

# Global Outlook 2026

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# Defying Gravity

Crosscurrents buffeted investors in 2025. On the downside, protectionist US trade policy, more restrictive immigration policies, and persistent geopolitical tension represented new shocks to supply chains that were still healing from the aftereffects of the pandemic. On the upside, enthusiasm about the potential speed and scale of the productivity and corporate profitability impact of artificial intelligence (AI) lifted investor confidence and drove markets to new heights. But in 2026, gravity is likely to reassert itself.

- **United States:** Elevated tariffs may lift inflation through the first half of 2026 while tighter immigration enforcement reduces labor supply and GDP growth. AI investment is surging, but rising debt-funded spending with no clear path to profitability should raise yellow flags.
- **China:** The new Five-Year Plan prioritizes stability over near-term growth, focusing on high-tech sectors and reducing US dependencies. China's housing crisis will continue to exacerbate economic imbalances, with limited expected fiscal stimulus.
- **Eurozone:** Low interest rates and energy prices, rising real wages, and continued fiscal expansion support growth in 2026. Risks include uncertainty around defense spending, political fragility, and countries' willingness to implement economic reforms.
- **Japan:** Prime Minister Sanae Takaichi will pursue an expansionary fiscal and regulatory agenda reminiscent of Abenomics. But the Bank of Japan's (BoJ) inclination to tighten monetary policy given domestic inflationary pressures will pose a new tension that her mentor did not encounter.
- **Global Markets:** US exceptionalism may fade as non-US opportunities continue to outperform—aided by a weaker US dollar. There is little doubt that AI will boost productivity, but in 2026, investors are likely to discriminate more skeptically between winners and losers.
- **Rates & Policy:** Divergent central bank policies could meaningfully increase volatility as the BoJ tightens policy while other developed market central banks ease. While short-term rates fall, large sustained fiscal deficits are likely to put upward pressure on long-term yields, leading to further steepening of developed market yield curves.

# United States

Decisions in 2025 will shape the 2026 outlook to a large degree. Tariffs are likely to push core inflation to 3.5% or higher in the first half of 2026, while more stringent immigration enforcement will reduce labor force and GDP growth. AI investments contributed about two-thirds of GDP growth in 2025, a pace unlikely to be matched in 2026. With accelerating inflation and a weakening economy, Federal Reserve independence could be at risk, and the US midterm elections in November could occur against a tougher economic and market backdrop.

## Tariffs and Consequences

Through 2025, the US administration implemented a series of sweeping policy changes. The One Big Beautiful Bill Act (OBBA) made permanent the personal tax rates implemented in 2017 during Trump's first term; these reductions were funded in part by ~\$900 billion of Medicaid funding cuts beginning after 2026. Despite the Medicaid cuts, the Congressional Budget Office (CBO) estimated that the OBBA would add \$3.5–\$4 trillion to deficits over a ten-year forecast horizon. In part to pay for these added deficits, the Trump administration increased tariffs on goods imports from 2.7% at the end of 2024 to ~16.8% as of 17 November, the highest level since 1935 according to Yale Budget Lab (Exhibit 1).

One key question for 2026 is whether the Trump administration will be able to continue collecting tariffs imposed based on the International Emergency Economic Powers Act (IEEPA). After two federal court rulings that IEEPA does not allow the president to impose tariffs, the Supreme Court heard the Trump administration's appeal early in November. A ruling is likely to be delivered before the end of the first quarter of 2026.

If the Supreme Court rules that IEEPA was unlawfully used to impose tariffs, the Trump administration can impose tariffs under Sections 122, 232, 301, and 338 with varying degrees of freedom. The most positive aspect of ending the use of IEEPA for tariffs is that it would introduce more predictability into the process of imposing duties on imports.

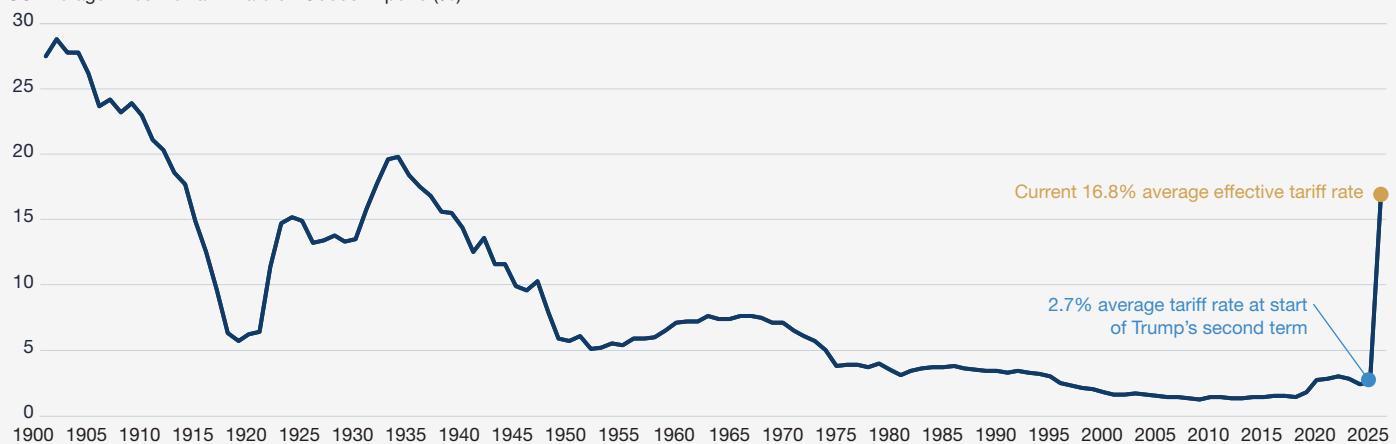
In mid-November, the Trump administration announced that it would lower tariffs on selected items such as coffee and bananas to mitigate household inflation. I expect more targeted tariff reductions like these in 2026, but the administration's ability to reduce tariffs will be limited by potential deficit implications. With additional sectoral duties likely to be imposed, I expect tariffs to stabilize near current levels through 2026.

