



Global Economics & Markets Outlook

VANTAGE POINT

RATES, RULES, AND REALITY Q1 2026

INVESTMENT INSTITUTE

INTRODUCTION

Welcome to another edition of Vantage Point, the quarterly economic and markets outlook from the BNY Investment Institute*

As we turn the page to a new year, we are watching many of the drivers of 2025's uncertainty move toward resolution in 2026. We've titled this Vantage Point outlook Rates, Rules, and Reality because the path ahead largely depends on two key judgments. On one side, we see the rate path set by the Federal Reserve (Fed) and other central banks remaining the immediate driver of market sentiment and economic momentum. On the other hand, the U.S. Supreme Court is expected to rule on several cases that could broadly redefine the scope of executive power, particularly on tariffs and the President's ability to remove officials from independent agencies. The interplay between these two forces – monetary policy and constitutional governance – defines the reality facing investors in 2026.

Our base case is Recovery (40% probability), a constructive outlook. This path sees uncertainty from the 2025 tariff shock and government shutdown beginning to fade. We anticipate increased fiscal support and a Fed that continues its easing cycle, bringing the target rate below 3.0% in 2026. Under this scenario, corporate growth remains robust, supported by strong earnings and the structural tailwinds of AI-related capital expenditure, leading to higher equity valuations. Although inflation is sticky due to tariff pass-through, the Fed's dovish stance supports the job market and drives real yields lower. Globally, the Eurozone joins the party with a cyclical pickup driven by German fiscal stimulus and European Central Bank (ECB) cuts, while China navigates its own balance between stimulus and capacity cuts.

Under our Expansion scenario (35% probability), the primary risks to the outlook are to the upside. U.S. consumers and corporations successfully absorb the tariff shock, driving robust underlying demand. Supported by a fiscal boost in 2026, growth accelerates beyond trend. This resilience forces the Fed to recalibrate its path, cutting rates less aggressively to settle at 3.5%. While equities still gain ground, the upside is capped by these higher-than-expected short-term rates. In this scenario, bonds struggle, but with a broad-based global recovery, particularly a strengthening outlook in China, the credit environment should remain stable.

Conversely, we cannot ignore the risks tilting to the downside, captured in our Slowdown scenario (25% probability). The combination of tariff hikes and persistent fiscal uncertainty finally become too much. The U.S. labor market softens acutely, consumer spending drops, and recessionary risks spike. Despite earlier resilience, deteriorating consumer confidence pushes the Fed into deeper, faster cuts, lowering rates to 2.5%. Equities become a significant source of risk in portfolios and credit spreads widen as recession fears mount. While sovereign bonds are clear outperformers due to an anticipated flight to safety, cooling global demand negates any limited stimulus efforts in Europe or China.

2026 will not be boring. The ultimate decisions and interplay between the Fed's path on interest rates and rulings from Supreme Court promise a shifting landscape. By clarifying these three distinct paths, BNY Investments helps you navigate today's market realities – synthesizing the forces at play to separate signal from noise in what promises to be an interesting year.



Eric Hundahl, CFA
Head of Investment Institute,
BNY Advisors

EXECUTIVE SUMMARY

We base the outlook on the idea that financial market moves largely reflect growth, inflation and monetary policy. Tactical investment opportunities arise when our views significantly differ from market pricing.

