Governing Council meeting with the caveat that it is not in a ‘fixed place’.
- Monetary policy changes in the Eurozone have a more magnified and immediate effect than changes in Fed policies in the US ,as more debt in Europe is floating rate. Approximately half of Eurozone residential mortgage debt is floating rate versus less than 10% in the US, and roughly half of Eurozone corporate debt is floating rate versus only 20% in the US.
- Against the backdrop of a broadly balanced growth outlook, inflation in the near term is set to undershoot the ECB’s 2% target, although this is largely driven by energy (and to a lesser extent the stronger euro), with core inflation expected to hold broadly steady. With the conclusion of the ECB's rate-cutting cycle and elevated debt supply issuance next year, there is limited potential for 10y bund yield to decline. There is decisive upward pressure on long-term yields, with bond vigilantes on alert, ready to respond to signs of fiscal slippage.

7.China Economy

The Chinese housing market simply refuses to bottom out., whereas China is busy building buzzy new economy in real time churning out tech success stories.

Importance of Two sessions

- From a Growth perspective, the annual plenary sessions in March of the National People's Congress and the National Committee of the Chinese People's Political Consultative Conference, known as the "Two Sessions", will reveal whether the government sets a lower target for growth.
- China has set multiple objectives over time, including building a "moderately prosperous society in all respects" by 2020, which was achieved. The current objective is to achieve "socialist modernization" emphasizing "high-quality development" and "common prosperity" with an understood goal of doubling GDP by 2035.
- To double GDP over the next decade, China would need to grow real GDP by about 4.2% per annum. This target is a stretch given that the working-age population is expected to decline by about 0.5% per annum over the next decade.
- To give a sense of the severity of the demographic challenge, in 1990, the median age of a Chinese citizen was 23.7. By 2023, the median age had increased to 39.1. By 2050, over 40% of China's population is expected to be over the age of 60 with only 10% under the age of 15.
- It is important to remember that aging also reduces productivity growth, adding to the negative demographic effect on GDP.

Emphasis on New Economy

- China has successfully replicated its prior success in winning global market share in the renewable energy landscape, dominating electric vehicles, lithium batteries, solar photovoltaic cells, and more recently, advanced robotics.
- The Chinese technological juggernaut appears to be unstoppable in some ways, with industrial policy being a key driver of this success. In fact, the Fifteenth Five-Year Plan agreed on in late October highlighted China's commitment to continued advancement in these leading-edge technology arenas. With new economy industries estimated to account for 15%–20% of China's GDP as of 2025, these sectors can increasingly compensate for deterioration in the residential real estate industry that at one point represented as much as 30% of GDP but now likely represents closer to 15%.
- While the strategy of shifting the economy to be more dependent on new manufacturing capabilities makes sense, the success of this strategy depends on other countries allowing China to export its excess production to their markets.
- In the case of photovoltaic cells and solar panel production, China has become the dominant provider globally, with a market share of nearly 80% as of 2025. In the case of new energy vehicles, China is now exporting passenger vehicles at a pace of about 6 million per year, with half being renewable energy vehicles including EVs and plug-in hybrids.

New Frontier

- Another new frontier for China's manufacturing prowess is in the production and use of advanced robotics.
- In 2017, China had deployed 97 robots for every 10,000 workers. By 2024, that ratio had increased to 470 robots per 10,000 human workers, ranking China as the most aggressive adopter of robots among major economies.
- Importantly, many of the robots used in China are also made domestically at a materially lower cost than robots produced in Japan and other developed economies.
- According to the International Federation of Robotics, China now operates more industrial robots than the rest of the world combined, with over 2 million units in service as of 2024.

Property Crisis

- While advancements in high technology sectors help boost growth, and trade stabilises, housing to continue to be a drag on the economy.
- Unfortunately, home prices continue to decline , with all of the 70 largest cities reporting that existing home prices were down both m/m and y/y in October 2025.
- For new homes, 64 of the 70 largest cities reported m-o-m price declines and 61 reported lower y-o-y levels. According to the National Bureau of Statistics , cumulative declines in home prices are ~12% for new homes and ~21% for previously occupied homes.
- However, these figures often overstate home prices—and understate the decline of prices as they rely on the listing price (not the transaction price) for a home and ignore “shadow discounting” such as a developer offering a free parking spot with an apartment to entice the purchaser.
- New home prices are likely down on the order of 15%–20% with a skew toward larger declines in Tier 3 cities and smaller declines in Tier 1.
- For previously occupied homes, the actual average decline could be closer to 25%–40% with the same skew given private sector data published earlier in 2025.