Assuming tariff revenue remains at the current run-rate, the federal deficit is likely to remain on an unsustainable trajectory, exceeding 6% of GDP per annum for the foreseeable future.

Exhibit 1.

### The Weighted Average US Tariff on Goods Has Risen by 14 Percentage Points to the Highest Level since 1935

US Average Effective Tariff Rate on Goods Imports (%)



As of 17 November 2025

This rate estimate does not factor in substitution effects. Actual rates will depend on final policy implementation.

Source: Yale Budget Lab

## Key Inflation Metrics to Watch

If tariffs remain near current levels, as we expect, the US Consumer Price Index (CPI) inflation rate is likely to top 3.5% in the first half of 2026 (Exhibit 2). 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.

Exhibit 2.

### US Inflation Is Likely to Peak in H1 2026

US Core Consumer Price Index Inflation for Key Categories (%, YoY)



As of September 2025

Core goods represent ~24% of core CPI, shelter represents ~44%, and services ex-shelter and ex-energy services represent ~32%.

Source: Bureau of Labor Statistics, Haver Analytics

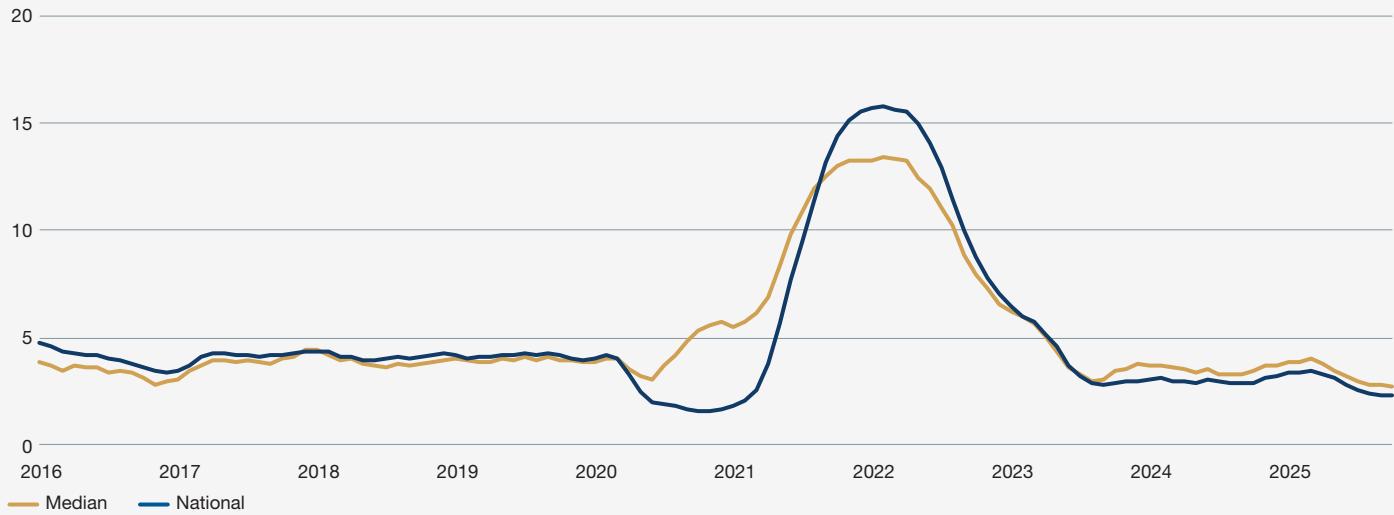
After pre-tariff inventories have been depleted, the cost of goods sold will be higher, and merchants will have to decide whether to protect their profit margins or insulate their customers. I expect most companies to opt to preserve their margins while cutting other expenses to avoid raising prices 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 (Exhibit 3). 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.

Exhibit 3.

### Rent Inflation Has Decelerated in 2025

US Year-on-Year Rental Price Changes (%)



As of October 2025

The Index covers approximately 100 major cities in the United States beginning in 2015. This index captures asking rents (not agreed rents) for new leases only. Lease renewals are excluded.

Source: Zillow Observed Rent Index

## A Complicated Labor Market

I expect the US labor market to weaken in 2026, but the key question is to what degree. Labor demand has clearly softened, but the supply shock to labor is likely to prove more important, in our view. US immigration policy shifts have led to a sharp decline in new migrant arrivals and a reduction in the labor-force participation rate for immigrants living in the United States.

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 (Exhibit 4) 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.

Exhibit 4.

#### US Nonfarm Payroll Growth Has Slowed to 17,000 per Month since May 2025

Average Monthly Change in Nonfarm Payrolls (Thousands, Seasonally Adjusted)



As of November 2025

Source: Bureau of Labor Statistics, Haver Analytics

Recent Challenger, Gray & Christmas job cut reports have raised questions about my relatively sanguine unemployment outlook. The October job cuts report showed the highest number of layoffs in an October since 2003, but in November, layoffs fell by over 50% sequentially. Until October, most data suggested that American employers were curtailing hiring, but not yet firing workers. If that trend is changing, we could be entering a more negative phase for workers and the economy.

Decision-making at the Fed is likely to become more fraught in 2026. Participants in Federal Open Market Committee (FOMC) discussions face the tension of whether to tighten policy to reduce rising inflation, or ease policy to address a softening labor market. In early 2026, we expect the tension between addressing the two mandates to be the highest in decades—but ultimately, the FOMC is likely to prioritize employment, operating under the assumption that tariff-induced price increases will be a one-off and isolated to goods prices, while threats to labor demand could be more persistent.

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#### Leadership Changes and Fed Independence

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, I will see this as a significant blow to Fed independence.

Even if Cook wins her case, investors will be watching the appointment of a new Fed Chair when Jay 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 I believe it was a meaningful contributor. The term premium for US Treasuries has not moved meaningfully over the same period. I expect perceptions regarding Fed

independence to be most visible via the US dollar and gold in the near term. If it appears Fed independence is being diminished, steepening of the US yield curve would become more likely, but the amount of time it would take for that to occur is difficult to forecast, as lower short-term interest rates would likely lead short- and intermediate-duration bonds to rally. It might take a significant inflation increase without a policy response to see a sizable bear steepening, and that could take years to occur.

