2026 Global Economic Outlook

A tale of two economies

Navigating the divergence between financial markets and real economy

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“The old world is dying, and the new world struggles to be born: now is the time of monsters.”

— Antonio Gramsci (*Quaderni del carcere*)

IMF Economic Projections (Jan-26 update)

in year over year

	2024 (E)	2025 (E)	2026 (P)	2027 (P)
World Output	3.3	3.3	3.3	3.2
Advanced Economies	5.0	-2.1	3.7	5.3
United States	1.8	1.7	1.8	1.7
Euro Area	0.9	1.4	1.3	1.4
Japan	-0.2	1.1	0.7	0.6
United Kingdom	1.1	1.4	1.3	1.5
Developing Economies	4.3	4.4	4.2	4.1
China	5.0	5.0	4.5	4.0
India	6.5	7.3	6.4	6.4
Russia	4.3	0.6	0.8	1.0
Brazil	3.4	2.5	1.6	2.3
Mexico	1.4	0.6	1.5	2.1

Source: IMF World Economic Outlook Update, January 2026
(P) indicates projection; (E) indicates estimation

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Part 1:
The Headlines

Papering Over the Cracks

Chapter Summary

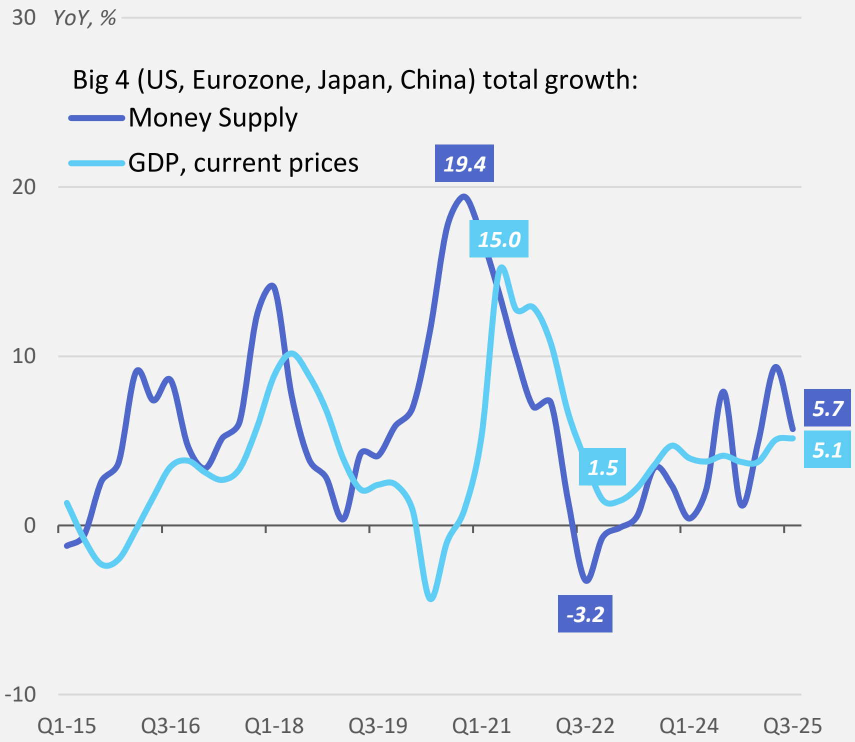
- 2025 was more resilient than expected as global liquidity recovered, led by central bank pivots and easing trade tensions. Yet liquidity has struggled to translate into real economic growth, creating a divergence with financial markets. Whether this divergence persists will be the key question for the 2026 outlook.
- Beneath the surface, most countries face a shared vulnerability of a worsening labor market. This, along with rising interest expenses, is limiting governments' fiscal space and pushing them to adopt "creative" policies, leaning towards populist and protectionist directions.
- Persistent inflation, rising budget deficits, and geopolitical instability are collectively pushing long-term government bond yields higher across the globe. The shift to issuing bonds with shorter tenors has become inevitable, but it carries refinancing risk if the environment deteriorates. All of this makes the economic growth recovery in 2026 still quite fragile.

Will the recovery of liquidity be followed by GDP acceleration?

- The year 2025 proved more resilient than early forecasts suggested, **primarily driven by a recovery in global liquidity.**
- Reversing the prior year's aggressive tightening campaigns, major central banks began to pivot to a more accommodative stance. In addition, tensions from the trade war have also continued to ease, supporting a gradual recovery in commodity prices.
- In theory, a liquidity recovery should precede a broader economic upswing. Unfortunately, three factors (which will be examined in more detail later) are making the real sector less attractive for that liquidity: fiscal risks, geopolitical issues, and structural shifts in the labor market and technology.
- There is a possibility that the preference for paper assets and gold is still eroding the elasticity coefficient of liquidity towards GDP growth. How far can this divergence continue, and what is its endgame? This is a central question for the 2026 outlook.

Chart 1.1

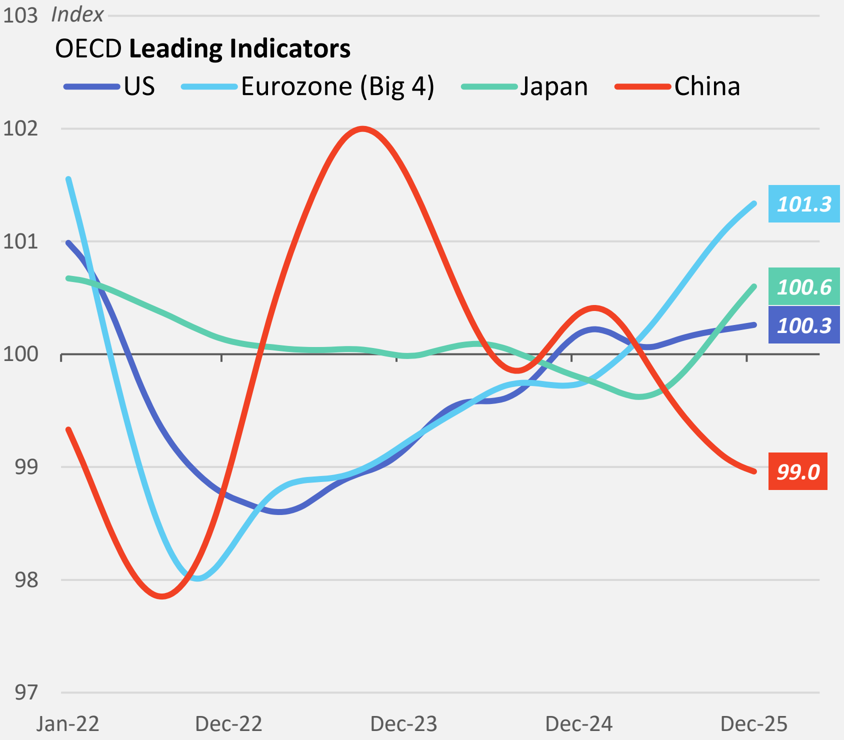
Recovery in liquidity is usually followed by an upbeat economic growth



Source: Bloomberg, BCA Economic Research calculations

Chart 1.2

Except for China, leading indicators show optimism for global growth



Source: Bloomberg

"It was the best of times,
it was the worst of times,
it was the age of wisdom,
it was the age of foolishness,
it was the epoch of belief,
it was the epoch of incredulity,
it was the season of light,
it was the season of darkness,
it was the spring of hope,
it was the winter of despair."

— Charles Dickens (*A Tale of Two Cities*)

The cost of jobless growth

- In 2025, the US outperformed its peers, with robust momentum on both its supply and demand sides. In contrast, the picture is more nuanced for other major economies. **Beneath this divergence in performance lies a shared vulnerability: a worsening labor market.** Across nearly all major economies, unemployment is rising, with no clear sign of abatement.

- Part of the reason is structural. Automation and AI drive efficiency, beginning to create a gap between the number of university graduate workers and the number of available jobs.

- This has several implications. First, reduced purchasing power could discourage entrepreneurs from investing in the real sector. Second, to maintain electoral viability, governments may lean towards populist policies focused on boosting consumption.

- This also carries the risk of a deeper fiscal deficit, as it will not be matched by tax revenues from individuals (which are certainly under pressure). Finally, we may still see some creative policies from the government (trade tariffs being one of them), some of which may have heavier implications on the geopolitical side.

Chart 1.3

Most countries face a rising unemployment rate

			Industrial Production (YoY, %)				**PMI**				**Retail sales** (YoY, %)				**Unemployment Rate** (%)			
			US	DE	CH	JP	US	DE	CH	JP	US	DE	CH	JP	US	DE	CH	JP
2024	Q1	J	-0.4	-4.4		-2.1	50.3	43.8	50.8	47.7	3.8	-0.1		3.0	3.8	3.2	5.1	2.5
		F	-0.9	-6.6	4.5	-3.8	51.6	43.3	50.9	47.8	3.1	0.0	3.1	2.7	3.8	3.3	5.1	2.6
		M	-0.8	-2.9	5.6	-3.9	51.4	42.3	51.1	48.3	4.0	2.3	2.7	2.6	3.9	3.3	5.1	2.6
	Q2	A	-0.6	-5.7	5.6	-2.5	51.1	43.3	51.4	49.4	3.0	0.5	3.0	2.0	3.9	3.4	5.1	2.6
		M	0.0	-3.8	5.9	-3.2	51.0	43.8	51.6	50.0	2.3	0.4	2.7	2.8	4.0	3.4	5.1	2.6
		J	0.0	-5.6	5.3	-1.6	50.8	44.0	51.1	49.8	2.5	-1.1	2.8	3.1	4.1	3.4	5.1	2.6
	Q3	J	-0.1	-4.5	5.0	-3.5	49.7	43.0	50.7	49.6	2.2	-0.7	2.3	3.1	4.2	3.4	5.1	2.5
		A	-0.7	-3.2	5.0	-1.8	48.3	42.1	49.8	49.5	2.3	1.0	2.7	2.1	4.2	3.4	5.2	2.5
		S	-0.7	-3.9	5.1	-2.4	47.9	42.0	50.0	49.6	2.4	2.0	3.4	1.7	4.1	3.4	5.2	2.5
	Q4	O	-1.2	-3.6	5.4	-1.9	48.5	42.2	50.4	49.3	3.0	2.5	3.7	1.6	4.1	3.4	5.1	2.5
		N	-1.0	-3.6	5.6	-1.5	49.2	42.8	50.8	49.3	4.5	2.2	3.8	2.6	4.1	3.4	5.1	2.5
		D	-0.3	-4.5	5.8	-1.1	50.1	43.5	50.7	49.1	4.6	1.5	3.4	3.6	4.1	3.5	5.1	2.5
2025	Q1	J	0.6	-4.7		0.0	51.1	44.7	50.5	49.1	3.2	0.7		3.0	4.1	3.5	5.1	2.5
		F	1.0	-2.8	7.7	1.1	51.4	46.6	50.7	48.7	3.2	1.2	5.9	2.9	4.1	3.6	5.1	2.5
		M	0.8	-3.7	6.9	0.5	51.0	47.7	50.8	48.7	3.3	0.9	5.5	2.5	4.2	3.6	5.1	2.5
	Q2	A	0.4	-0.7	6.5	-0.3	50.8	48.3	50.0	48.8	4.4	2.6	5.8	2.7	4.2	3.7	5.1	2.5
		M	0.3	-2.7	6.2	0.9	51.7	48.6	49.7	49.4	4.2	2.2	5.4	2.4	4.2	3.7	5.1	2.5
		J	0.8	-0.2	6.1	0.6	51.6	48.8	49.4	49.5	3.9	2.8	5.0	1.4	4.2	3.7	5.1	2.4
	Q3	J	1.1	-3.3	5.9	0.8	51.9	49.3	50.1	49.6	4.0	1.1	4.0	0.4	4.2	3.8	5.1	2.5
		A	1.6	-1.1	5.8	0.6	51.6	49.5	50.4	49.0	4.5	2.2	3.4	-0.2	4.3	3.8	5.2	2.5
		S	1.6	-1.2	5.5	1.2	52.5	49.6	50.8	48.8	4.2	1.3	3.1	0.3	4.4	3.8	5.2	2.6
	Q4	O	2.2	1.0	5.4	1.0	52.2	49.1	50.6	48.5	3.7	2.5	2.4	0.9	4.5	3.8	5.2	2.6
		N	2.3	0.4	5.0	-0.3	52.2	48.3	50.2	49.0	2.7	1.1	1.7	1.3	4.5	3.8	5.2	2.6
		D					52.0	47.6	50.0	49.4								