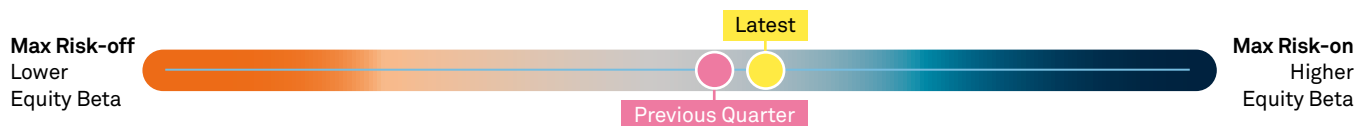


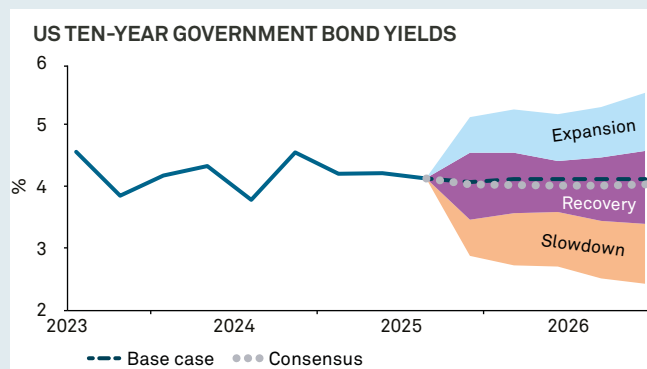
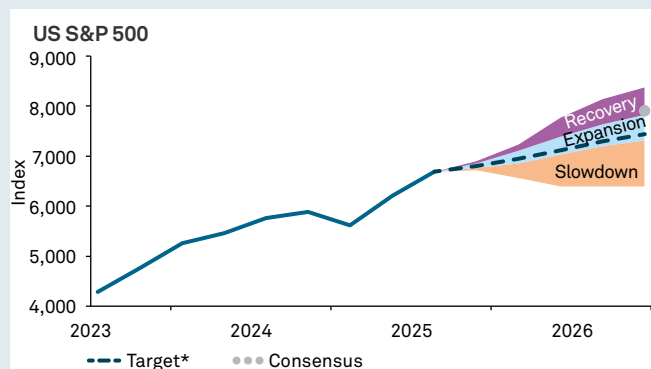
Table 1: Our Outlook vs. Consensus

	Q1 2026	Q/Q Change	Takeaway
Growth		↑	Our expectation for growth over the next 12 months remains slightly above consensus in the US, slightly above consensus in the Eurozone, and slightly below consensus in China. Risks around our base case lie to the downside for all forecasted major regions.
Inflation			We see inflation above target but in line with market expectations for the US and in line with target but slightly above expectations for the Eurozone. We expect continued deflation in China. Risks around our base case lie to the downside in the US and the Eurozone.
Policy			Our expectation for policy rates over the next 12 months is in line with market pricing in the US and the Eurozone. Risks around our base case lie to the upside for the US and to the downside in the Eurozone.

How to read the heatmap. **Blue** indicates much better than expected (relative to the consensus) growth, much lower than expected inflation and significantly greater than expected monetary policy accommodation. **Light blue** indicates better than expected growth, lower than expected inflation and greater than expected policy accommodation. Grey indicates that expectations for economic growth, inflation and policy are broadly in line with the consensus. **Light orange** indicates worse than expected growth, greater than expected inflation and a tighter than expected monetary policy. **Orange** indicates significantly worse than expected growth, much greater than expected inflation and a much tighter than expected monetary policy.

Table 2: Tactical Investment Views

Major Asset Class	Q1 2026	Q/Q Change	Takeaway
Global Equity		↑	Lagged effects of the tariff shock could challenge global growth in the near-term, but monetary and fiscal policy loosening and resiliency from the rest of the world is expected to limit downside risks.
Sovereign Bonds			Elevated yields offer attractive entry points and income returns, but we remain cautious on US Treasuries compared to international sovereign bonds due to fiscal concerns and inflation risks.
Credit			Credit spreads remain compressed with limited upside due to downside risks to growth, prompting a preference for higher quality. EM debt is expected to benefit from monetary easing and USD weakness.
Real Assets			We maintain a favorable view on real asset diversifiers, such as precious metals, given volatility and inflation hedging potential. We favor infrastructure given equity exposure but greater stability and income benefits. Natural resources exposure utilized as a hedge to potential inflationary pressures.
Cash			Policy loosening will lower cash rates. Higher yields make a better entry point into the belly of the curve. Intermediate duration is relatively attractive.



Source: BNY Investment Institute. Data as of December 2, 2025.

* Target is the expected outcome based on the average of three scenarios weighted by how likely they are to occur. Please see additional disclosures and glossary.