## Will AI Enthusiasm Turn to Skepticism?

US trade policies and much stricter enforcement of immigration policies have led to a downshift in sustainable GDP growth from 1.7%–2.0% previously to perhaps 1.2%–1.5% looking forward. US growth will beat this forecast in 2025, but approximately 2/3 of US GDP growth was driven by investment in AI and related infrastructure. The rising share prices of AI-focused companies have provided an additional boost to consumption, translating into greater wealth for shareholders.

I am skeptical that this AI boom will be sustained through 2026. Investors are increasingly questioning the funding sources for major capex announcements as vendor financing and debt offerings become increasingly prominent. Moreover, the use of funds is also raising questions regarding the productive longevity of certain assets and whether they can recoup their costs, much less earn a return before becoming obsolete.

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 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 it.

Make no mistake: AI will be revolutionary for the global economy and for how companies across all sectors operate. However, the rules of economics and finance still apply. Debtholders demand repayment, and shareholders demand a meaningful return on capital adjusted for risk. In many cases, the AI trade increasingly appears unlikely to deliver on these demands.

## Policy Trajectory

Looking toward the end of 2026, the mid-term elections could change the US policy trajectory by limiting the Administration's ability to legislate. The November 2025 elections in Virginia, New Jersey, and New York City delivered a boost to Democrats with voters shifting away from Republican candidates. A December Congressional election in Tennessee, a reliably "red state", also raised eyebrows as the margin of victory for the GOP winner of the election was nine points versus the prior Republican representative's 22-point margin in 2024.

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.

If I am correct about the election outcome, investors should not expect any meaningful legislation in the next two years, as a divided Congress is likely to revert to gridlock. The House of Representatives would likely use its subpoena powers and may well attempt to impeach the president yet again, but these actions would be largely performative, as a Republican-controlled Senate would be highly unlikely to follow through with any punitive action against a sitting Republican president.

From a market perspective, a gridlocked Congress would mean that the White House's primary tools would relate to foreign policy and trade policy. Any appointments requiring Senate confirmation would be likely to pass with a GOP majority, but market-moving acts would likely be confined to tariffs and trade agreements.

# China

Through 2026, I expect China's inflation to remain between 0% and 1% with only marginal benefits from the government's "anti-involution" campaign, which aims to reduce "destructive competition" and mitigate deflationary pressures. GDP growth is likely to approximate 5% according to official data, but I believe a more honest estimate could fall short of 4%. While China's "new economy" capabilities are likely to continue growing, international trade is a mixed story as protectionism abroad could act as a headwind to the world-beating cost advantages lifting demand for Chinese exports. Meanwhile, the housing crisis is likely to continue, and investors' hopes for fiscal stimulus are likely to be dashed again, as the central government in China views current growth rates as being satisfactory.

## A Positive Shift in Production

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.

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.

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## Neutral (Near-Term) Trade Policy

I believe we will look back at 2025 as the year China proved it had the stronger position in trade negotiations, given its stranglehold on the supply of critical minerals and rare earths. Looking forward, I expect China to exert its strength by putting extraterritorial controls on sales of products that contain Chinese critical minerals—as deployed in the past by the United States. China has already announced such restrictions with a complex process for gaining approvals. I see this as the beginning of a longer-term story that will force the West to grapple with developing its own critical mineral supplies and refining capabilities despite the environmental hazards that accompany the processes.

In 2025, global supply chains were thrown into chaos due to much higher-than-expected US tariffs on Chinese goods—and then by subsequent changes to those tariffs in response to bilateral negotiations between the United States and China. In 2026, I expect the US sanctions regime to stabilize, with the average tariff level on Chinese goods being sold to US customers remaining stable or potentially even declining marginally after Presidents Trump and Xi meet in April.

A key question for 2026 will be the degree to which countries other than the United States erect barriers to Chinese exports given the perception of dumping of excess supplies. With non-US countries increasingly seeking to limit imports from China due to pressure from the United States and their own domestic industries, the importance of China's anti-involution campaign will increase in 2026. The government initiative was formulated in mid-2024 to reduce excess capacity in a range of industries that was leading to deflation and diminishing corporate viability, but serious implementation did not begin until mid-2025. While the policy objective is solid, most economists agree that the anti-involution campaign is unlikely to meaningfully reduce deflationary pressures.

## Real Estate Crisis Continues

While advancements in high technology sectors help boost growth, and trade stabilizes, I expect housing to continue to be a drag on the economy. Unfortunately, home prices continue to decline (Exhibit 5), with all of the 70 largest cities reporting that existing home prices were down both month-on-month (m-o-m) and y-o-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 (NBS), cumulative declines in home prices are ~12% for new homes and ~21% for previously occupied homes. However, these figures often overstate home prices—and underestimate 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. My assessment is that 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, I estimate that the actual average decline could be closer to 25%–40% with the same skew given private sector data published earlier in 2025.

Exhibit 5.