Source: CEIC, BCA Economic Research calculations

All figures are smoothed with 3-month centered moving average

Green indicates improvement, red indicates worsening

Bluffing with tariffs

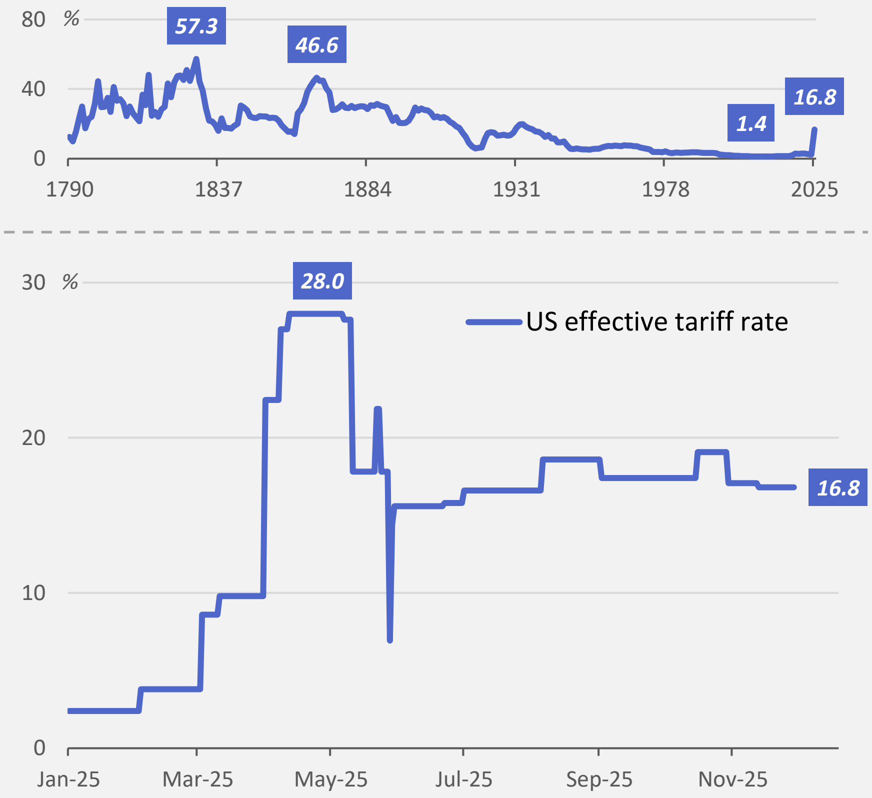
- **Protectionism is a common consequence of budget deficits and rising unemployment.** This fully materialized last year when President Trump raised the average US effective tariff rate to its highest level in over a century.

- **It is now clear that the tariff threat is not only to increase revenue from the trade balance but can also be weaponized for other purposes**, such as the recent developments with Greenland. This means we might see tariffs raised several times in 2026 as a bluff, but with implementation being somewhat lower or completely removed if an agreement is reached.

- Effectively, however, this still creates a high-tariff environment. Meanwhile, many countries will use non-tariff barriers (such as import-export restrictions) to secure their own revenues. In 2026, we will begin to see: (a) how negative the impact on the economy will be and (b) how positive some new trade collaborations that emerge in response will be. We will also continue to see, as a subsequent effect, each country trying to secure critical commodities such as food, minerals, and energy, which could create a new landscape of globalization.

Chart 1.4

Effective tariff rate is on century-high



Source: The Budget Lab at Yale

Risk on, risk off – both at once

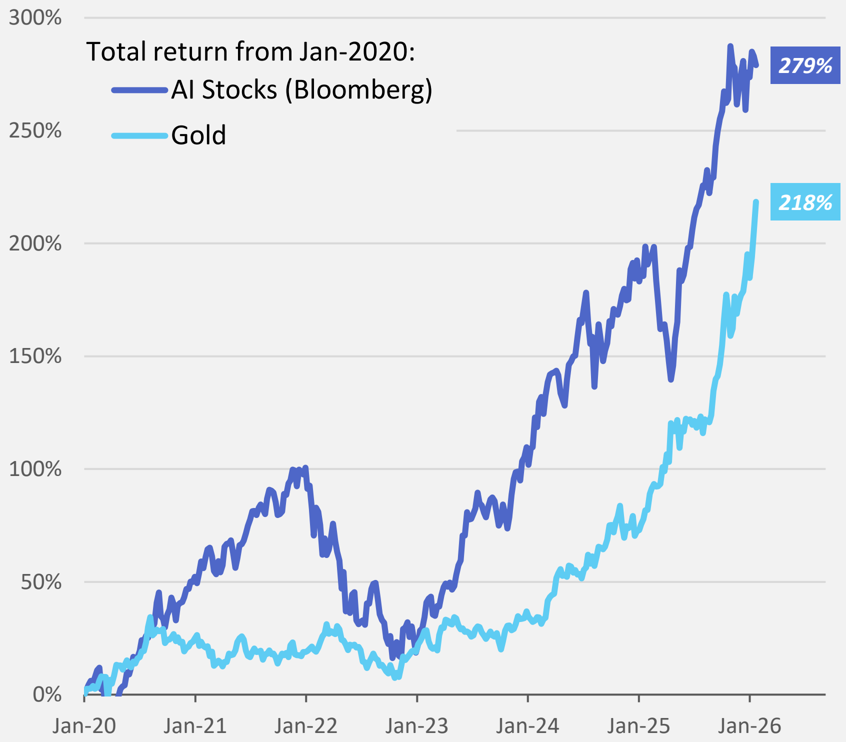
- **While the strength in the economy is not broad-based across all indicators, paper assets and gold are having a superb time.** Accommodative policy has injected capital into the system, but with the real economy showing weakness, that capital is chasing returns in financial assets rather than funding new physical investments.

- AI stocks and gold are two prime examples. Fundamentally, they illustrate something different. AI stocks should represent a "risk on" sentiment, especially when liquidity is easing, while gold should represent a "risk off" sentiment, serving as a hedge against rising inflation and geopolitical instability. So why are both rising sharply at the same time?

- **Perhaps, this is not a bubble. The rise of these two instruments with different natures may no longer be seen merely as an alternative because other sectors are weakening.** We see that the market is pricing in: (1) The structural impact brought by AI will be permanent, and (2) gold's position as the primary safe haven is being reaffirmed as the global financial world enters a new chapter (be it fragmentation, dedollarization, or else). But keep in mind, the essence of a bubble is that no one knows when it will burst, so we may be wrong (again).

Chart 1.5

Returns from paper assets are extravagant



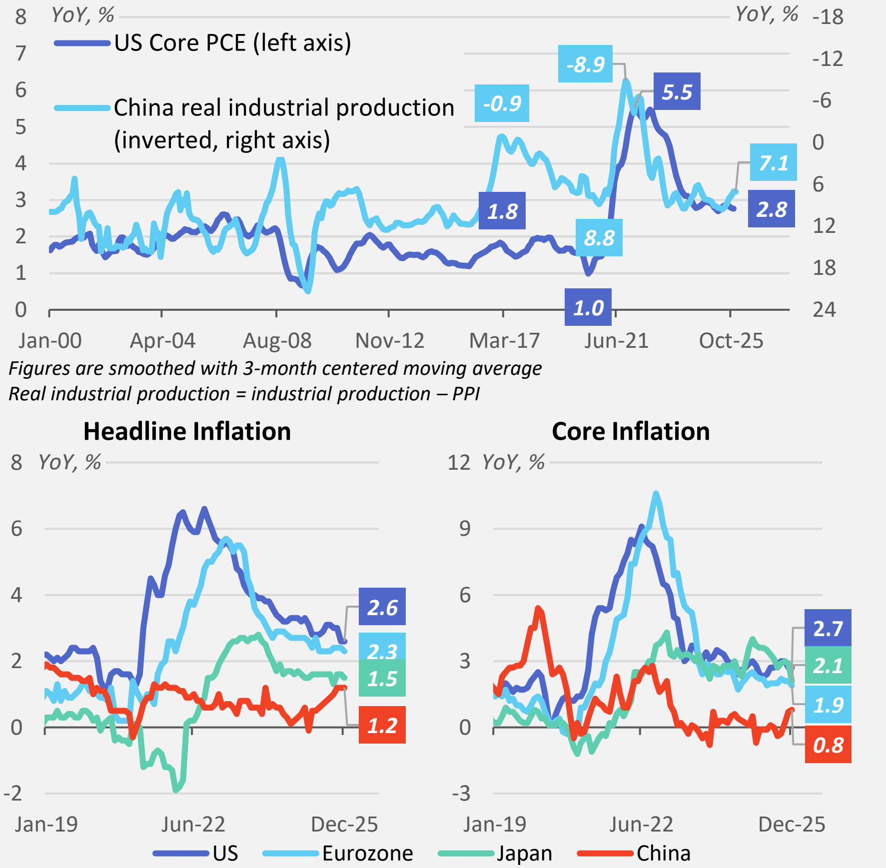
Source: Bloomberg

Inflation is alive, just not exploding

- Inflated asset prices are creating a positive wealth effect, significantly increasing the wealth of high-income individuals. In turn, this keeps demand afloat and contributes to persistent core inflation. **As long as asset prices soar, demand-pull inflation can be maintained.**
- On the other hand, tariffs represent a direct source of cost-push inflation. They have had little effect on inflation since being enforced in April 2025, but this is partly because businesses ramped up inventories beforehand. As those inventories deplete, we expect tariffs to gradually affect inflation in 2026.
- **In contrast, China is a major disinflationary force.** For years, it has exported disinflation due to its industrial overcapacity and weak domestic demand (more on Part 3).
- The final factor is the Fed. If the US labor market continues to slow down, the Fed may proceed with interest rate cuts (with other central banks following suit), **providing an additional boost to asset prices** (more on Part 2).

Chart 1.6

While demand pushes core inflation, China has been keeping inflation tone down



Source: Bloomberg, BCA Economic Research calculations

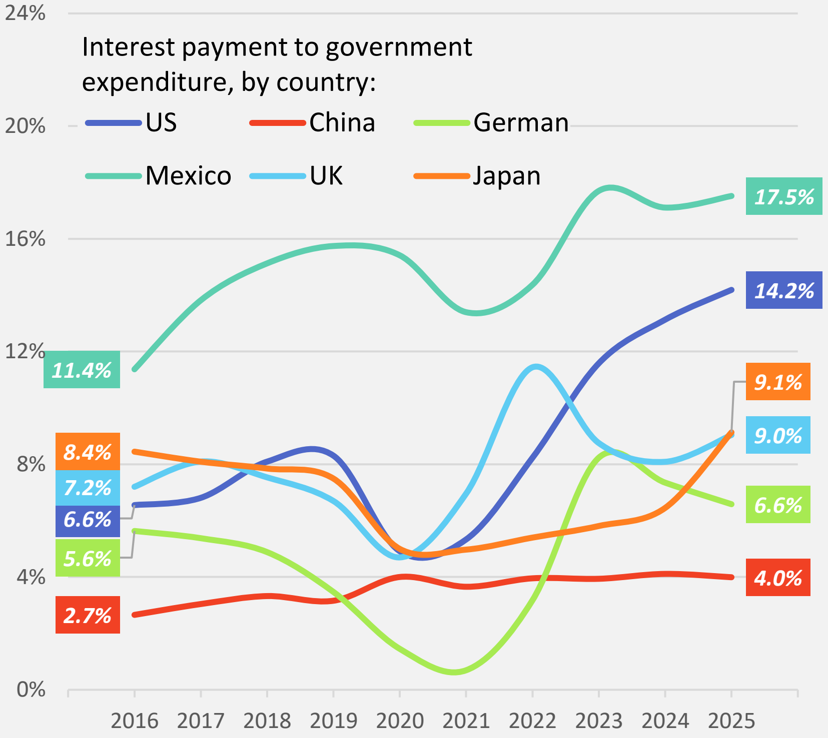
Too indebted to tighten

- Governments around the world are entering a period of constrained fiscal space. The primary driver is the ballooning cost of debt service. Legacy borrowing from the COVID era, compounded by high interest rates, is causing interest expenses to grow faster than the government budgets.

- However, the need for fiscal consolidation is colliding with political reality. **Governments might turn to creative policies, both on the domestic front (micromanaging the economy, forcing wealth transfers) and the international front (trade wars or even real wars)**.

- **Consequently, fiscal tightening is politically unpopular.** Instead of narrowing the budget gap, the more probable scenario is a deepening fiscal deficit, funded by issuing more sovereign bonds. The inevitable consequence will be a rise in long-term bond yields.

Chart 1.7
Interest expenses are rising throughout the world



Source: Bloomberg, BCA Economic Research calculations
Data for 2025 is the latest available

High for longer and the duration bet

- As a direct result of persistent inflation and higher budget deficits, the logical trajectory for long-term government bond yields is upward. And that's not the only risk.