S&P 500		
12-month Outlook	Base Case	Probability Weighted
EPS Estimate	302	297
Earnings Growth	+12%	+11%
Price/Earnings	27	25
Approximate Level	8,300	7,500
Return Estimate	+21%	+9%

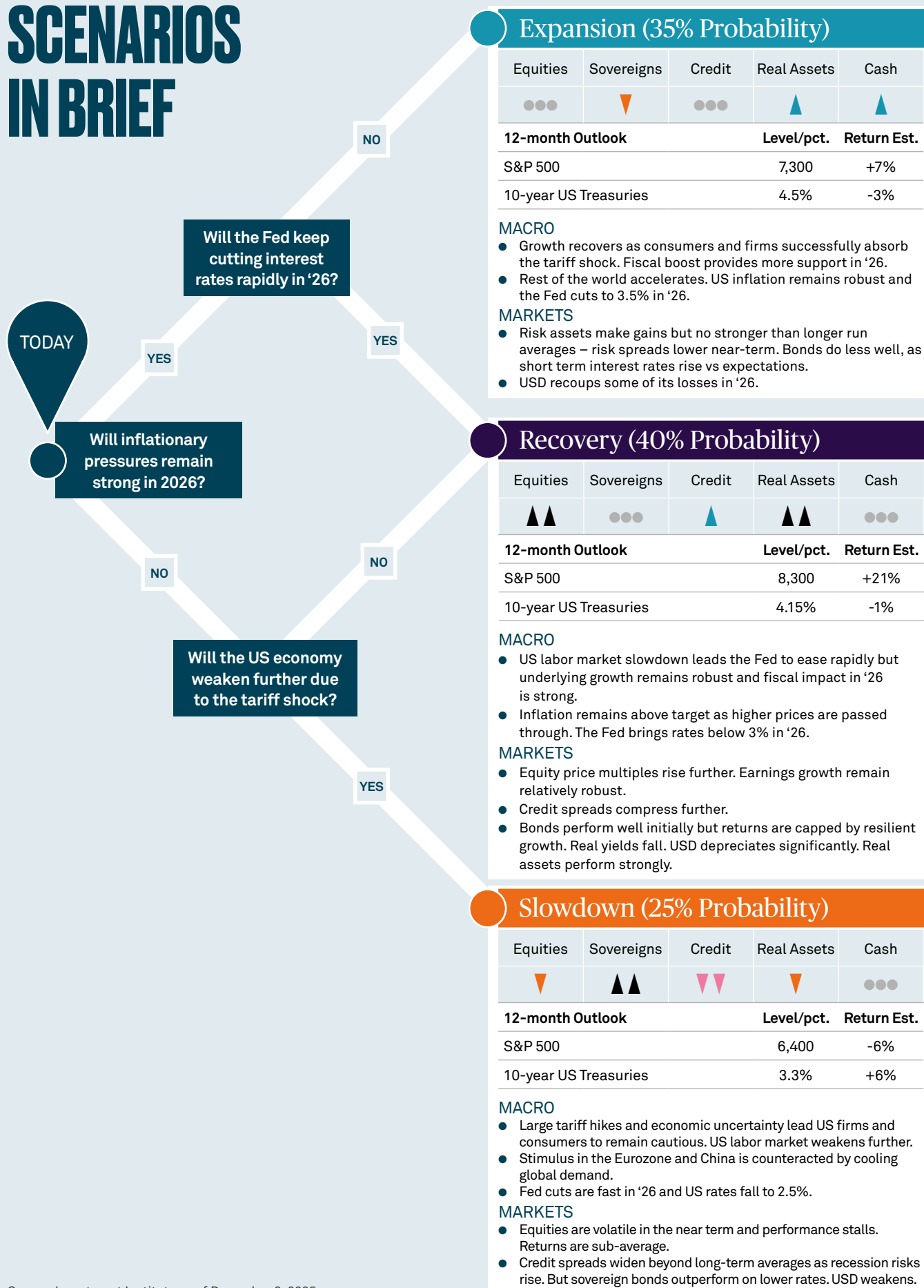
Source: Investment Institute as of December 2, 2025.