### China Property Prices Remain Weak, Dampening Confidence

70-City Price Index of Existing Residential Buildings (Index Level)



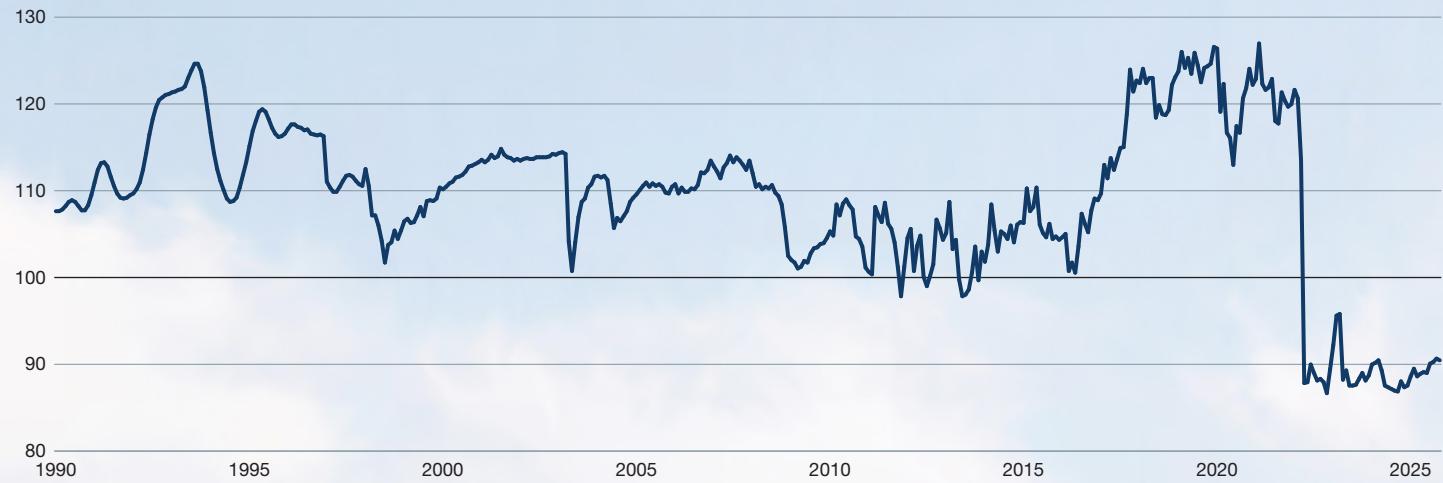
The median household in China has ~60% of its assets in residential real estate, which means home prices are a key driver of consumer sentiment. Through 2025, China's consumer confidence figures have remained near record-low levels with both expectations and current satisfaction levels staying near their historic lows (Exhibit 6). While the collapse in confidence in early

2022 was driven by the government's mishandling of the zero-COVID lockdowns, the initial bounce when lockdowns ended was short-lived. I attribute the sustained negativity since COVID to a combination of falling house prices, weak economic growth, and a loss of confidence in the government.

Exhibit 6.

### Chinese Consumer Confidence Remains Near Record-Low Levels

Survey of Chinese Consumer Confidence (Greater than 100 = Optimistic)



As of October 2025

Source: Chinese National Bureau of Statistics, Haver Analytics



One encouraging sign is that housing starts have declined to levels well below purchases of new residential real estate, which suggests that excess inventories will be depleted over time. Housing starts by area have declined by almost 75% from the peak level of approximately 1.7 billion square meters in 2019 to a year-to-date (YTD) October 2025 run-rate of 430 million square meters. But sales of residential real estate have also collapsed after peaking in 2021 at approximately 1.6 billion square meters to a YTD October 2025 run-rate of 720 million square feet.

## Key Drivers of Inflation and GDP

After slipping into deflation for several months in 2025, I expect CPI inflation to return to positive territory in 2026. The key driver pulling inflation above zero will be the normalization of food prices, which have been in deflation since February 2025. Core CPI, on the other hand, only slipped into deflation for the single month of February 2025 and reached its highest level of the year in the fourth quarter of 2025 at 1.2% y-o-y (Exhibit 7). This figure was boosted by gold jewelry prices—but even without the impact of sharply rising precious metals prices on the small sliver of consumer goods with those inputs, we see core CPI beginning to normalize.

While the anti-involution campaign is aimed to decrease deflationary pressure, I do not expect a meaningful increase in CPI or Producer Price Index inflation to result from the campaign.

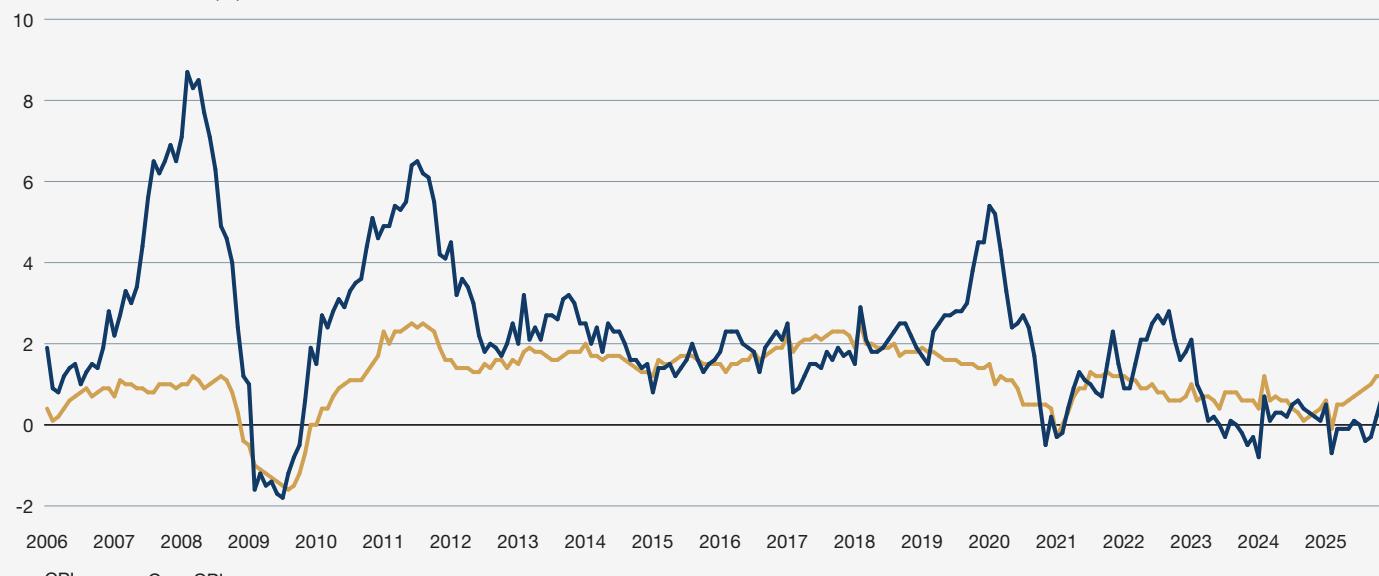
From a GDP perspective, the annual plenary sessions in March of the National People's Congress and the National Committee of the Chinese People's Political Consultative Conference, known as the “Two Sessions”, will reveal whether the government sets a lower target for growth. China has set multiple objectives 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. I believe 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.