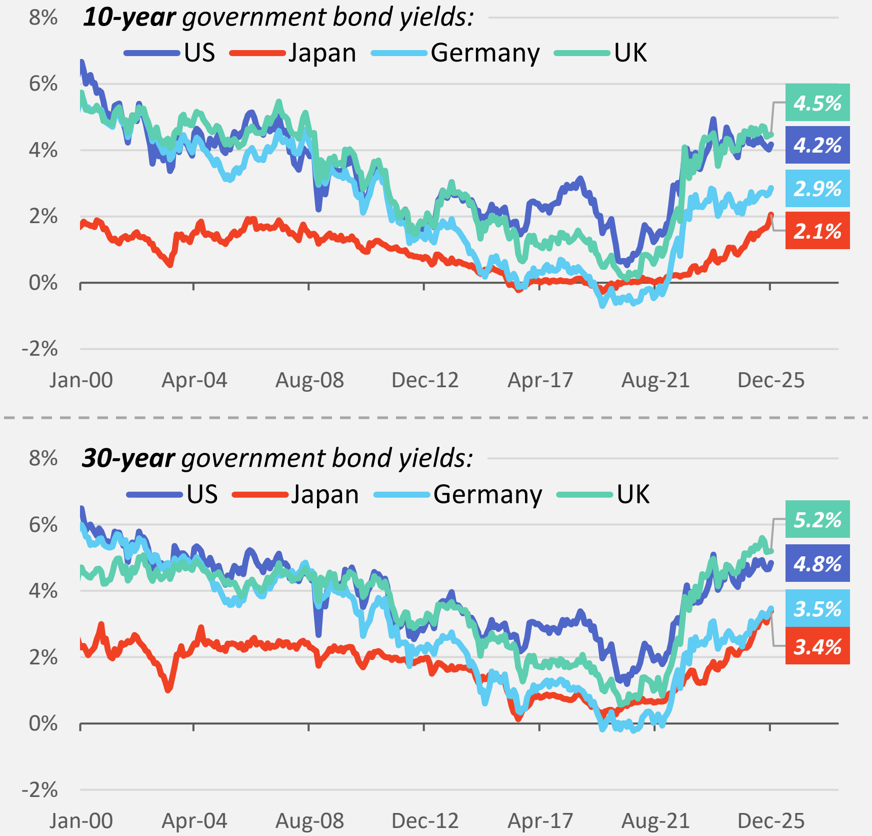
- **Yields on long-term Japanese Government Bonds (JGBs) are increasing fast, adding another layer of risk.** The new prime minister's expansive fiscal policy – a tax cut pledge – is spooking investors, while the Bank of Japan's (BoJ) decision to end its ultra-low-rate policy has added fuel to the fire.

- For decades, Japan has been the center of the world's biggest carry trade, where investors borrowed yen at virtually zero cost to invest in higher-yielding overseas assets. Now, as the yield differential shrinks, a global repricing of risk is underway. The unwinding of the yen carry trade carries a powerful ripple through global yields, reducing bonds demand in the other major economies.

- **This situation has led governments to rotate their issuance of bonds to shorter tenors.** However, this is like betting that interest rates will decrease and revenues will improve, as there is refinancing risk if that does not happen. One more thing, a flattening yield curve (due to the increase in supply at shorter tenors) can put pressure on economic growth and banking margins.

Chart 1.8

Rising yields of JGBs push global yields higher



Source: Bloomberg

Military Keynesianism

- The fragile geopolitical landscape of 2025 deteriorated sharply at the start of 2026. The flashpoint was the US-led intervention in Venezuela, a key energy supplier for China. This move can be interpreted not as an isolated conflict, but as part of the broader US-China strategic competition. This is just one of many active geopolitical hotspots.

- **The immediate consequence of heightened tension is a global pivot to 'Military Keynesianism',** with countries like the EU ramping up defense spending. While this can provide a short-term GDP boost, it collides with governments' fiscal straitjackets, further bloating already-strained budgets.

- **The inevitable outcome is another upward force on long-term yields.** To fund defense spending, governments must issue more debt, adding to the supply glut in the bond market. Consequently, the term premium will expand, as it must now compensate not only for fiscal risk but also for geopolitical risk.

- Another risk is that this uncertainty may reduce the appetite of businesses for expansion, leading to indirect impacts on growth and the fiscal revenue. Not to mention if it is followed by a strengthening USD (Chart 1.10), which means that government spending from some countries could become more expensive.

Chart 1.9

Geopolitical hotspots around the world

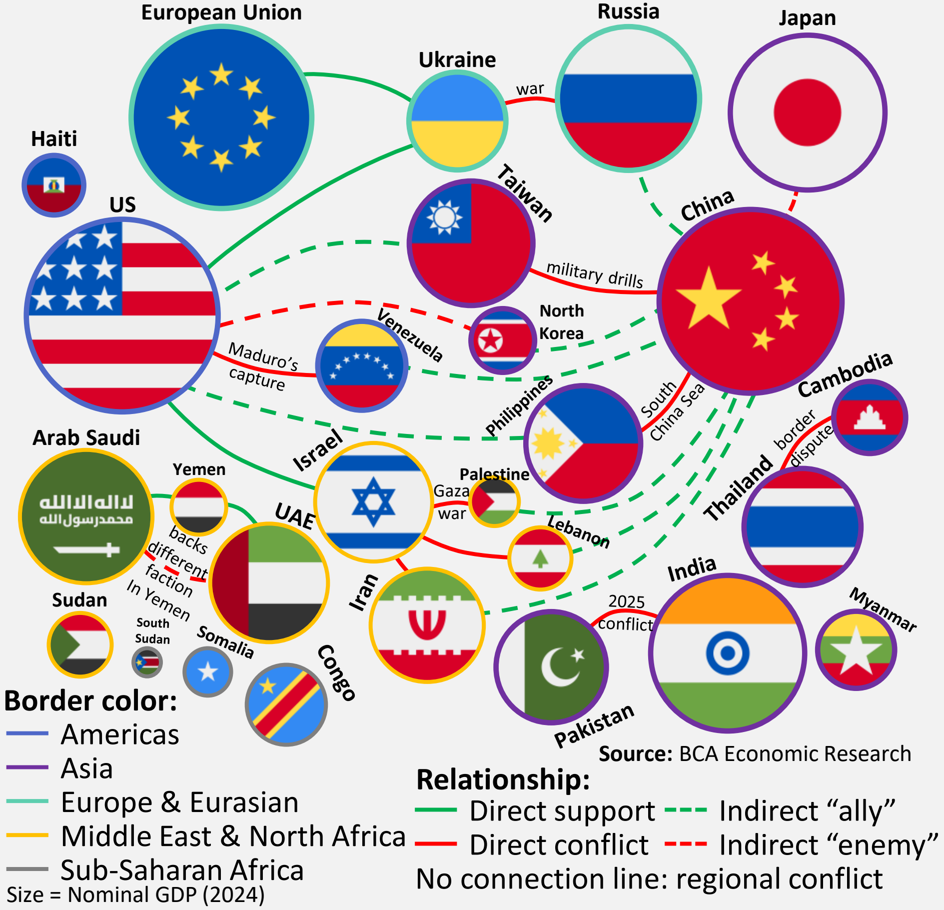
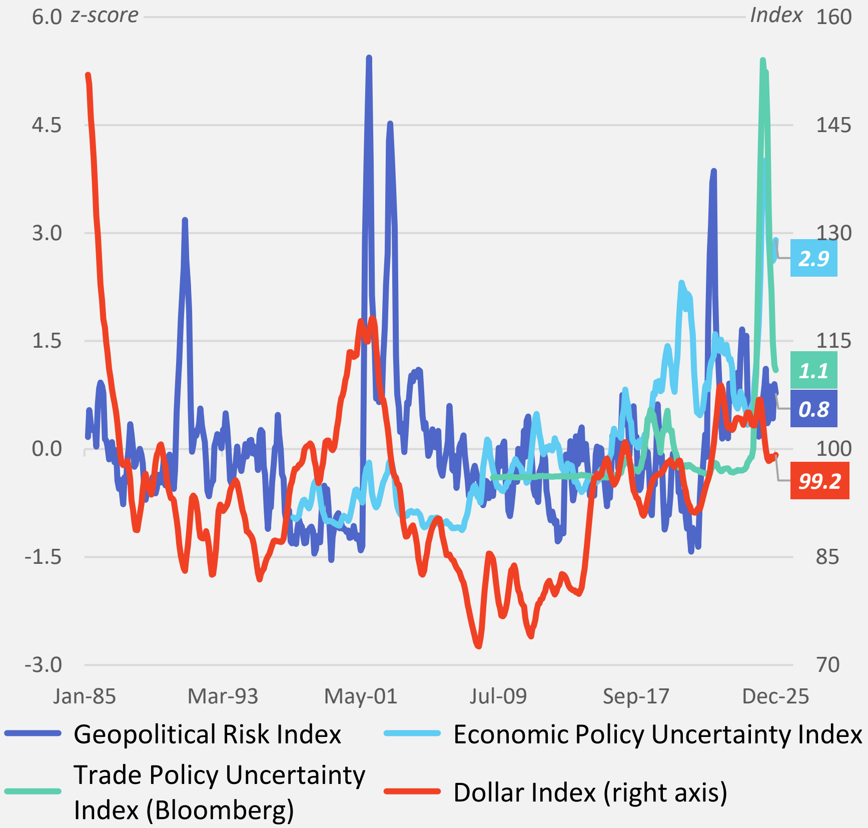


Chart 1.10

The dollar usually strengthens in times of higher uncertainty



Source: Bloomberg, BCA Economic Research calculations

"Things fall apart; the centre cannot hold;
Mere anarchy is loosed upon the world,
The blood-dimmed tide is loosed, and everywhere
The ceremony of innocence is drowned."

— William Butler Yeats (*The Second Coming*)

Part 2:
US & Rates
The K-Shaped Divide

Credit: Jon Tyson / Unsplash

Chapter Summary

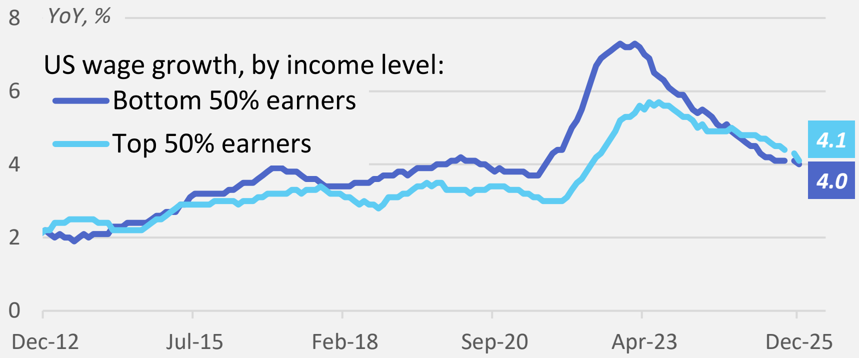
- The K-shaped recovery in the US is intensifying, with wage gains for top earners outpacing those for lower-income households, exacerbating income disparity. This growing divide is further fueled by persistent inflation, which disproportionately impacts lower-income families, while the upper class has so far been protected by the wealth effect from rising paper asset prices.
- The recent tax cuts from the One Big Beautiful Bill Act (OBBBA) have led to concerns about a deepening budget deficit as the revenue from tariffs fails to offset the fiscal costs. As political pressures mount, particularly with Trump's declining approval ratings, there may be a push for even larger tax cuts, complicating the fiscal landscape.
- Although the Fed is likely to lower its short-term policy rate, US long-term bond yields are expected to remain high, and this is strongly correlated with lending rates such as mortgages. The government’s efforts to bypass this correlation through supply-side policies (such as capping lending rates or buying mortgage bonds) will still be constrained by the narrative of demand and the risk preferences of banks.

The deepening bifurcation

- **On the US consumer side, the K-shaped recovery that began after the pandemic is deepening.** A key feature is the reversal of a decade-long trend: wage gains for top earners are now outpacing those at the bottom.
- This growing income disparity is amplified by persistent inflation. Lower-income households bear the brunt of rising prices, while the wealthy benefit from financialization (more on Part 4). The recovery in liquidity has fueled asset price inflation, creating a wealth effect that offsets higher consumer prices for the rich, further widening the gap.
- The situation is aggravated by the distributional effects of the OBBBA, as the tax cuts benefit the wealthy while reductions in social spending hurt the poor.
- **This condition creates a more fragile economy** by channeling wealth to the top, starving the real economy of its most potent source of demand: the middle and lower classes.