10-year US Treasuries		
12-month Outlook	Base Case	Probability Weighted
Fed funds rate	2.75%	3%
Yield curve slope	+140bp	+100bp
Approximate Level	4.15%	4%
Yield change	+5bp	+0bp
Return Estimate	-1%	+0%

Source: Investment Institute as of December 2, 2025.

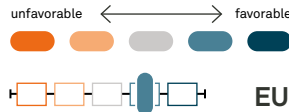
Table figures may not add up due to rounding.

SCENARIOS IN BRIEF



GROWTH

Our Outlook vs. Consensus



US

Our Outlook vs. Consensus

Our probability weighted forecast for the US economy sees growth remaining below trend in the very near term, before recovering from Q1 2026. We are in line, if not slightly above, consensus on growth over the whole 12 months (~1.9%). Our mean path for growth is characterized by looser fiscal policy, relatively reduced trade uncertainty, and a Fed very responsive to signs of weakness in the labor market.

Base Case

Our base case is 'Recovery' and is a constructive outlook. It sees weakness in Q4 2025, but a rebound in Q1 '26 driven by the end of the US government shutdown, increased fiscal support, and further monetary stimulus. In this scenario, the Fed responds swiftly to temporary softening payrolls, delivering multiple rate cuts in 2026 - despite elevated inflation. The economy then rebounds strongly, supported by a more expansionary fiscal stance and the loosening in financial conditions.

Risks

Risks around our base case mostly lie to the downside. While economic activity has so far proven resilient in the face of the tariff shock, the US labor market is unusually soft and points to softer consumer spending. While we think a US recession is unlikely given resilience in corporate earnings and structural AI-related capex, risks remain given labor market vulnerabilities.

EUROPE AND CHINA



Our Outlook vs. Consensus

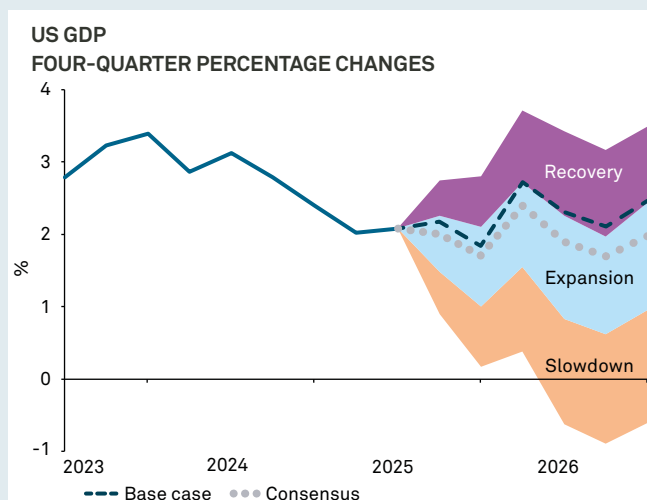
Our view on growth prospects outside of the US remains constructive and in line with consensus. Our probability weighted forecast for Eurozone growth stands at 1.5% for the next 12 months, a little above consensus (1.4%). For China, our forecast sees growth slowing to around 4%, below consensus (around 4.4%) and softer than the 'around 5%' growth target set for 2026.

Base Case

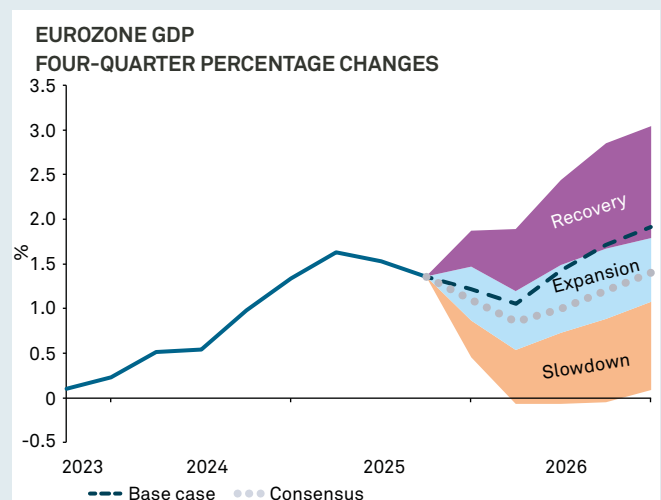
Our base case for the Eurozone is for a cyclical pickup in growth in 2026, as ECB rate cuts filter through to the real economy, Germany provides substantial fiscal support, corporate fundamentals remain solid, and leading indicators continue to improve. China's economy will encounter opposing forces from cuts in excess capacity and efforts to stimulate consumption. Deflation to eventually abate, but it will linger and weigh on corporate profits. The drag from property should stabilize but not become a meaningful driver of growth. Export penetration of non-US markets may face greater protectionism. We expect growth to slow toward 4% - smoothed by gradually intensifying consumption-oriented stimulus.