Exhibit 7.

### Falling Food Prices Have Been a Drag on Headline CPI

China CPI and Core CPI (%)



As of November 2025

Source: Bloomberg, National Bureau of Statistics

# Eurozone

We expect a brighter outlook for the Eurozone economy in 2026. Indeed, 2025 would have been a better year were it not for the US trade war and the impact it had on confidence, spending, and investment in Europe. Next year, trade policies are likely to stabilize, which should reduce uncertainty for consumers and businesses making capital commitments. Moreover, I expect inflation to fall below the European Central Bank's (ECB) 2% target, which could allow for one or two additional rate cuts despite more hawkish commentary from some ECB members of late. Increases in defense and infrastructure spending are also likely to boost growth, if they actually occur.

## Ongoing Benefits from ECB Rate Cuts

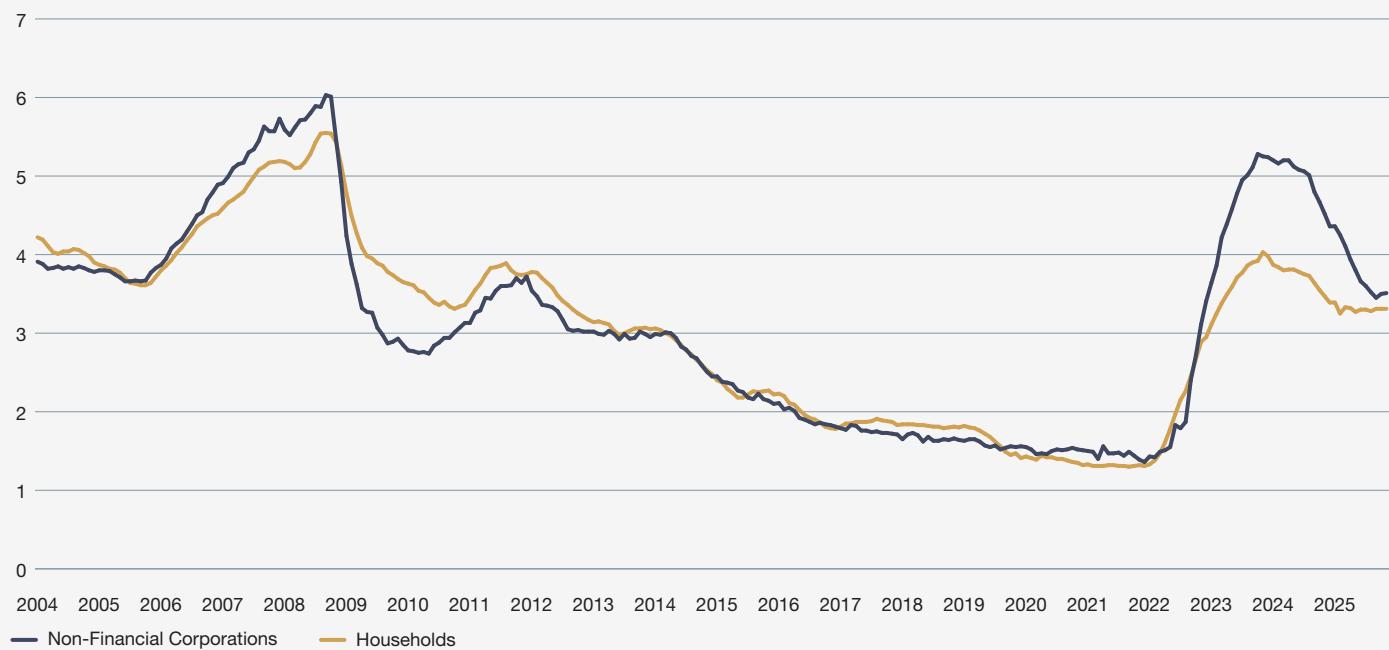
From mid-2024 to mid-2025, the ECB reduced its key lending rates by 200 basis points (bps), with the deposit rate ending November 2025 at 2%. Monetary policy changes in the Eurozone have a more magnified and immediate effect than changes in Fed policies in the United States, as more debt in Europe is floating rate. Approximately half of Eurozone residential mortgage debt is floating rate versus less than 10% in the United States, and roughly half of Eurozone corporate debt is floating rate versus only 20% in the United States.

We have already seen the benefits transmitted to European consumers and companies reflected in borrowing rates tracked by the ECB (Exhibit 8) as well as in the accelerating loan growth being observed in the region.

Exhibit 8.

### Consumers and Companies Are Benefiting from ECB Rate Cuts

Average Eurozone Cost of Borrowing for Households and Non-Financial Corporations  
(Interest Rate, %)



As of October 2025

Source: ECB, Haver Analytics



To date, Germany is the only major economy that has delivered significantly more funding for defense, but presumably other countries will begin to ramp up their investments as well.

## Defense-Driven Growth

In February 2025, Germany agreed to a radical shift in fiscal rules: The country now only counts defense spending of up to 1% of GDP against the “debt brake.” As a result, the German government can increase defense spending by an unlimited amount and remain in compliance with its fiscal rules. Germany also committed to investing €500 billion in infrastructure over the ensuing 12 years.

The German government began investing these funds late in 2025, but the more sizable wave of additional spending will kick in during 2026. I expect this fiscal stimulus to meaningfully lift German GDP growth and to boost Eurozone GDP growth as well.

Above and beyond the German commitments, all members of the North Atlantic Treaty Organization (NATO) except Spain committed to boosting defense spending, over time, to 5% of GDP with 3.5% being represented by traditional defense spending and 1.5% of GDP being allocated to defense-related infrastructure. To date, Germany is the only major economy that has delivered significantly more funding, but presumably other countries will begin to ramp up their investments as well.