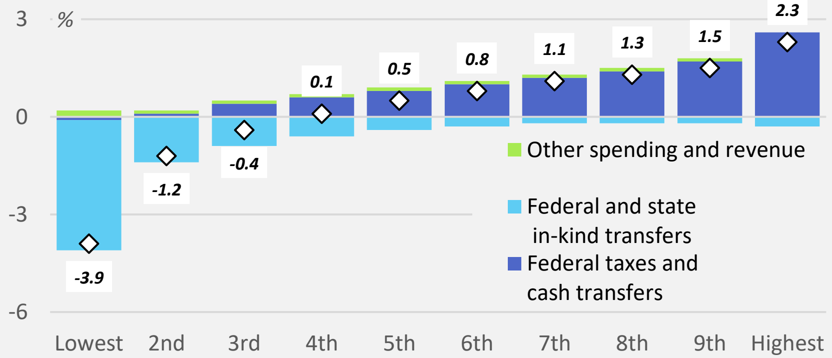
Chart 2.1

Low-income households get negative effect from tax cut policy



Source: US Bureau of Labor Statistics

OBBBA effects to household resource
(average annual change, 2026 to 2034)



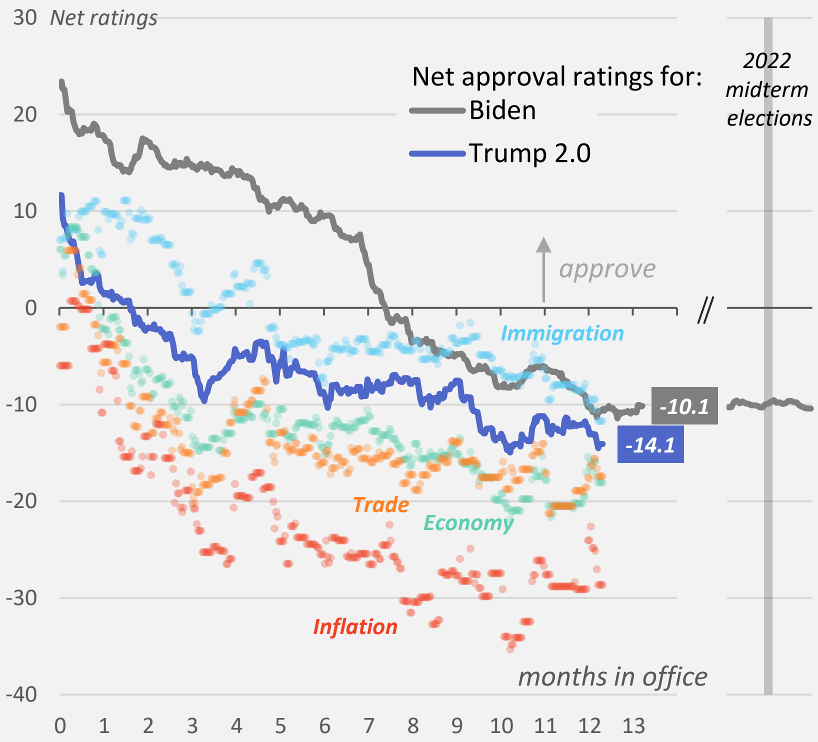
Source: CBO, staff of the Joint Committee on Taxation

Electability at stake

- More tax cuts might be on the way. While tax cuts have been implemented with the One Big Beautiful Bill Act (OBBBA) as the 6th largest tax cut in US history as a share of GDP, recent developments point to a push for even bigger cuts. **A pivot to a more populist approach seems plausible as Trump's approval rating is declining.**
- Trump's approval has been falling amid tensions in US foreign policy – especially around Venezuela and Greenland. However, his handling of immigration is what drags his approval down the most, with images of ICE violence circulating online.
- A higher approval rating is crucial for Trump with the looming mid-term election. If the Democrats win, Trump's power will be limited. Thus, the administration cannot afford unpopular policies.
- However, the US will still try to secure critical commodities, as was the case with Venezuela. Thus, we may still see fluctuating tariff threats, in parallel with some efforts to 'embrace' other regions that could increase global geopolitical risks.
- In the short term, the net effect of this development is positive for the US consumer, propping up aggregate demand. **However, it comes with a risk of a budget deficit.** This is a primary concern for next year, as the revenue generated from tariffs fails to cover the immense fiscal cost of the tax cuts.

Chart 2.2

Trump's approval ratings have been falling since inauguration



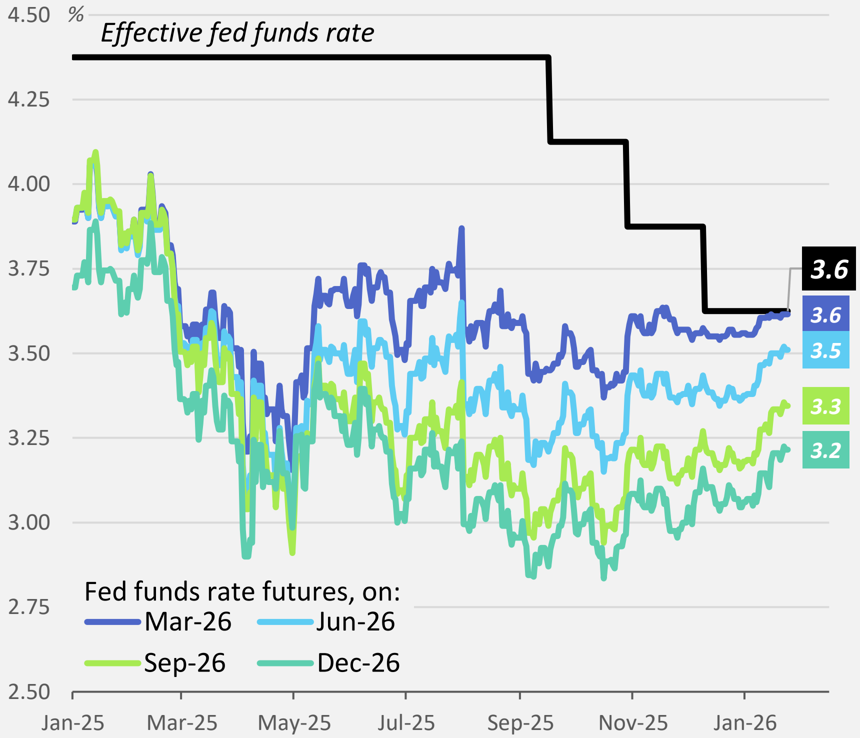
Source: FiveThirtyEight, Nate Silver

The Fed's inevitable but contested path to easing

- 2025 marked a decisive pivot in the Fed's policy. The central bank began an easing cycle, delivering 75 basis points in cuts and sparking other central banks to follow suit.
- **The consensus among policymakers and market participants is that the easing cycle will continue.** The Fed's own projection signals one more cut, while the market bets on one or two more. This is viewed as inevitable – a necessary response to a global slowdown and a softening labor market.
- With the growing risk of a budget deficit, it is no wonder President Trump is pressing Fed Chair Jerome Powell to cut rates. However, even when Trump appoints a new Fed chair, it would be hard to budge the consensus among policymakers with just the chair's single vote.
- However, the Fed faces a classic dilemma. On one hand, the case for fewer cuts is compelling, as inflation remains stubbornly above the 2% target and its projection for US GDP is high (above 2%). On the other hand, the pressure to cut is immense as the labor market shows clear signs of softening.

Chart 2.3

The market expects at least a 25 bps cut next year



Source: Bloomberg, BCA Economic Research calculations

Chart 2.4

The case for an aggressive cut might not be as strong as during the GFC because inflation and unemployment data do not move cohesively as they did during the GFC.

Indicators		2024												2025											
		Q1			Q2			Q3			Q4			Q1			Q2			Q3			Q4		
Inflation	US CPI (% YoY)	3.1	3.2	3.5	3.4	3.3	3.0	2.9	2.5	2.4	2.6	2.7	2.9	3.0	2.8	2.4	2.3	2.4	2.7	2.7	2.9	3.0		2.7	2.7
	Core PCE (% YoY)	3.2	3.1	3.1	3.0	2.8	2.8	2.8	2.9	2.8	3.0	3.0	3.0	2.8	3.0	2.7	2.6	2.8	2.8	2.9	2.9	2.8	2.7	2.8	
	PPI (% YoY)	-0.8	1.0	1.8	1.9	2.2	1.7	1.8	0.3	-0.8	0.9	2.0	2.8	3.1	2.1	0.8	0.3	1.2	1.9	1.9	1.9	3.1	2.5	2.9	
	Core PPI (% YoY)	2.3	2.3	2.2	2.3	2.2	2.3	2.2	2.4	2.4	2.4	2.5	2.6	2.4	2.3	2.3	2.5	2.6	2.7	2.8	2.9	2.9	3.2	3.2	
Job market	US Unemployment (%)	3.8	3.8	3.8	3.8	3.8	4.0	4.0	4.0	4.2	4.2	4.2	4.1	4.1	4.1	4.1	4.1	4.1	4.2	4.2	4.2	4.3	4.3	4.3	4.3
	NFP (th change)	119	222	246	118	193	87	88	71	240	44	261	323	111	102	120	158	19	-13	72	-26	108	-173	56	50
	Cont. jobless claims (Mn)	2.1	2.1	1.9	1.7	1.7	1.8	1.9	1.7	1.6	1.6	1.9	2.2	2.2	2.2	2.0	1.8	1.8	1.9	2.0	1.8	1.7	1.7	2.0	2.2
	Job vacancy (Mn)	8.5	8.4	8.1	7.6	7.9	7.4	7.5	7.6	7.1	7.6	8.0	7.5	7.8	7.5	7.2	7.4	7.7	7.4	7.2	7.2	7.7	7.4	7.1	7.1
	Job hires (Mn)	5.6	5.7	5.5	5.6	5.6	5.1	5.5	5.2	5.5	5.4	5.3	5.4	5.4	5.4	5.4	5.6	5.5	5.3	5.2	5.1	5.4	5.4	5.1	5.1
	Job separation (Mn)	5.4	5.5	5.3	5.4	5.3	5.1	5.4	5.2	5.2	5.3	5.1	5.1	5.3	5.3	5.2	5.3	5.2	5.3	5.2	5.1	5.3	5.1	5.1	5.1
	Wage growth (% YoY)	5.3	5.3	6.0	6.0	6.0	5.4	5.4	5.4	4.9	4.9	4.9	4.5	4.5	4.5	4.3	4.3	4.3	3.5	3.5	3.5	3.2	3.2	3.2	3.2

Indicators		2007												2008											
		Q1			Q2			Q3			Q4			Q1			Q2			Q3			Q4		
Inflation	US CPI (% YoY)	2.1	2.4	2.8	2.6	2.7	2.7	2.4	2.0	2.8	3.5	4.3	4.1	4.3	4.0	4.0	3.9	4.2	5.0	5.6	5.4	4.9	3.7	1.1	0.1
	Core PCE (% YoY)	2.5	2.6	2.4	2.2	2.1	2.0	2.0	2.0	2.1	2.2	2.3	2.4	2.2	2.1	2.2	2.1	2.1	2.2	2.2	2.2	2.0	1.6	1.4	1.1
	PPI (% YoY)	0.1	2.4	3.1	3.2	3.9	3.3	4.2	2.3	4.4	6.1	7.3	6.2	7.4	6.5	6.7	6.4	7.3	9.1	9.9	9.7	8.8	5.2	0.4	-0.9
	Core PPI (% YoY)	1.7	1.8	1.6	1.6	1.6	1.7	2.5	2.2	2.0	2.6	2.1	2.0	2.4	2.4	2.5	2.9	3.0	2.9	3.3	3.7	4.0	4.7	4.3	4.5
Job market	US Unemployment (%)	4.4	4.4	4.5	4.5	4.5	4.5	4.5	4.5	4.7	4.7	4.7	4.8	4.8	4.8	5.0	5.0	5.0	5.3	5.3	5.3	6.0	6.0	6.0	6.9
	NFP (th change)	223	86	224	63	148	76	-25	-31	88	76	114	104	-4	-64	-70	-219	-187	-153	-200	-287	-449	-469	-750	-696
	Cont. jobless claims (Mn)	3.0	3.0	2.7	2.5	2.3	2.3	2.4	2.2	2.1	2.3	2.6	3.3	3.3	3.4	3.2	3.0	2.8	2.9	3.2	3.1	3.1	3.5	4.5	5.3
	Job vacancy (Mn)	4.8	4.7	5.0	4.7	4.7	4.9	4.6	4.5	4.7	4.6	4.6	4.5	4.6	4.3	4.2	4.0	4.2	3.8	3.7	3.7	3.2	3.4	3.2	3.1
	Job hires (Mn)	5.4	5.2	5.5	5.4	5.5	5.3	5.2	5.4	5.3	5.4	5.2	5.1	5.1	5.1	4.9	4.9	4.7	4.9	4.6	4.7	4.5	4.5	4.1	4.3
	Job separation (Mn)	5.3	5.2	5.2	5.3	5.3	5.1	5.2	5.4	5.2	5.3	5.1	5.0	5.1	5.2	4.9	5.2	4.9	5.1	4.8	5.0	4.9	5.0	4.8	4.9
	Wage growth (% YoY)	4.0	4.0	4.4	4.4	4.4	4.1	4.1	4.1	4.3	4.3	4.3	3.9	3.9	3.9	2.6	2.6	2.6	2.8	2.8	2.8	3.4	3.4	3.4	3.5

Source: Bloomberg

Green indicates improvement, red indicates worsening

“How did you go bankrupt?” Bill asked. “Two ways,” Mike said. “Gradually, then suddenly.”