8. UK Economy

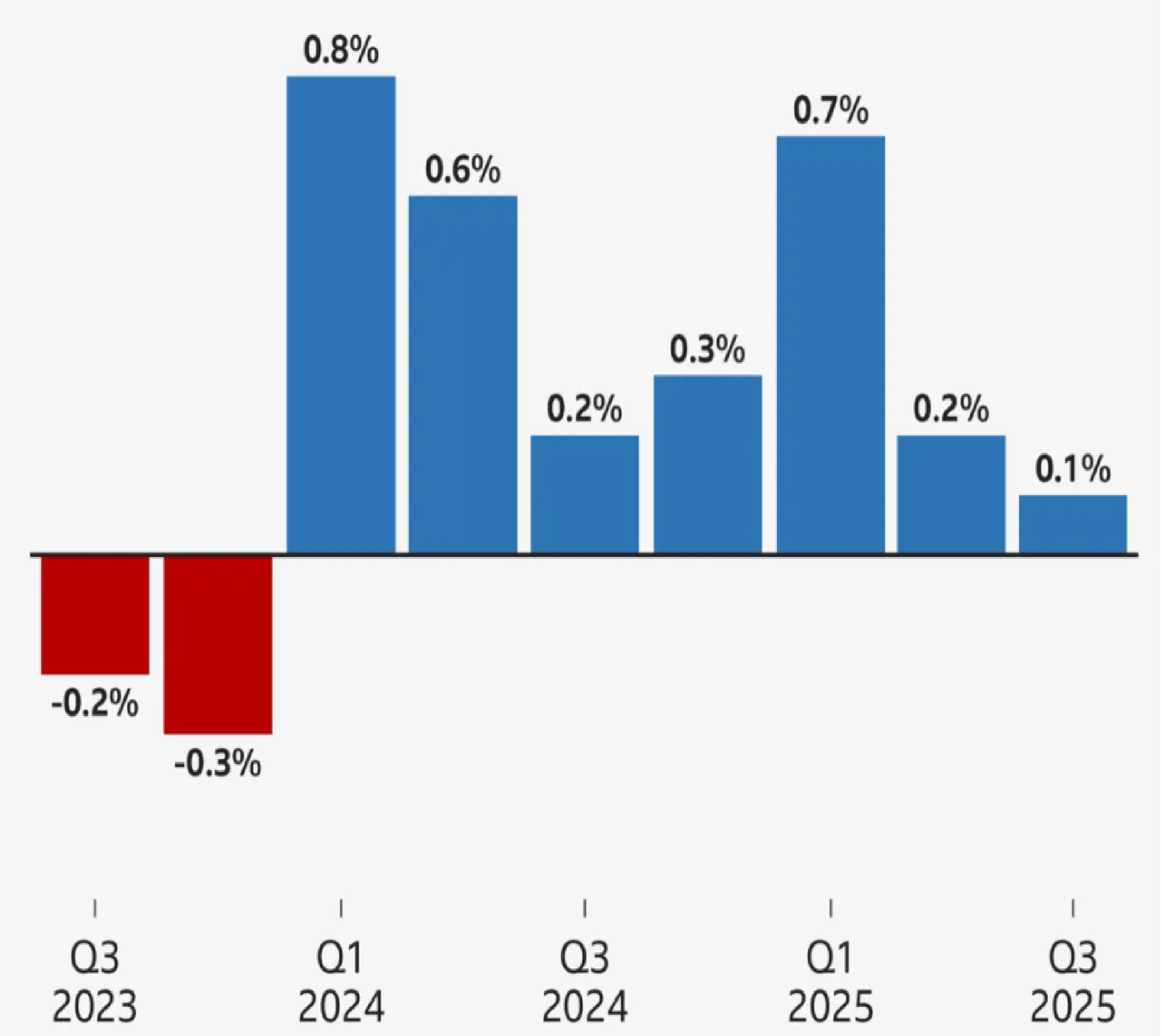
…feels like bond markets are in danger of learning the wrong lessons from Liz Truss, or simply weaponising a pretty unique debacle for overly wide usage.