If these spending commitments are fulfilled, GDP benefits will accumulate over time. My out-of-consensus view is that if the spending is sustained at materially higher levels, and the funds are used largely for military research, development, and production of military equipment in Europe, the multiplier effects could surprise on the upside.

The key negative of increased defense spending is likely to be larger fiscal deficits. Fortunately, the long history of fiscal discipline has given Germany substantial space to increase deficits without triggering alarm regarding fiscal sustainability. Other countries do not enjoy the same flexibility given their much higher debt-to-GDP ratios. In 2025, we have already seen a meaningful steepening of European yield curves as markets digested the implications of higher defense spending and deficits. Steeper yield curves could offset some of the benefits of fiscal stimulus.

## Lingering Uncertainties

My base case is that Eurozone GDP could expand more than the current consensus expectation for 1.1% growth in 2026. However, the key uncertainties around this optimism relate to political instability, the lack of “fiscal space,” and questions about the sincerity of commitments across several key countries.

Political instability and limited fiscal space are most evident in France. Since President Emmanuel Macron called snap elections in mid-2024, France has had four prime ministers with several falling after failing to reduce France’s fiscal deficit of over 5% of GDP. Given the magnitude of the deficit, the prospects for a significant increase in defense spending appear questionable.

Italy is another case in point. The country might have more fiscal flexibility than France but is starting from a deeper hole relative to its target. In 2024, Italy only spent 1.5% of GDP on the military with the figure rising to 2% in 2025 after a series of reclassifications and increases in outlays. Italy has committed to reach 5% of GDP by 2035 with 3.5% of that spending on core defense and 1.5% of GDP on broader security with an incremental 0.2% of GDP being spent each year. But with one of the highest debt-to-GDP ratios in the developed world, it still has limited flexibility.

Spain’s government has only pledged to increase spending to 2% of GDP in 2025 while demanding an agreement that it will not be required to exceed 2.1% of GDP thereafter. The government has also indicated that any increased military spending will not affect the welfare state or lead to tax increases but will instead be funded by reallocating funds from other parts of the budget.

If three of the four largest economies in the Eurozone are at high risk of failing to deliver on military spending commitments, the boost from multiplier effects could be disappointing.

# Japan

Japan's multi-year economic normalization is likely to enter a new phase in 2026. Prime Minister Takaichi in some ways represents a second iteration of her predecessor Shinzo Abe's attempts to reform the economy. But unlike Abe, who presented three arrows focused on monetary, fiscal, and structural reforms, Takaichi faces a BoJ that is much more focused on tightening monetary policy to control inflation versus its willingness to eagerly ease policy in 2012. Rising tensions with China and Japan's ability to fulfill its US trade agreement commitments represent two significant challenges that could undermine Takaichi's success.

## Political Change and Fiscal Stimulus Promises

Japanese deflation has ended, with consumer prices up over 12% in the four years ended 2025 versus a cumulative increase of only one percentage point in the preceding 24 years (Exhibit 10). In part due to voter dissatisfaction over higher prices, Prime Minister Shigeru Ishida resigned, and the Liberal Democratic Party chose Sanae Takaichi as its new leader.

Exhibit 10.

### Prices Have Increased by >12% since 2021 after 24 Years of Almost No Inflation

Japan General Consumer Price Index (SA, 2020 = 100)



As of October 2025

Source: Haver Analytics, Japan Ministry of Internal Affairs and Communications

Takaichi campaigned in part on a platform of mitigating the suffering imposed on households by rising prices. In mid-December, Japan's Diet passed into law a new ¥18.3 trillion supplementary budget that aims to mitigate inflationary pressures on households and stimulate investment in key sectors including artificial intelligence and shipbuilding.

I expect these stimulus measures to be implemented without meaningful fiscal offsets, which would imply over 2% of GDP of stimulus in 2026. The absence of offsets suggests that the new administration will take a less conservative approach to fiscal issues, at least in the near term.

## Inflation, Wages, and Rates

Despite the sizable fiscal stimulus measures, I expect inflation to subside in 2026 while remaining at or above the 2% BoJ target. The primary reason to expect lower inflation is the normalization of rice prices. In 2024 and 2025, rice prices skyrocketed, reaching a peak increase of over 120% by mid-2025. At the peak in mid-2025, rice accounted for 60 bps of the 3.3% CPI inflation. Prices have since fallen slightly and are likely to stabilize, if not fall further, as Japanese supplies increase alongside imports from the United States.

Energy prices are also likely to be less inflationary in 2026 as Brent crude prices are near four-year lows in US dollars, and the depreciation of the Japanese yen has slowed. All said, I expect inflation to remain at or above 2%, but not at the 3%-plus levels of 2025.

Continued strong wage gains are likely, but I suspect the increases might be a bit less than in 2024 and 2025. Early indications suggest that Rengo, Japan's largest labor union federation, will demand a wage increase of at least 5% of which 3% is related to base pay. This would mean that real wages would increase 1% at the base pay level. This is the same level as the demands in the prior two years, but with inflation expected to decelerate, the actual outcomes of the negotiations could fall short of the prior years' results.

Markets are pricing rate hikes to 1% by the end of 2026 from the BoJ (Exhibit 11). I would caution that with inflation likely to decelerate, the pressure on the BoJ to "normalize" policy will fade. As such, my base case expectation is in line with the market, but my confidence in getting to 1% is limited.

Exhibit 11.

### Markets Suggest ~55 bps of Additional BoJ Rate Hikes through October 2026

Implied BoJ Policy Rate through October 2026 (%)



As of 12 December 2025  
Source: Bloomberg

## Further Progress on Corporate Governance

Prime Minister Takaichi has indicated support in the past for measures to incentivize companies to distribute more of their profits. One idea she has promoted is to tax retained earnings. While the specifics of any such proposal would be important, underlying objective Takaichi is trying to achieve is a desirable one. The return on equity for Japanese companies has long been one of the lowest globally in large part because companies have too much cash on their balance sheets. It is understandable that after over 20 years of deflation, companies would want liquidity buffers—but the levels of cash have been unacceptably high as they depress the return on equity and hence the valuation of their shares. Moreover, from a policy perspective, this means that capital allocation across the Japanese economy has been suboptimal for years, reducing the potential growth rate.