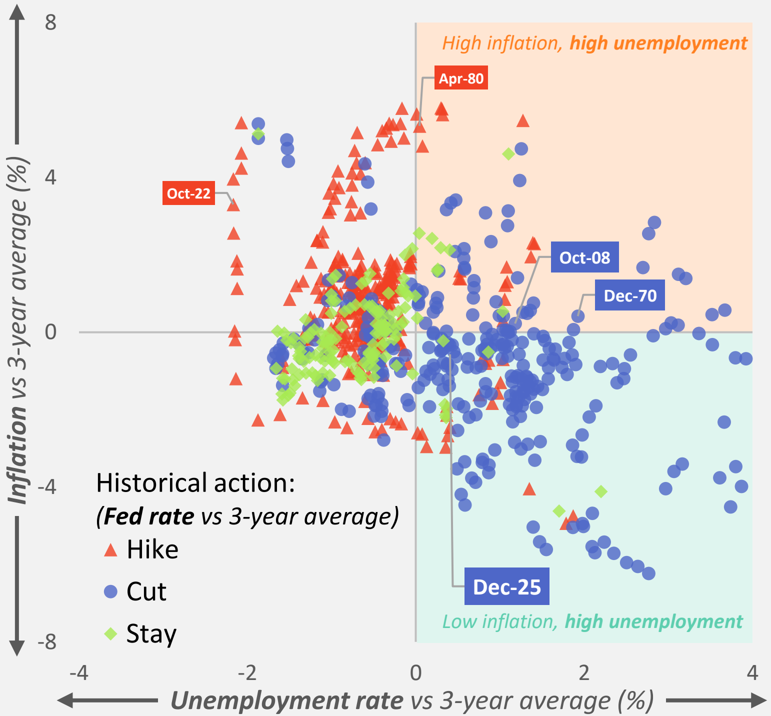
— Ernest Hemingway (*The Sun Also Rises*)

Historical precedent favors a pro-employment bias

- When faced with the classic dilemma of rising inflation and rising unemployment, **historical precedent suggests the Fed is more sensitive to unemployment.** Historically, a higher unemployment rate prompts the Fed to cut rates. Even when both are high, the typical course of action has been monetary easing.
- The 2008 Global Financial Crisis is a key case study: with CPI above 5%, a fast-rising unemployment rate prompted the Fed to cut rates. Conversely, the Fed only hiked rates into rising unemployment when inflation was exceptionally high, as in the early 1980s (over 13%). **Thus, the current situation leans toward a rate cut.**
- This historic bias is rooted in an assessment of asymmetric risks. Allowing unemployment to spiral can trigger a deep recession, a risk perceived as far greater than letting inflation run moderately above target in the short term.

Chart 2.5

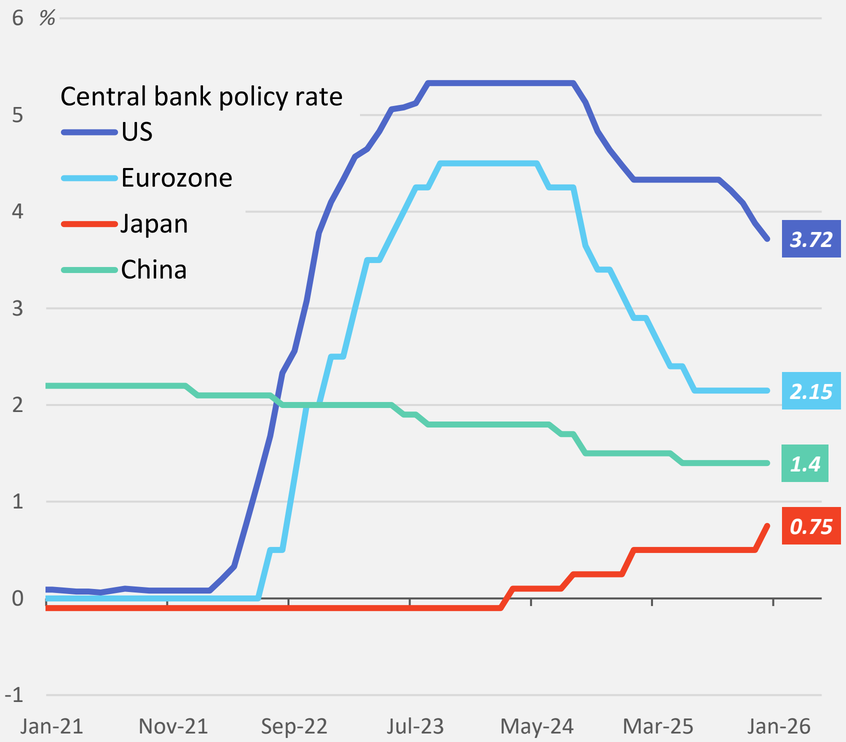
The current condition has a higher cut probability



Source: Bloomberg, BCA Economic Research calculations

Chart 2.6

The Fed cut might be followed by other central banks, both developed and developing countries, except the Bank of Japan



Source: Bloomberg, BCA Economic Research calculations

To every action there is always opposed an equal reaction: or the mutual actions of two bodies upon each other are always equal, and directed to contrary parts.

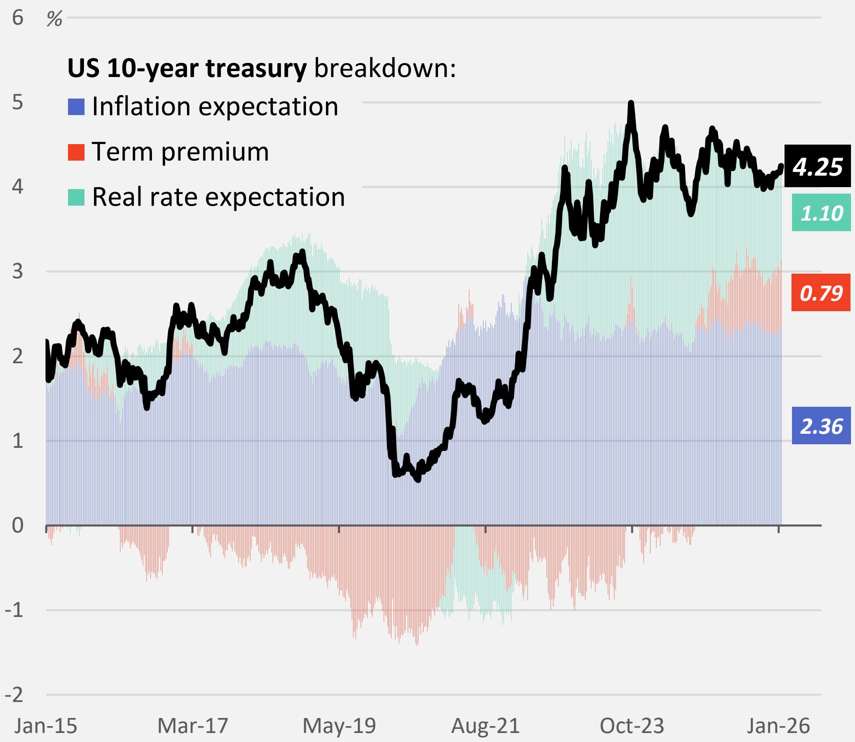
— Isaac Newton (*Principia*)

Their yields, but everyone's problem

- Although the Fed will lower the short-term policy rate, **it is unlikely to translate into a decline in medium- and long-term bond yields**.
- First, persistent supply-side risks are keeping inflation expectations elevated. Second, **the term premium** (the extra yield investors demand to compensate for risk) **is being repriced higher**. This is a direct consequence of growing concerns about fiscal deficits and political uncertainty.
- Strikingly, this is happening while the real rate, a proxy for long-term trend growth, is declining. This signals that the market perceives a weakening real economy with impaired growth potential. As the main anchor of long-term yields, this trend also affects long-term yields worldwide.
- The concern over 'sell America' (following Trump's actions regarding Greenland) has had a limited impact on yields. The large-scale unloading of US Treasuries is unlikely because the 'cost' of doing so for countries holding them is also significant.
- Due to the strong correlation between long-term bond yields and lending rates, the US government is attempting to bypass market mechanisms by putting a cap on lending rates and buying mortgage bonds. However, the effectiveness of this supply-side policy is indeed limited, given the issues related to demand and loan risk. Additionally, there is a risk of a negative wealth effect if asset prices, such as homes, are artificially forced to decline.

Chart 2.7

The term premium is pushing UST higher



Source: Bloomberg, BCA Economic Research calculations

Part 3:
China & Commodity
Challenging Rebalancing

Chapter Summary

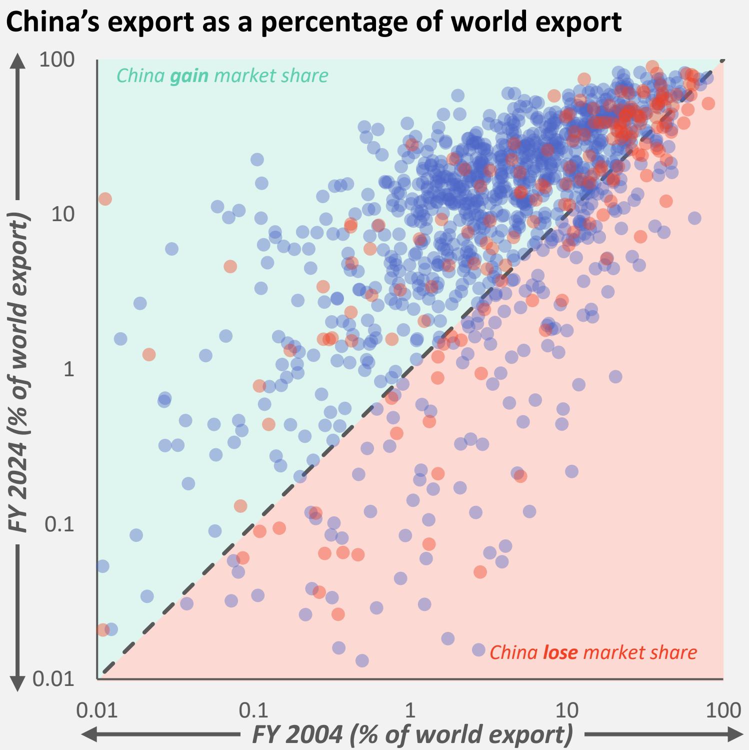
- China’s economy is sustained not by efficiency but by massive, state-supported production that has led to the rise of unprofitable “zombie companies.” This vast overcapacity creates a major disinflationary force globally as China exports goods at low prices.
- China is facing a structural crisis, including a declining population and weak consumer confidence, which fundamentally constrains its long-term growth potential. Unable to stimulate domestic demand, the government is forced to double down on external markets, pushing trade surpluses and outward investment higher.
- China’s continued industrial output will create sustained demand for commodities, setting up a strong outlook for metals that are crucial for the digital and green transitions. The outlook for other commodities is mixed, as the energy market appears bearish while agriculture faces significant risks from worsening weather patterns.

One giant factory

- In recent decades, **China has transformed itself into the world's manufacturing hub**, with dominance not just in a few products, but across the board. This transformation has made the world rely on China, not just for finished goods but for intermediate goods as well.
- **This was made possible by a state-led strategy to boost investment** through programs like 'Made in China 2025.' While it has an inexpensive labor force, China did not stop at labor-intensive sectors but also expanded into capital-intensive ones.

Chart 3.1

China's market share is increasing in a lot of products



Each circle represents a HS 4-digit code

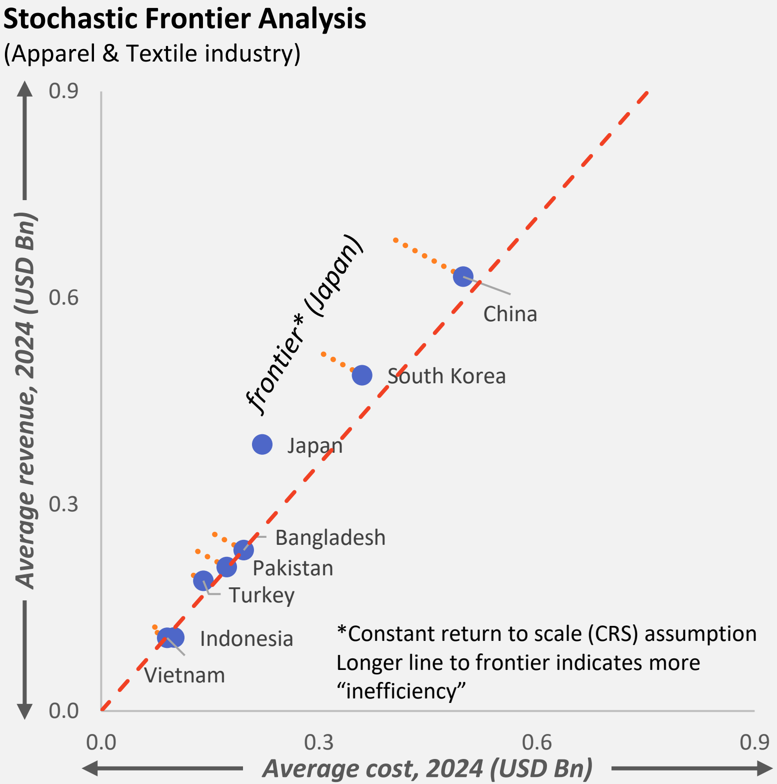
Red: labor intensive, blue: capital intensive

Source: International Trade Center, BCA Economic Research calculations

One giant (*inefficient*) factory

- While China continues its dominance in the global market, its advantage lies not in efficiency but in a massive, state-supported scale of production. As Frontier Analysis suggests, Chinese companies are often less efficient than their global peers. **This means they operate with structurally low margins.**
- Under normal conditions, low margins would force companies to innovate or become more productive. In China, however, **government stimulus keeps these financially weak companies afloat**, allowing them to produce even at a loss and leading to the rise of 'zombie companies.'
- Combined with weak domestic demand, **this massive overcapacity creates hungry competitors who engage in predatory pricing**, exporting goods at low prices. While this is a major disinflationary force, this practice undercuts manufacturing in other countries.