Risks

Outside of the US, the risks around our base case lie to the downside. The Eurozone and China are reliant on exports and sensitive to a broader worsening of global trade conditions. We also have long term structural concerns about Europe, in large part driven by increased manufacturing competition from China.



Source: BNY Investment Institute. Data as of December 2, 2025.



Source: BNY Investment Institute. Data as of December 2, 2025.

INFLATION & POLICY

Our Outlook vs. Consensus



US



Our Outlook vs. Consensus

Our probability weighted expectation for US policy rates is broadly in line with market pricing over the next 12 months (3% vs 2.9%). We expect inflation to remain above target over the next 12 months (~2.6%), reflecting the increase in tariffs on US imports, and in line with what is priced in by the market. Real interest rates have repriced higher – a risk we flagged in our previous outlook (see [here](#)) – and are now in line with our expectations.

Base Case

Our base case for US policy rates is one of 'Recovery'. We see the Fed cutting below 3% by end of 2026. In fact, despite inflation remaining above target by early 2026, price pressures are less than expected in the near term, and the Fed is eager to pre-empt further weakness in the labor market.

Risks

The risks around our base case lie to the upside for US policy rates, and to the downside for US inflation. In 'Expansion', our second most likely scenario, the Fed funds rate settles at 3.5%, as the labor market recovers and the Fed re-focuses on bringing inflation down to 2%. In 'Slowdown', the policy stance is loosened more quickly to about 2.5% as labor market weakness translates into low GDP growth and disinflation.

EUROPE AND CHINA



Our Outlook vs. Consensus

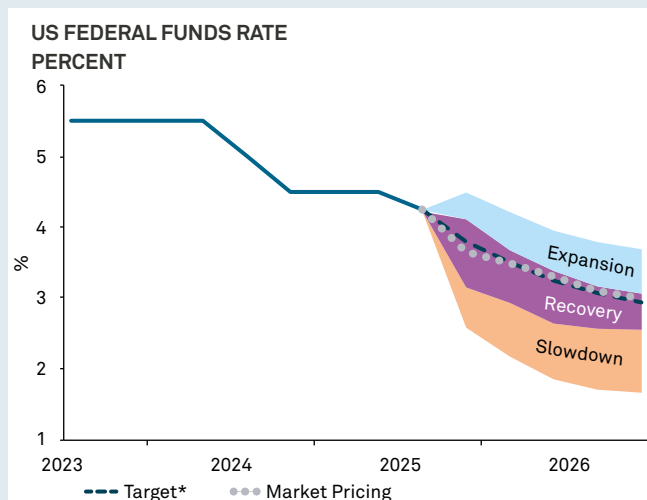
Our probability weighted expectation for Eurozone policy rates is a little above market pricing in the near term (no more cuts by the ECB in the coming months) as growth picks up further in '26 and inflation remains around target. For China, entrenched deflation is likely to elicit greater credit and fiscal easing geared to boosting consumption, but the rebalancing process will be slow. We think the PBoC eases a bit more in 2026 and maintains ample liquidity.