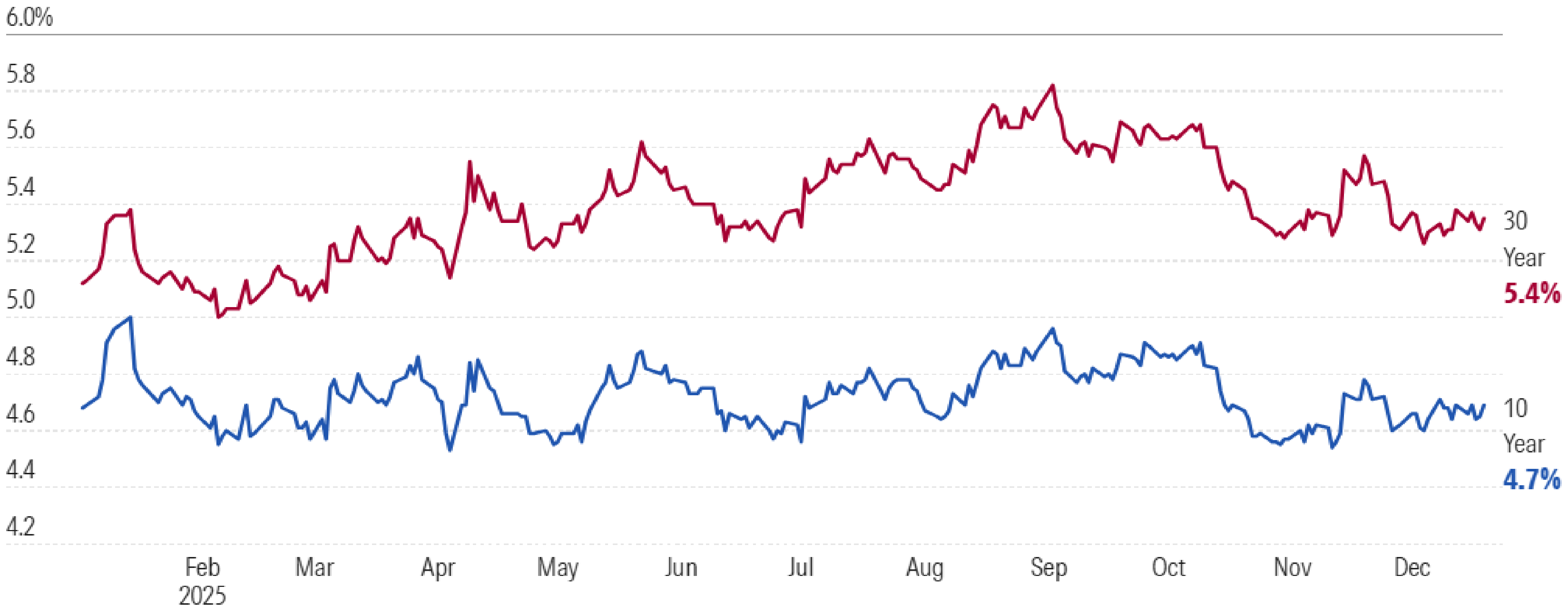
UK : The Playbook

- The UK has long been the playbook as a bellwether for global investors’ tolerance of countries with high debt levels and an unclear path toward debt consolidation.
- It also faces a particular challenge from persistent inflation, with a wide distribution of possible outcomes, including renewed economic growth on the one hand and the tail risk of stagflation on the other.
- Unless inflation is brought down by tighter demand- or supply-side policies, we expect UK rates to remain persistently higher., especially as Bank of England still has more than £500 billion of UK government bonds acquired after the financial crisis to sell into the market.
- The very fact that the UK is entering terminal rate territory will naturally lead to increased caution and an increasing data dependency approach.
- On the positive side , the November budget is modestly positive for growth in 2026 as day-to-day government spending will increase, while most of the £26 billion worth of tax increases will come into effect only from 2028 onward.