Chart 3.2
China is the most inefficient producer in the textile industry compared to peers



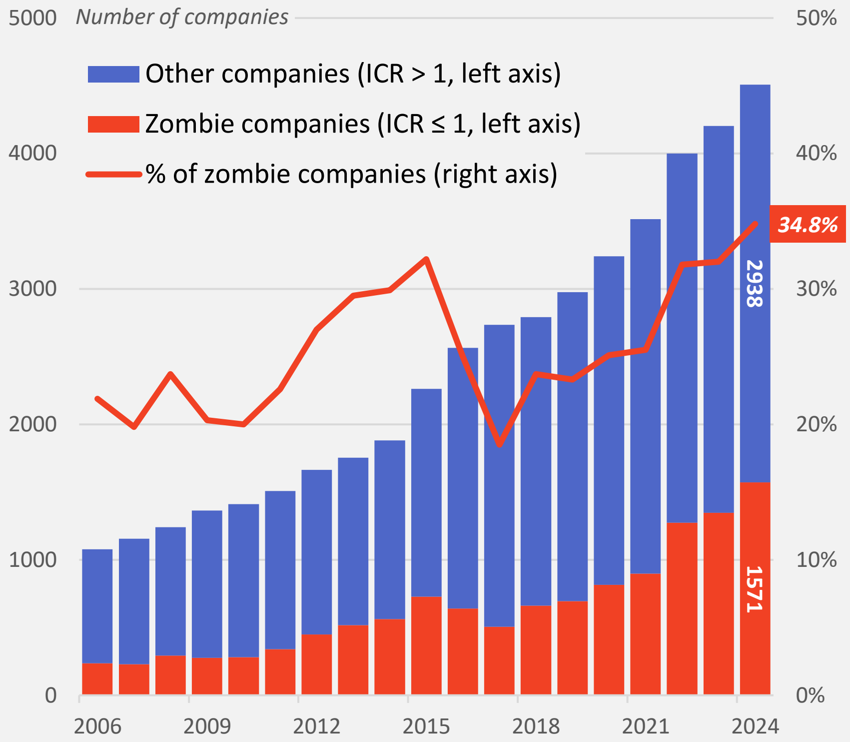
Source: Bloomberg, BCA Economic Research calculations

The rise of zombies

- As discussed, government stimulus keeps many companies alive. **This creates intense domestic competition, forcing companies to survive by lowering prices and maintaining production volume.** The phenomenon is so massive that the Chinese have a term for this self-defeating competition: 'nèi juǎn' (内卷).
- This intense competition, combined with government stimulus, creates a perfect environment for 'zombie companies': unproductive firms that are technically insolvent but kept alive by state support.
- The rise of 'zombie companies' is an ominous sign for China's future growth and **echoes the trend that killed Japan's economy after its 1980s boom**. Following its asset bubble collapse, Japan kept companies alive with never-ending loans, turning them into 'zombies' and forcing the country into a "Lost Decade" of stagnation.

Chart 3.3

Zombie companies in China are rising



Source: Bloomberg, BCA Economic Research calculations

Publicly traded companies in China whose age is 5 years old or more only

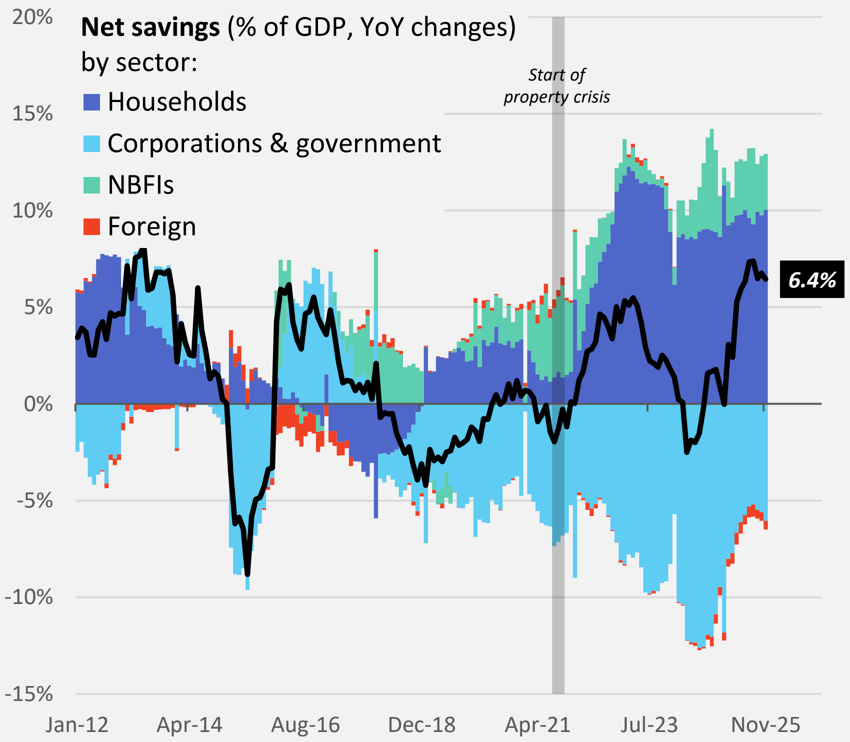
ICR: interest coverage ratio (EBIT/interest expense)

A bad time to save

- **The core problem in China is extremely weak domestic demand.** While not a new issue, the property crisis that began in mid-2021 quickly supercharged the problem. It sparked a huge imbalance between supply and demand as households aggressively shifted to being net savers, hitting consumer confidence hard.
- Without this collapse in domestic demand, China's overcapacity would be more manageable. However, stimulating consumption has proven to be a trillion-dollar problem. For decades, China has been fostering an investment-driven growth model. **Shifting this model to consumption-driven is not easy.**
- The government rolled out consumer stimulus in 2025, but it proved ineffective. It now plans to make consumption one of the focuses in the new Five-Year Plan (2026-2030), to be approved in March 2026.

Chart 3.4

Households have been building up savings since the property crisis



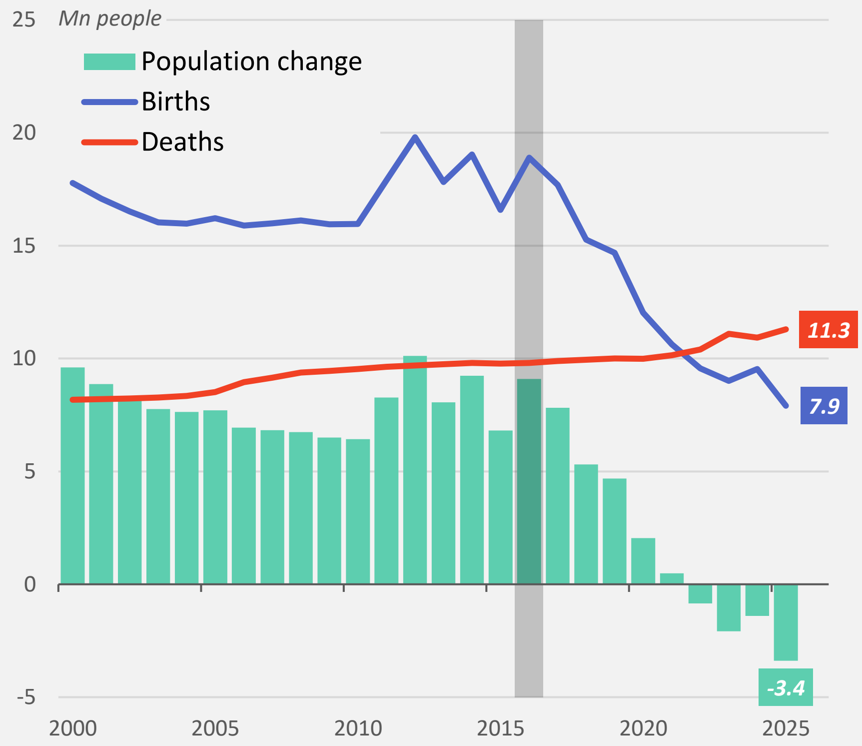
Source: People's Bank of China, BCA Economic Research calculations

Declining population

- China's consumption problem does not stop at weak confidence. **A far more structural crisis is unfolding: a demographic decline**. China's population has been declining for four consecutive years, which will fundamentally constrain China's growth potential for decades to come.
- The government has recognized this threat and taken some steps. They abandoned the one-child policy in 2016, rolling out incentives to encourage childbirth, and recently increased value-added taxes on contraception.
- However, these policies are not that effective. For Chinese millennials and Gen Z, having children is much more of an economic matter. A bleak economic outlook, high unemployment, the exorbitant cost of raising children, and a competitive society make raising children a daunting financial burden.
- There are no short-term solutions to this problem. The demographic and confidence problems might **force China to rely on external markets** to absorb its industrial overcapacity.

Chart 3.5

China's population declines as the birth rate falls



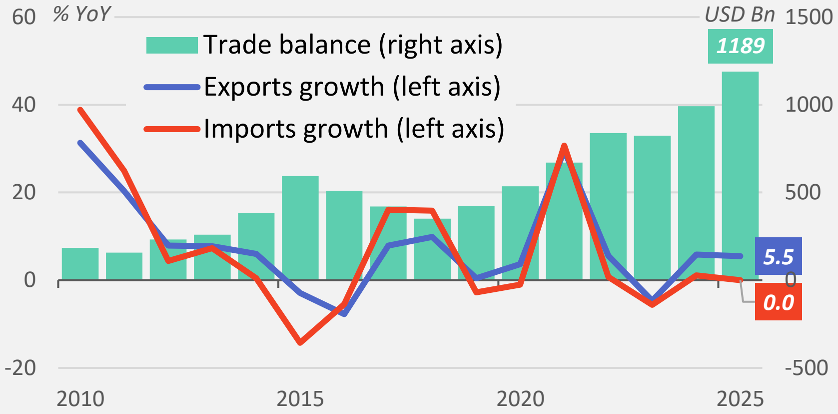
Source: Bloomberg, National Bureau of Statistics of China

Doubling down on external markets

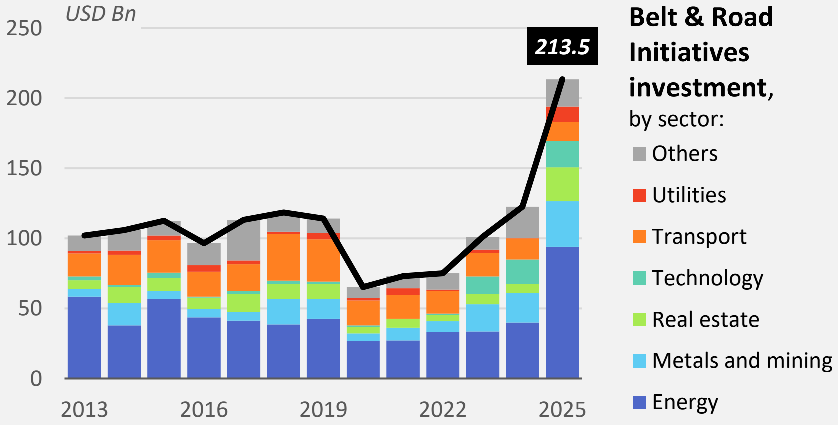
- Considering its weak domestic demand and declining population, **the logical course of action is to maintain growth by pushing harder on the external market.** If the domestic market won't absorb China's vast output, the rest of the world must. That is, if China wants to maintain high short-term growth.
- China has at least two main strategies for this. **First is to push its trade balance** to another record high. While its exports remain robust, imports have flatlined, suggesting the Chinese have little appetite for foreign goods. It's no wonder the trade balance surpassed US$1 trillion in 2025.
- **China's second strategy is to boost outward investment** by re-energizing its Belt & Road Initiative (BRI). BRI investment nearly doubled in 2025 as China asserts its dominance in developing economies.