Base Case

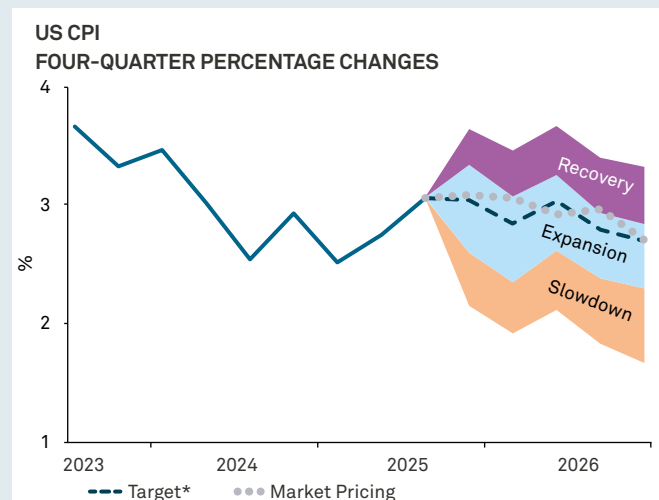
In our most likely scenario, 'Recovery', we see no additional ECB cut, which is a little more hawkish than market expectations, as growth improves in the near term and inflation remains around 2%. We expect the authorities in China will shed their policy reticence and begin loosening regulatory and policy settings more meaningfully to shore up productivity and wages more prominently. Further USD weakness will also ease global financial conditions and boost policy space at other major economies.

Risks

The path for rates in the Eurozone in 'Slowdown' is below market pricing given downside risk to inflation driven by weakness in energy prices, a strong euro, and a possible fall in Chinese import prices (of which, so far, the evidence is limited). In China, the balance of risks are tilted lower on entrenched deflation, weak profits, and slowing investment. But it could change meaningfully on any decisive policy pivot to boosting private consumption and lowering precautionary savings.



Source: BNY Investment Institute. Data as of December 2, 2025.



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ASSET CLASS VIEWS

Summary

The past quarter was a challenging period in the US due to the government shutdown, temporarily limiting visibility on key data. Our key judgements remain largely consistent with what we discussed a quarter ago – Fed reaction function, fiscal impact, and US trade policy. However, a few more unknowns were introduced, ranging from the uncertainty around private credit to where we are in the AI cycle to the pending Supreme Court ruling on IEEPA tariffs and Fed personnel.

On net, our view is that US growth rebounds in Q1 2026, reflecting looser fiscal policy, reduced trade uncertainty, and a Fed more responsive to labor market developments. Risks are skewed to the downside given an unusually soft labor market and potential pressure on consumer spending. However, we view recession risks contained by resilient corporate earnings. Similarly, we expect growth in the Eurozone to pick up cyclically in 2026 as ECB rate cuts work through the economy and German fiscal support becomes more meaningful. In China, we expect slower growth than consensus and softer than the 5% official target that is driven by lingering deflationary pressures, a stabilizing but non-accelerating property sector, and challenges to export penetration amid rising protectionism.

Our base case has shifted firmly to 'Recovery', but the current macro environment remains noisy. We encourage investors to leverage [Monthly Checkpoints](#) from the Investment Institute to stay abreast on macro developments and how data are lining up with our forecasts on a month-over-month basis. To review our long-term themes and long-term asset class risk and return forecasts visit our [Capital Market Assumptions](#).

Major asset class	12-month view	10-year view	Comments
Global Equity			The global economy is showing resilience and stimulus is picking up, but downside risks to growth persist in the near-term. Despite this, recession risks are odds against, the US has also entered a new phase of policy easing, and previous rate cuts in other regions are expected to keep supporting the ongoing economic cycle.
Sovereign Bonds			Elevated yields do entrench favorable income returns. We remain underweight US Treasuries vs International Sovereign bonds, due to worsening fiscal fundamentals and ongoing US inflation risks.
Credit			Spreads remain compressed. There is less upside in credit from the AI theme. Trade volatility and economic uncertainty may weigh on consumption and overall growth. We expect a rotation toward cheaper, safer fixed income assets. We prefer higher quality credits over HY, European credits over US.
Real Assets			Maintain favorable view on precious metals (gold, silver) and selected metals given macro volatility and inflation hedging potential. We have a favorable view on real return strategies and infrastructure.
Cash			We see merit in putting cash to work as policy loosening will lower cash rates. Higher yields make a better entry point into the belly of the curve. Intermediate duration is relatively attractive. We view absolute return strategies capable of exploiting monetary and fiscal divergence.