- The markets are hugely concerned that the UK economy is not growing fast enough. When the Labour government took power in July 2024, it made growth its top priority.
- Although the economy grew faster than expected at the start of 2025 - expanding by 0.7% in the January-to-March period - its performance has been slowing steadily as the year has progressed.
- The economy grew by 0.2% in the three months to the end of June, but then slowed to 0.1% for the third quarter covering July to September.
- At the time of November's Budget, OBR predicted that the UK's economy would expand by 1.5% this year. In October, IMF predicted the UK would grow by 1.3% this year.

Real quarterly UK GDP Growth





- UK bond yields spiked, first in January, then in September and then in the lead-up to the Autumn Budget. Yields on long-term debt came close to 30-year highs as bonds sold off amid concern over government finances.
- The risk of a leadership challenge to Starmer offers the potential for further gilt market disquiet, particularly for the longer-end of the curve - The local elections on May 7 are a major political risk for bond and FX investors in the UK.

9. Japan Economy

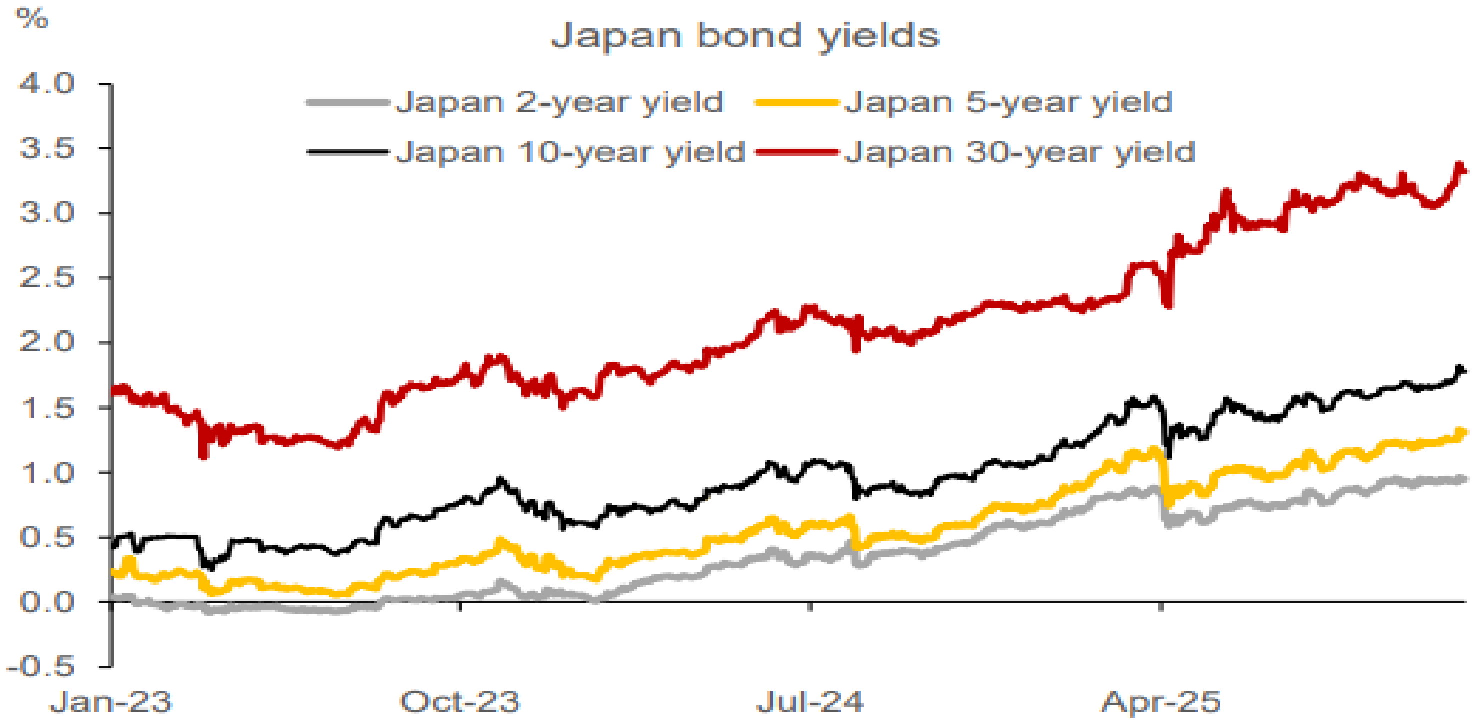
Japan’s new 'Sanaenomics' measures will be put to test at the ground in 2026