I am hopeful that the new government will act on these proposals and continue driving returns on capital higher, as our analysis indicates that companies that increase their returns on capital tend to see stronger share price performance.

While the specifics of any proposal to tax retained earnings would be important, the underlying objective Takaichi is trying to achieve is a desirable one.

## Twin Uncertainties

The two biggest uncertainties for Japan are geopolitical. The first is increasing tensions with China. In a November speech to the Japanese parliament, Takaichi said that a Chinese attack on Taiwan could cause a “survival-threatening situation” for Japan that could justify a collective self-defense response by the Japanese military. China responded to this speech by curtailing tourist visits to Japan and cancelling other scheduled events involving Japan. With Chinese visitors accounting for almost 20% of all foreign visitors in 2024, a 50% decline in Chinese arrivals could reduce Japanese GDP by 10 to 20 bps.

The other uncertainty is how and when Japan will fulfill the terms of its US trade agreement, specifically as it relates to its pledge to invest \$550 billion in the United States. There are still many unanswered questions regarding this agreement, including the process around identifying suitable investments and conducting due diligence, not to mention the purported share of profits that would be granted to the United States. This could become an issue if the United States alleges that Japan has failed to deliver the investments on a timely basis in 2026.

# Investment Implications

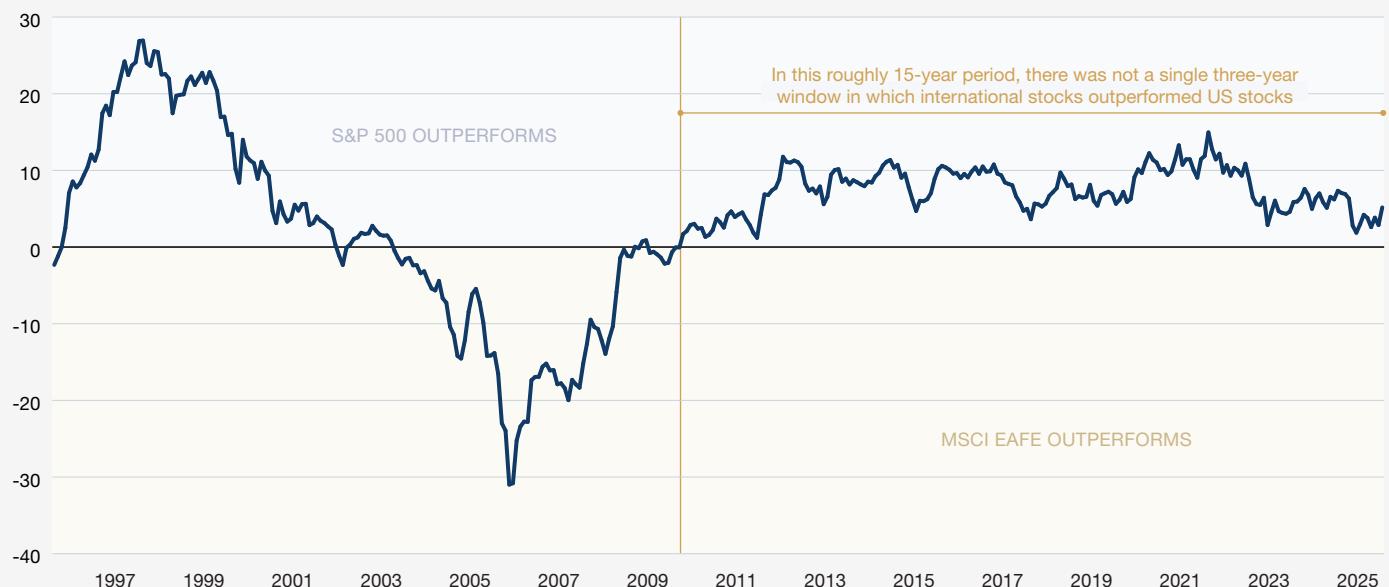
## The Beginning of the End of US Exceptionalism?

2025 may have marked a turning point for US markets. Despite hitting multiple new all-time highs, the S&P 500 Index was far outpaced by many non-US markets—especially after currency gains—suggesting a reversal of the long-standing trend of US outperformance. From 2009–2024, the S&P 500 outperformed the MSCI EAFE Index by 8.1% annually on a rolling three-year basis (Exhibit 12), underperforming in only three years. 2025 looks to be the fourth year of US underperformance, with the MSCI EAFE outpacing the S&P 500 by nearly 1200 bps through mid-December.<sup>1</sup>

Exhibit 12.

### After 15 Years, 2025 Might Have Marked the Beginning of the End of US Outperformance

Three-Year Rolling Difference, S&P 500 vs. MSCI EAFE (%)



As of 30 November 2025

Source: Bloomberg

I believe we have reached an inflection point, where the US GDP growth advantage has largely, though not completely, been eliminated. US inflation is likely to peak in early 2026 even while other economies meet or fall below their 2% targets, creating tension for future Fed policy. A weaker dollar, stretched equity valuations, and earnings concentrated in a narrow set of AI-linked tech firms add to the risk of US equity underperformance. With these factors likely to persist through 2026, non-US equities, with lower valuations and broader earnings drivers, appear better positioned for sustained outperformance.

## Risks in the AI Trade

As mentioned, one reason for my skepticism regarding sustained US outperformance is the narrowness of the advance in US equities. The technology sector has driven the majority of US earnings growth and share price appreciation. In contrast, outside the United States, gains have been more diversified across sectors and countries. AI-related capex is increasingly debt funded, with assets that may become obsolete in a relatively short period of time, raising the risk of overcapacity and delayed returns. If tech earnings disappoint, the broader market could face meaningful drawdowns given its dependence on this sector. Security selection among AI leaders will be critical in 2026.