Equity	12-month view	10-year view	Comments
Developed Market Equity			Policy uncertainty remains elevated, but global stimulus is a significant offset. Risks of deterioration in the near-term macro data persists from the lagged effects of the tariff shock but 2026 is optimistic from monetary and fiscal loosening. The AI theme is expected to continue, but with more scrutiny from investors. Cyclical considerations and concentration risks may introduce volatility, which warrants a well diversified approach across geographies.
US Equity			Labor market weakness and abating but still elevated policy uncertainty could see markets remaining sensitive to the macro data in the near term. Disagreement at the Fed on the future path for policy rates may also lead to greater US equity volatility. The AI-driven rally in equities is under increasing scrutiny. Within US equities, we favor large caps over small caps and emphasize exposure to quality. Expectations for AI led productivity gains, and significant AI-related capex, limit deep downside risks in the near term.
UK Equity			UK equities are attractive for income-seeking investors given elevated yields. We see income-equities as a hedge against structurally higher inflationary risks in the global economy.

Source: BNY Investment Institute as of December 2, 2025.



Equity	12-month view	10-year view	Comments
Europe ex UK			We see the ECB as remaining on hold as growth picks up in 2026 and inflation remains around target. We expect the lagged effects of policy loosening and greater fiscal stimulus as supporting the cycle. De-escalation of the Ukraine-Russia war could be a catalyst for performance in 2026. In relative terms, we think selected European indices (e.g., Spain, Italy) or Styles (Value, Income) can keep outperforming. Small caps trading at relative discounts to large caps are becoming attractive. However, the broader European market may lag as global trade and industrial production suffers from US trade policy.
Japan Equity			Consumption and household incomes to be boosted in 2026 by easing inflation (towards the Bank of Japan's 2% target) and rising wages. Nominal growth to remain higher than 3% y/y. The JPY should stabilize on BOJ normalization (& Fed rate cuts) but the real exchange rate should stay competitive and sustain a modest expansion of foreign receipts and income.
EM Equity			Emerging markets to be boosted by a stable-to-weaker USD, local rate cuts and stable-to-improving activity at G3 economies and China. The AI-related capex pickup is generating new opportunities and providing an important offset against lingering drags from US tariffs. EM equities are cheap and will gain from long-term supply chain rotation.
China Equity			The trade truce with the US to limit external shocks. But further Sino-US de-coupling to persist (albeit, more gradually). The tech sector is a bright spot, and property is on a better footing. Further stimulus to re-balance the economy and curb deflation is needed and should be forthcoming.
EM ex China			Electronics oriented EMs should continue reaping gains from strong AI-driven semiconductor orderbooks. Commodity intensive EMs to benefit from rising data-center related metals and minerals demand. China stabilization to also help. Relative advantages versus China (such as lower tariffs) likely to provide a leg-up, valuations are fair-to-attractive. Country-and-sector correlations are lower.
Fixed Income	12-month view	10-year view	Comments
US Treasuries			We see lingering risks to growth in the near-term but also inflation pressures that the Fed will likely look through. Large deficits remain a risk, but attractive yields and correspondingly favorable income returns keep us engaged. We are cautious on the prospect of limited duration gains and elevated volatility. We prefer Treasury inflation-protected securities (TIPS) to nominal US Treasuries.
Intl. Sovereign Debt			FX hedged income returns in selected DM countries remain attractive in absolute terms and versus US Treasuries (we retain an overweight to UK Gilts and neutral view on German Bunds and JGB's). A weakening US dollar makes the asset class attractive on a non-FX hedged basis as well. We see greater risks of interest rates repricing higher in the US vs rest of developed economies.
Global IG			Our outlook is constructive on credit, but spreads are rich and there is a limit in how much narrower they can get. Yield remains attractive, but we prefer using credit as a funding source. Whilst IG may hold up better than HY, risk-adjusted and relative-returns are not compelling.
High Yield Debt			Spreads are rich and we stay underweight. Amid heightened trade and financial volatility, weakening energy and industrial commodity prices and reactive Fed policy easing, we see the likelihood of spreads re-widening on HY corporates' stalling margins and re-financing pressures. Relative preference, within the space, is for short duration positioning for credit visibility and carry.
EM Local Currency Debt			Even after recent local rate cuts, EM real rates are still high. A stable to weaker trend in the USD should present additional price gains through FX as well as duration channels. Relatively low FX carry is a risk but is offset, for now, by reasonable macro fundamentals, financial flexibility, and policy management at most major EMs.
EM USD Debt			Valuations are less expensive in comparison with global IG and HY credits. Our neutral view balances decent policy buffers, flexible currencies and a softer tone in the US dollar against the odds of a near-term softening in global trade flows in early 2026.