Sanaenomics at work

- Japan’s new 'Sanaenomics' measures will be put to test at the ground in 2026.
- Real GDP will grow just 0.7% YoY in 2026, down from estimated growth of 1.2% in 2025, although on a quarterly basis the economy will continue expanding at an annualized pace of around 1%, implying a modest recovery from 2025. Goods exports will pick up gradually as the impact of US tariffs fades and tax cuts drive a US economic recovery.
- Capital investment remains sluggish into early 2026 but maintains its upward trajectory, underpinned by solid autonomous investment and an improved earnings outlook.
- The policy mix is contributing to the ongoing weakness in JPY , which is likely to continue with the adoption of a more expansionary fiscal policy in a context of full employment of production factors.
- Over the past five years, the slope in the relationship between the output gap and inflation has steepened. The exchange rate pass-through from FX to CPI has also risen, notably in services, which reflects inbound tourism. And prices are sticky on the downside.

Japanese Inflation Dynamics

- Inflation in Japan is different from other advanced economies. It has been driven by import-dependent food and energy, while inflation in the US and the Euro area has been driven by domestic items such as rent and services.
- Core inflation (excluding fresh food) has been above 2% y/y since April 2022 and will not return to its target before 2028 at the earliest – with the exception of a dip in Q2 2026 (to +1.9% y/y) due to energy support measures, before rising again.
- The increase in prices is the result of both imported inflation against a backdrop of a depreciating yen (USD/JPY around 100 at the beginning of 2021, now above 150) and the food component. Headline inflation is following similar patterns.
- Meanwhile, interest rate hikes by BoJ have been limited so far, maintaining an accommodative stance and reinforcing the perception of a 'behind the curve' monetary policy. Finally, market inflation expectations, as indicated by the 10-year breakeven inflation rate, are at an historic high of +1.6%.
- The rising trend of bond yields is associated with ongoing primary deficits, which are subject to upside risks, both structural (ageing population, defence needs) and cyclical (divided Parliament, inflation). Added to this is a monetary policy that is absorbing less JGB supply and appears to be responding too slowly to persistent inflation.
- 10-year JGB yield is likely to hold in 2026 between 1.850% - 2.450%.



- After the accelerated rise in yields starting in mid-November, any retracements are likely to prompt relief selling or position adjustments ahead of the fiscal year-end, thus limiting the downside for yields. 10-year JGB yield may find more support if a more hawkish BoJ stance picks up ahead of the January 22-23 meeti.ng

- Markets will be watching the nomination of a replacement for Policy Board member Asahi Noguchi, which the prime minister may submit to the Diet as early as late January. Should Prime Minister Sanae Takaichi appoint a proponent of reflationary policies or “high-pressure economy” to serve on the Board, it could be perceived as an attempt to discourage further rate hikes, putting bear-steepening pressure on the yield curve by amplifying concerns that the central bank will fall behind the curve. Conversely, the nomination of a more neutral candidate would support the view that the selection will have little influence on the next rate hike decision.

Japan : Job Market

- The labour market is constrained by labour shortages, as illustrated by the Tankan index of factor utilisation hitting an historic low in Q4 2025.
- At the same time, the total number of hours worked continues to decrease (-1.2% y/y in Q1-Q3 2025). The unemployment rate remained low at 2.6% in October, despite a slight rise (+0.3 pp in 2025 to date).
- Growth in scheduled contractual wages has averaged +2.0% y/y so far in 2025, a trend that is expected to continue in 2026.
- The Rengo trade union confederation has set the same target as last year for its annual negotiations, suggesting that current growth standards will be maintained for the coming year.
- However, this increase is inadequate in light of inflation: the real wage index has contracted by -1.5% y/y on average in 2025 to date, and the outlook for inflation remains unfavourable in this regard.