Chart 3.6

China's trade surplus and investment grow increasingly fast



Source: Bloomberg



Source: Griffith Asia Institute, Green Finance & Development Center, FISF Fudan

The year of commodities, and the EM pulse

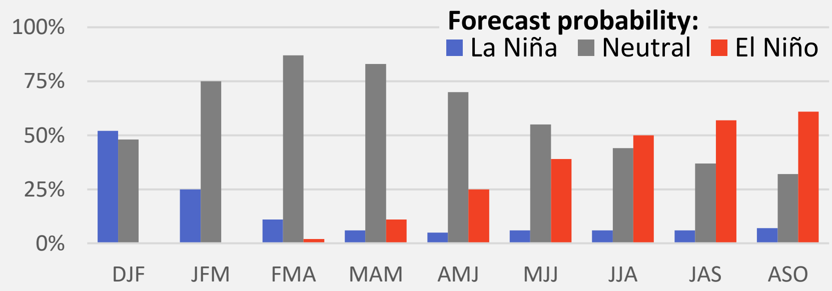
- The year 2026 could be a story about commodities, serving as a catalyst for emerging markets that are strongly correlated with them. China's continued production will create sustained demand, lifting demand for metals and energy. **Energy prices, however, have a bearish outlook**, which comes from OPEC+'s steady output setting the oil market for a surplus.
- Meanwhile, metals have a different outlook. **Those crucial for the digital and green transitions should see continued strength**. The efforts of major countries to secure critical minerals for their own benefit will continue to drive demand for these commodities. Gold deserves a special mention, as current geopolitical conditions continue to drive its price up.
- On the other hand, the **primary risk for agricultural commodities is worsening weather.** Forecasts indicate a higher probability of an El Niño starting in mid-2026, leading to droughts in some regions and floods in others.

Chart 3.7

Metals and agricultural commodities have a bullish outlook

	Commodity	Spot	Futures market	Analyst consensus
Energy	Brent crude oil (USD/bbl)	64.1	↓	↓
	Gasoil (USD/MT)	671	↓	↓
	Natural gas (USD/MMBTU)	4.7	↓	↓
	Coal (USD/T)	110	↑	↑
Agriculture	Corn (c/bsh)	426	↑	↑
	Soybeans (c/bsh)	1061	↑	↑
	Wheat (c/bsh)	512	↑	↑
	Sugar (c/lb)	14.8	↓	↑
Metals	Copper (USD/MT)	12754	↑	↓
	Aluminum (USD/MT)	3108	↑	↓
	Gold (USD/oz)	4872	↓	↑
	Nickel (USD/MT)	17614	↑	↑

Source: Bloomberg (as of January 21, 2026)



Source: National Oceanic and Atmospheric Administration

Part 4:
Financialization
The Cost of a Reversal

Chapter Summary

- A rate cut is expected to push the stock market higher, as the market is now hyper-sensitive to Fed rate expectations, a phenomenon that did not exist until recently. This disconnection from fundamental value is not confined to stocks but is also seen in other assets, like gold.
- Financial markets have dramatically outpaced the real economy. Even within the real economy, CAPEX is concentrated in AI, while companies are increasingly favoring share buybacks over long-term investment.
- This condition is unlikely to persist. History shows that such extreme valuations result in low long-term returns. The rebalancing process need not be a sudden ‘pop’ but could be a prolonged stagnation. The end result, however, is clear: capital will eventually return to the real economy, likely at the expense of the financial market (with the risk of a negative wealth effect).

The bypass economy

- Here is the catch: **while the Fed is embarking on an easing cycle, its actions may fail to stimulate the real economy**. There is a risk that the liquidity injected by the Fed will not flow into new investment and jobs, but will instead flow into financial assets, fueling a stock market rally detached from economic fundamentals.

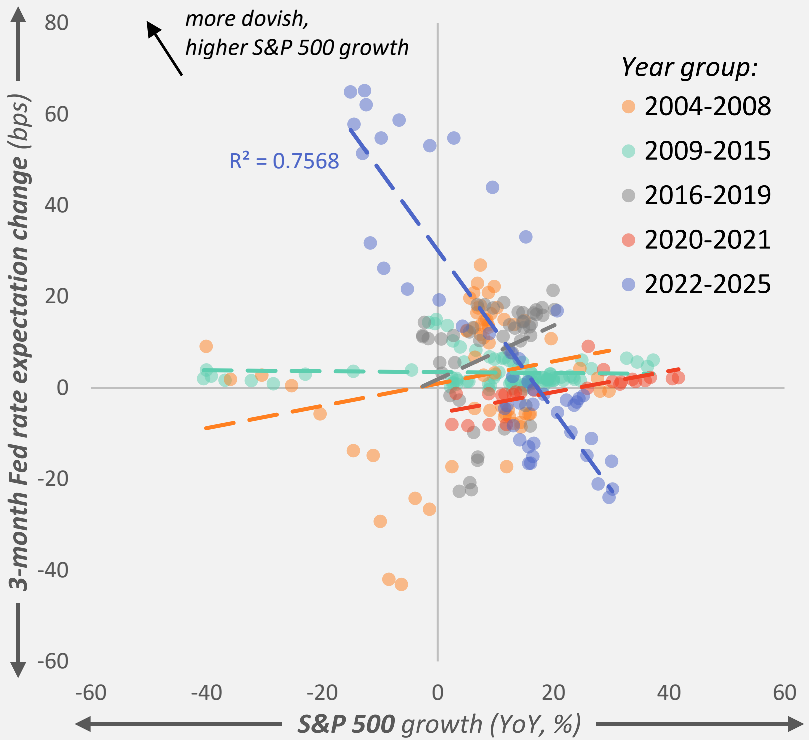
- There has been a clear shift in market behavior. The market is now hyper-sensitive to Fed policy expectations. This is a stark contrast to previous cycles, where a broader range of factors drove performance.

- This shift is a response to an environment where the return on real-world investment is perceived as low due to high long-term capital costs. Capital is following the path of least resistance into financial markets, **creating a vicious cycle where the real economy is bypassed**. As the real sector weakens, more fiscal stimulus is needed, but some of this stimulus will flow back into paper assets.

- Another reason is the sharp increase in digitalization in financial markets during the pandemic. The ease with which people can enter the market (combined fiscal and monetary stimulus) has created additional demand for paper assets, generating more attractive returns at least until this trend normalizes.

Chart 4.1

The market is increasingly reliant on the Fed rate expectation



Source: Bloomberg, BCA Economic Research calculations

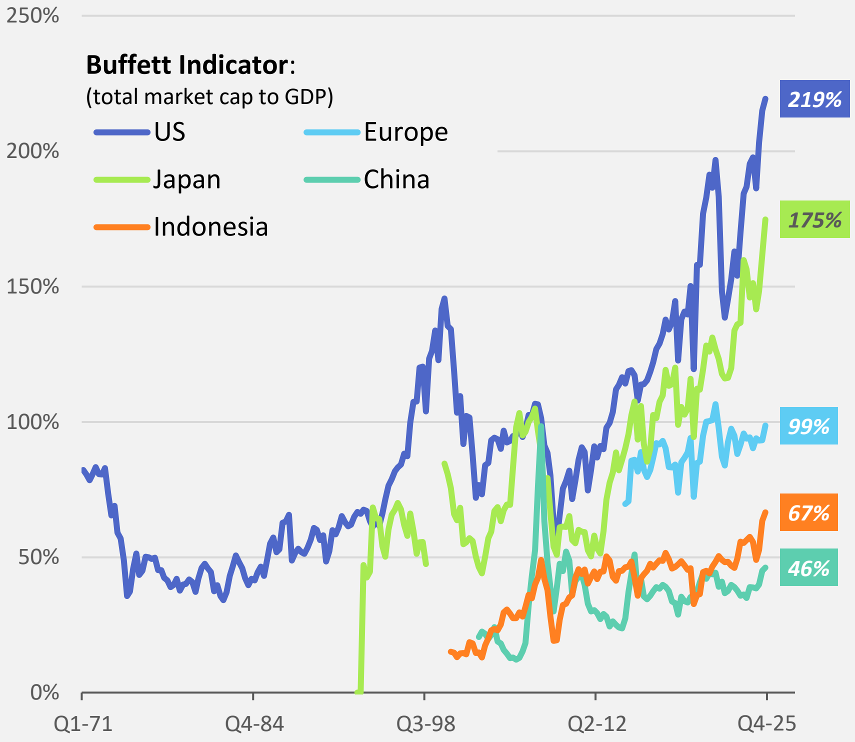
All figures are smoothed with 5-month centered moving average

The great decoupling

- The most telling signal of financialization is the decoupling of asset valuations from real economic output. **The Buffett Indicator – the ratio of total stock market capitalization to GDP – has surged past 200% in the US.** This figure only measured equities and does not account for other inflated asset classes like bonds and crypto.
- While the US is an extreme case, this phenomenon is a global trend. **In many regions, valuations are rising quickly**, driven by accommodative liquidity conditions.
- A high level of the Buffett Indicator shows that markets are pricing in future economic growth that is disconnected from the fundamentals. It creates a fragile foundation in the economy, where paper wealth is built on an increasingly unstable base.

Chart 4.2

The Buffett Indicator in many countries is at an all-time high



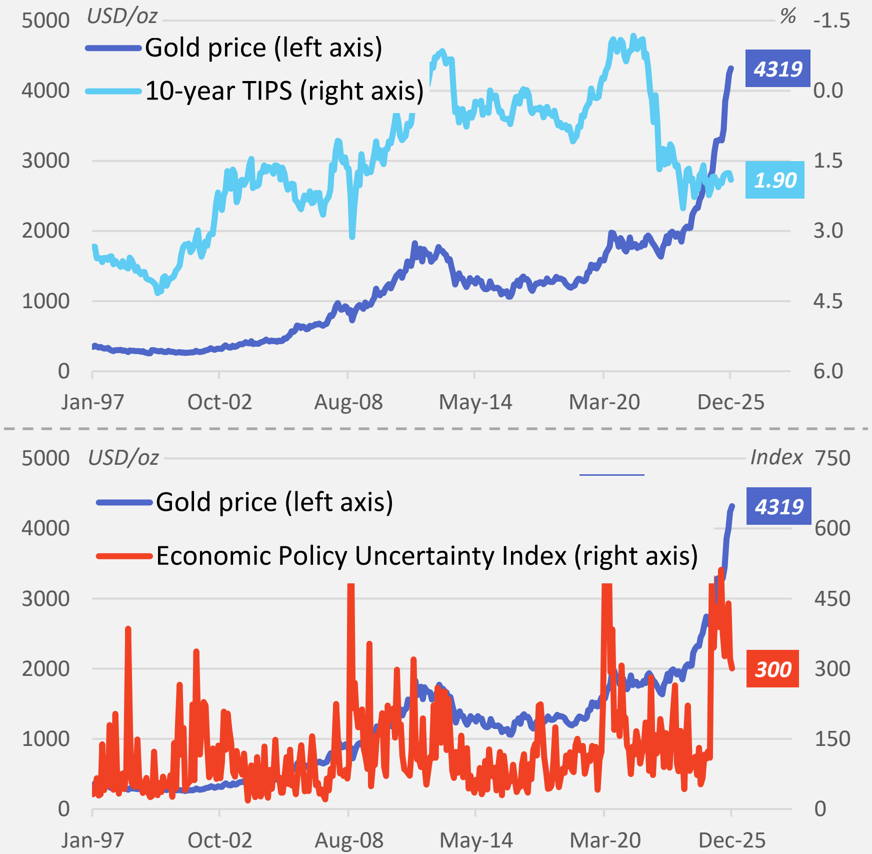
Source: Bloomberg, BCA Economic Research calculations

The hidden fragility of a safe haven

- This decoupling from fundamentals has happened in other assets, **most notably gold**. For decades, gold was a straightforward hedge against inflation. However, this relationship has broken down, and a new playbook is driving gold prices.
- Two powerful drivers are at work. The first is structural: **emerging market central banks**, particularly China's, **are becoming a primary source of demand** as they shift portfolios away from the USD.
- The second is speculative: **gold's price is increasingly sensitive to spikes in geopolitical uncertainty.** In a sense, gold is seen as a hedge against complex risks that are difficult to price. This detachment is a risk in itself, transforming a traditional safe haven into a more speculative instrument.
- The last sentence may represent the risk looming over 2026. What will happen to individual assets and consumption growth when gold prices turn around? **Because, learning from history, a single piece of news from a country selling gold to pay its debts is enough to reverse the trend in gold prices.** Given that we are now in an environment where budget deficits have become a problem for almost all countries, it is tempting to think that this could happen again.

Chart 4.3

Currently, economic uncertainty, not inflation, affects gold prices significantly



Source: Bloomberg, Economic Policy Uncertainty

A(I) tree does not grow to the sky

- On the surface, US corporations appear to be expanding. Headline CAPEX figures remain on an uptrend, projected to surpass 2024's robust level. This suggests broad business confidence.