BNY INVESTMENT INSTITUTE

BNY Investment Institute draws upon the breadth and expertise of BNY Investments to generate thoughtful insights on macroeconomic trends, investable markets and portfolio construction to facilitate higher probabilities of higher outcomes for our portfolio managers and our clients.



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Investors should consult their financial professional prior to making an investment decision.

INDICES AND DEFINITIONS

Japan (Nikkei 225): The NIKKEI 225 is an index that tracks the performance of the largest 225 companies traded in the Japanese market. **10Y UK Gilt** – Average yield of a range of UK government bonds all adjusted to the equivalent of a ten-year maturity. **Phillips Curve:** An economic theory that inflation and unemployment have a stable and inverse relationship. **US Consumer Prices (CPI) Index** measure of prices paid by consumers for a market basket of consumer goods and services. The yearly (or monthly) growth rate represents the inflation rate. The **10Y US Treasuries Average Yield** of a range of Treasury securities all adjusted to the equivalent of a ten-year maturity. The **CBOE VIX Index (VIX)** is an indicator of the implied volatility of S&P 500 Index as calculated by the Chicago Board Options Exchange (CBOE). The **Majors Dollar Index (USD)** measures the value of the US dollar relative to a basket of currencies of the most significant trading partners of the US including the euro, Japanese yen, Canadian dollar, British pound, Swedish krona, and Swiss franc. The **MSCI EM Index (Emerging Markets Equities)** tracks the total return performance of emerging market equities. The **S&P 500 Composite Index (S&P 500)** is designed to track the performance of the largest 500 US companies. **Europe STOXX 600** Index represents the performance of 600 large, mid and small capitalization companies across 18 countries in the European Union. **Bloomberg US Corporate High Yield:** covers the universe of fixed-rate, non-investment grade corporate debt in the US. **Bloomberg US Corporate Investment Grade:** designed to measure the performance of the investment grade corporate sector in the US **1-mth. 1-year forward swap:** the avg. interest rate for 1-mth. in 1-year forward. **GDP:** gross domestic product is the total monetary or market value of all the finished goods and services produced within a country's borders over a given time period. **Fed funds Rate:** the target interest rate for overnight lending and borrowing between banks. **Purchasing Managers Index (PMI):** An economic indicator derived from monthly surveys of private sector companies. A level above 50 indicates expansion compared to the prior month and below 50 contraction. Investors cannot invest directly in any index. **Slowdown:** GDP growth slowing below trend. **Global Financial Crisis:** The severe economic downturn that began in 2007-2008, characterized by widespread banking failures, a collapse in housing markets, and subsequent global recession. **Expansion:** GDP growth above trend. **Recovery:** growth recovering towards long-term trend growth. **Neutral Rate of Interest (r-star or r*)** is the short-term interest rate that would prevail when the economy is at full employment and stable inflation. A rate at which monetary policy is neither contractionary nor expansionary.

STATISTICAL TERMS

Skewness in statistics represents an imbalance and an asymmetry from the mean of a data distribution. In a normal data distribution with a symmetrical bell curve, the mean and median are the same. **Probability-weighted mean** is similar to an ordinary arithmetic mean, except that instead of each of the data points contributing equally to the final average, data points are weighted by the statistical probability for a particular scenario outcome. **Duration** is a measure of a bond's interest-rate sensitivity, expressed in years. The higher the number, the greater the potential for volatility as interest rates change.

OTHER

QE: quantitative easing. **Fed:** US Federal Reserve. **ECB:** European Central Bank. **BOJ:** Bank of Japan. **BOE:** Bank of England.

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