## Global Opportunities

Outside of the United States, valuations start at materially lower levels, which means expectations for earnings growth are much less demanding (Exhibit 13). With global investors increasingly seeking to hedge their US dollar exposure on any US currency rally,<sup>2</sup> there are also potential gains on FX in addition to share prices.

Emerging markets are particularly appealing, and they can offer AI exposure at far lower valuations—the MSCI EM Technology sector trades at ~40% below its US counterpart—alongside multiple uncorrelated growth drivers. Risks from geopolitical intervention remain, but similar risks are rising in the United States. Japanese equities also look attractive, with policy support for consumption and corporate returns, even if GDP growth remains modest.

## Fixed Income and Currencies

The biggest US debt market risk is diminished Fed independence, which could undermine inflation-fighting credibility and the dollar. Reactions may be gradual, with yields initially falling before any steepening. Outside the United States, the risk to central bank independence is less of a concern, but debt sustainability concerns limit the appeal of many other developed market bonds. By contrast, in many cases, local currency EM debt stands out for more conservative fiscal policy, orthodox monetary management, and FX appreciation potential.

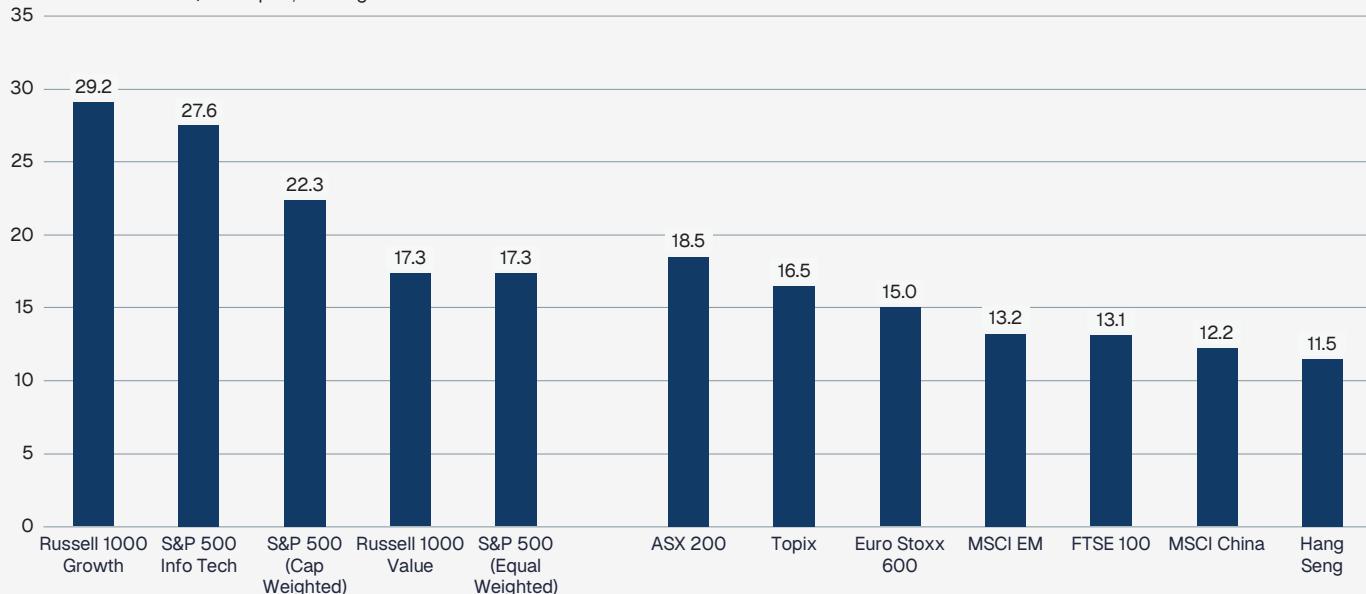
## Real Assets and Gold

In a world of stretched valuations, uncertain growth, and modest bond yields, income-producing real assets—especially infrastructure—offer inflation protection and moderate appreciation with lower volatility. Gold, while lacking cash flow, could also continue to serve as tail risk insurance in an environment of reduced dollar exposure and rising central bank demand.

Exhibit 13.

### US Equities Trade at a Sustained Valuation Premium to Non-US Equities

Forward US and non-US P/E multiples, from highest to lowest



As of 12 December 2025

Source: Bloomberg

# Gravity Reasserts Itself

I expect 2026 to be a year of relatively muted growth with US and Chinese GDP decelerating and Eurozone and Japanese GDP accelerating. I anticipate that the US trade war will subside as the Trump administration will not want voters focusing on higher tariffs ahead of mid-term elections. This could give investors a macro reprieve, but the implications of last year's tariffs are likely to become more evident in 2026. With valuations stretched in the US equity market, and global investors reassessing their US dollar and US asset exposure more broadly, I believe investors would be well-advised to continue assessing ways to reallocate capital to non-US opportunities; this would help diversify the drivers of capital appreciation and reduce valuation risk while also mitigating US currency exposure.

This is not a call to run for the hills. It is instead a risk management exercise after years of significant US outperformance. If I am correct that we are at the beginning of the end of American exceptionalism in markets, these moves will be fruitful for years to come.

## About the Author

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Ronald Temple is the Chief Market Strategist for Lazard's Financial Advisory and Asset Management businesses. In this role, Ron provides macroeconomic and market perspectives to Lazard's investment teams on a firmwide basis and works closely with Lazard's Geopolitical Advisory group to assess economic and market implications of key geopolitical issues globally. Ron also advises clients of Lazard's Asset Management businesses regarding macroeconomic and market considerations that are important to achieving their objectives.



# Important Information

## Notes

1. **The Risk Exhaustion Regime Continues**  
(Lazard, August 2025)

2. **Recalibrating Dollar Dominance in a Shifting Global Order** (Lazard, October 2025)

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