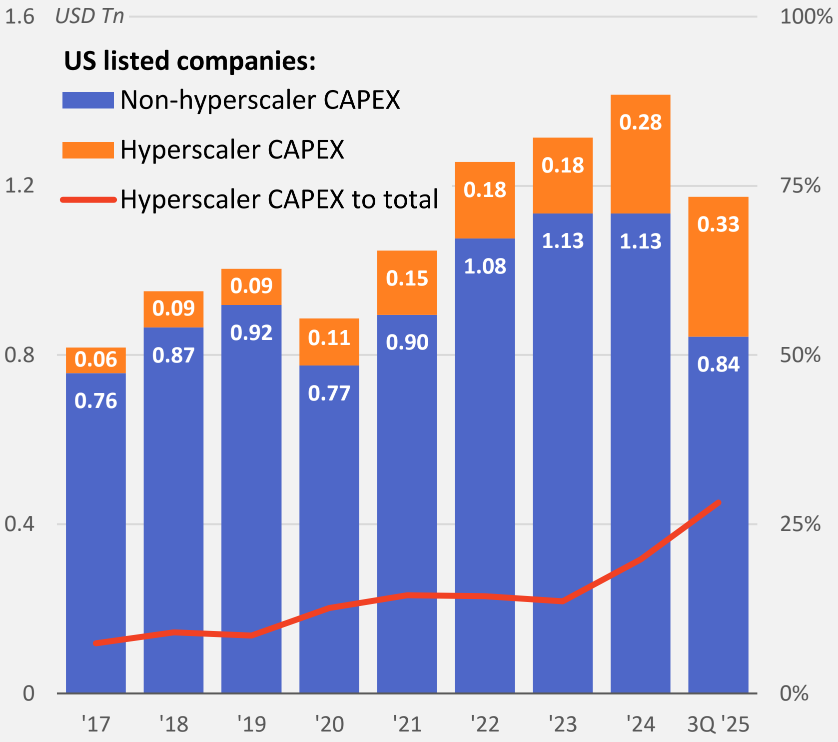
- However, this masks a vulnerable landscape. The CAPEX boom is not broad-based but is **intensely concentrated within a handful of companies at the center of the AI ecosystem**. A disproportionate share of new investment is directed towards AI infrastructure, while investment across the broader economy remains tepid.

- Furthermore, **much of this spending operates in a 'round-tripping' scheme**, where tech companies invest in one another. While this creates impressive headline numbers, it builds a fragile system vulnerable to a single point of failure. The final nail in the AI coffin is related to energy supply, considering that this industry requires a significant amount of energy.

- However, fairly speaking, we see that the AI-related industry has a strong moat (ecosystem, technology), protecting the top three players from competition. AI from China also seems to have yet to reach the level of Western AI. Additionally, the shift from manual labor to AI continues and cannot be stopped.

Chart 4.4

Hyperscaler CAPEX dominates US corporate investment

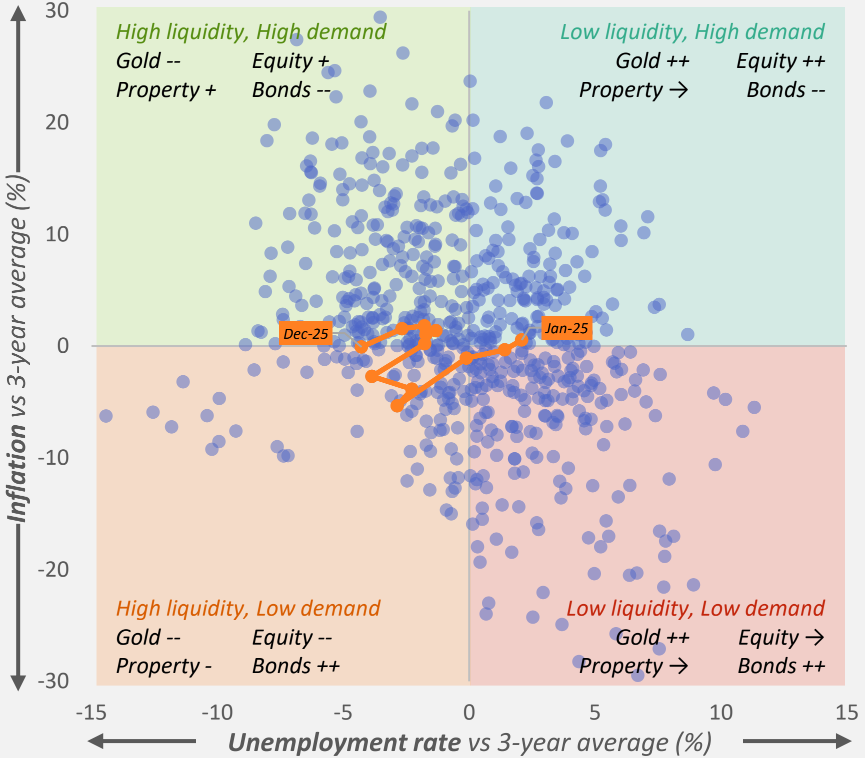


Source: Bloomberg

Hyperscalers include Meta, Amazon, Microsoft, Alphabet, Apple, Oracle, Tesla, CoreWeave

Chart 4.5

The current trend should increasingly lean towards risky assets, as long as there are no black swan events pulling back into the lower-right quadrant.



Compared to average growth 3 years before:

++	high chance of accelerating	--	high chance of slowing
+	small chance of accelerating	-	small chance of slowing
→	no clear trend		

Source: Bloomberg, BCA Economic Research calculations

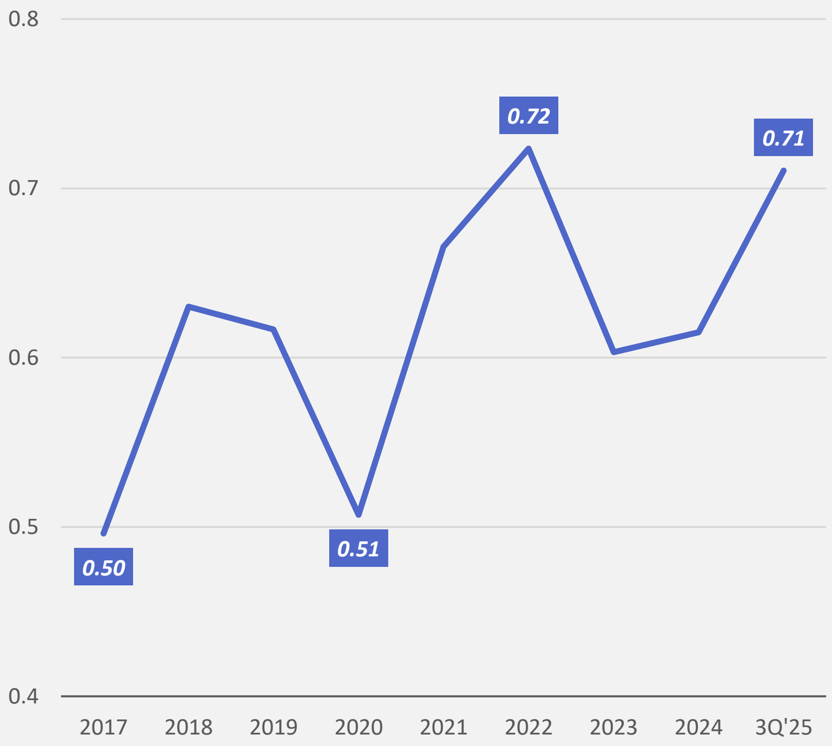
"I wish it need not have happened in my time," said Frodo.
"So do I," said Gandalf, "and so do all who live to see such times. But that is not for them to decide. All we have to decide is what to do with the time that is given us."

— J.R.R Tolkien (*The Fellowship of the Ring*)

Buybacks over building

- Another indicator of financialization is the shifting allocation of corporate cash flow. Faced with a choice between investing in long-term productive capacity or returning cash to shareholders via buybacks, **corporations are increasingly favoring the latter, pushing the buyback-to-CAPEX ratio higher.**
- This shift is a rational response to the current environment. High long-term borrowing costs make investment in the real sector appear risky and low-return. **In contrast, share buybacks offer a predictable, low-risk way to inflate EPS and support stock prices.**
- While beneficial for shareholders in the short-term, this trend has a corrosive long-term effect on the real economy. It perfectly illustrates the 2026 dilemma: even with recovering liquidity, the channel to the real economy narrows while the channel to financial markets widens.

Chart 4.6
Corporations are increasingly favoring buybacks over CAPEX



Source: Bloomberg, BCA Economic Research calculations
Data is from listed companies in US, EU, CH, JP, ID

The inevitable rebalancing: a return to the real world

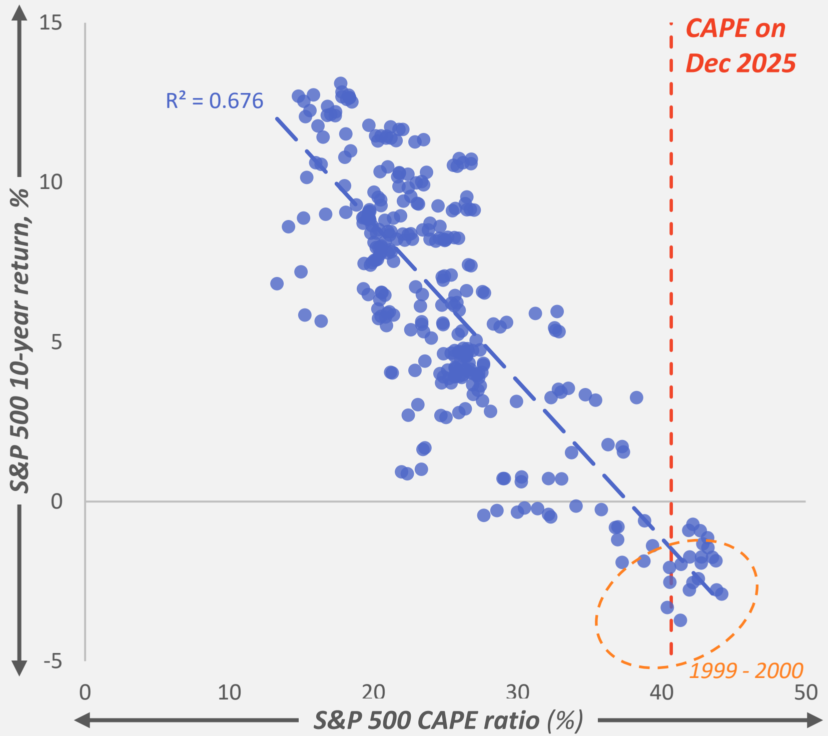
- The preceding analysis paints a picture of an unstable global economy. On one side, a financial market fueled by accommodative policy and speculation. On the other side, a real economy burdened by high debt and rising unemployment. This divergence, where paper assets outpace the real economy, is unsustainable.

- History provides a clear guide for such moments. **Metrics like the cyclically adjusted price-to-earnings ratio, when at extreme highs, reliably forecast lower long-term returns.** The dynamic of ignoring the real economy for easy profits in the financial market cannot last indefinitely.

- However, the rebalancing need not to a 'bubble'. It could be a long grind, a scenario where the market becomes saturated and enters prolonged stagnation. Still, both paths lead to the same destination. As prospective returns from paper assets diminish, capital will flow to the best risk-adjusted return: the real economy. **The question for 2026 and beyond is not *if* this rebalancing will occur, but *how* it will unfold.**

Chart 4.7

The cyclically adjusted price-to-earnings (CAPE) ratio is at a historic high.



Source: Bloomberg, Robert Shiller, BCA Economic Research calculations
Each dot represents monthly data from 1990 – 2015
Cyclically adjusted price-to-earnings (CAPE) ratio also known as Shiller PE ratio

Projections of Indonesian economic indicators

	2019	2020	2021	2022	2023	2024	2025E	2026E
Real GDP growth (% YoY)	5.0	-2.1	3.7	5.3	5.0	5.0	5.0	5.1
Nominal GDP growth (% YoY)	6.7	-2.5	9.9	15.4	6.7	6.0	7.2	7.9
GDP per capita (USD)	4175	3912	4350	4784	4920	4960	5014	5362
CPI inflation (% YoY)	2.7	1.7	1.9	5.5	2.6	1.6	2.9*	2.5
BI Rate (%)	5.00	3.75	3.50	5.50	6.00	6.00	4.75*	4.25
SBN 10Y yield (%)	7.04	5.86	6.36	6.92	6.45	6.97	6.05*	6.50
USD/IDR exchange rate (average)	14,141	14,529	14,297	14,874	15,248	15,841	16,468*	16,784
USD/IDR exchange rate (end of year)	13,866	14,050	14,262	15,568	15,397	16,102	16,690*	16,842
Trade balance (USD Bn)	-3.2	21.7	35.3	54.5	37.0	31.0	40.0	33.8
Current account balance (% of GDP)	-2.7	-0.4	0.3	1.0	-0.1	-0.6	0.0	-0.4

Notes:
USD/IDR exchange rate projections reflect our expectation of the fundamental value; market values may diverge significantly at any moment in time
Numbers marked with (*) for 2025 are final; other numbers for 2025 are our projections

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