INSIGHTS

SIGNALS FROM EUROPE'S FRONTLINES

Daleep Singh, PGIM's Vice Chair and Chief Economist, travelled across London, Amsterdam, Stockholm, Copenhagen, Geneva, Zurich and other European hubs, hosting a series of client roundtables to exchange views on the forces shaping the global economy in 2026.

Across cities, similar themes emerged: concerns about an overheating U.S. economy, questions about the durability and dividends of the AI investment super-cycle, recognition of accelerating geoeconomic fragmentation, and keen interest in what all of this means for managing portfolios in a more contested and uncertain world. Drawing on these conversations, the snapshots below reflect the areas top of mind for European investors, and Daleep's perspective on how to interpret them.

RUNNING HOT: THE U.S. ECONOMY

The U.S. narrative has moved from expectations of modest below trend growth to a likely overheating scenario. Nominal GDP momentum is being fuelled by two powerful engines.

First, the AI capex cycle continues to accelerate. Hyperscalers are forecast to spend roughly $700 billion this year, contributing close to half of U.S. real GDP growth. Second, household spending remains well supported by the accumulating wealth effect from rising asset prices, despite the slowdown in labour income gains.

Together, AI-related capex and consumption by the wealthy look set to accelerate inflation-adjusted GDP growth towards 2.5%, comfortably above potential.

TWIN STIMULUS ENGINES

Both monetary and fiscal policy will likely add further fuel.

Monetary policy will shift in a dovish direction. No matter the ultimate choice for leadership of the Federal Reserve, unrelenting pressure from the White House (and possibly Congress) will push the policy path into stimulus territory, with interest rates drifting toward 2.5% by late 2026 - below what markets consider neutral.

On the fiscal side, the approach to the 2026 midterms creates a narrow window for another injection of stimulus to address mounting affordability concerns. Targeted consumer support, strategic incentives tied to AI infrastructure and reshoring priorities, and measures to cushion cost of living pressures could all feature in an additional package. The result would be a positive fiscal impulse of roughly 50–75 basis points to growth in 2026.

DOLLAR BLUES AND BOND VIGILANTES

Roundtable discussions across the board dissected the structural direction of the U.S. dollar. Many investors see scope for 5–10% annual depreciation as global portfolios slowly rebalance away from overweight dollar exposures. Today, the dollar represents around 60% of global FX reserves despite the U.S. accounting for only a quarter of world GDP. A long running, incremental diversification into other reserve currencies could push its share closer to 50% over the next decade.

On the rates side, long-end government bond yields may face upward pressure if nominal growth remains strong. Higher inflation risk premia and wider fiscal risk premia could reprice the back end of the curve. While term premia appear low, investors noted that disorderly spikes may be short lived given the tools available to policy institutions. The U.S. Treasury, for example, can influence long-end yields through reductions in issuance maturity, its buyback program, or a new "market functioning QE" program to anchor long-end Treasury yields and assure the effective transmission of monetary policy – all of which would have the flavour of de facto "financial repression".

THE AI CONUNDRUM

The AI capex cycle remains front and centre for investors. Unlike previous capex booms - such as telecoms - the current cycle is underpinned by companies with strong balance sheets, high profitability and scalable business models. This raises the probability that the investment wave endures, potentially delivering sustained productivity improvements.

Policy support is reinforcing this trajectory. Governments increasingly view datacentre capacity and digital infrastructure as strategic assets, strengthening incentives for private investment. While there may be isolated stress among smaller ecosystem players, systemic disruption appears unlikely.

Europe, however, remains a laggard in AI scale. Despite world class research institutions and regulatory leadership, the region trails in private investment, compute availability and ecosystem depth. This gap is shaping strategic conversations across European boardrooms.

THE DIVERSIFICATION TRADE

European investors, who historically maintain large allocations to U.S. assets, are reassessing portfolio construction through a scenario based lens. This is not a retreat from U.S. innovation leadership, but rather a recalibration aimed at building portfolio resilience.

Tail-risk hedging strategies including strengthening portfolios with defensive currencies such as the Swiss franc and Japanese yen, increasing allocations to real assets with inflation protected cash flows, and exploring emerging illiquid opportunities in advanced manufacturing, robotics and battery technology are options for investors.

Some reserve managers are incrementally adding gold or experimenting with alternative currency arrangements, though these steps remain modest relative to the scale of the dollar's global role.

POLICY PIVOTS

A major geopolitical theme is the world's drift toward regional spheres of influence. With domestic constraints limiting large scale U.S. legislation, foreign policy may take centre stage under the so-called "Donroe Doctrine," which emphasises safeguarding Washington's influence in the Americas. In response, China and Russia may see an opportunity to reinforce their own regional spheres introducing long-term instability risks.

This fragmentation is the new reality, with some market commentators arguing it may even forestall conflict through pragmatic deal making. But history offers few examples where competing great power spheres coexist peacefully. Splintering the global system shrinks markets, reduces efficiency and weakens incentives for innovation. The balance of power tends to erode gradually, and then abruptly.

WHAT DALEEP SEES IN EUROPE

Europe currently operates near macro equilibrium: inflation close to target, growth near trend, and policy rates broadly aligned with the European Central Bank's definition of neutral. Under baseline conditions, little policy urgency exists.

The main swing factor is the U.S. overheating scenario. Should it materialise, the ECB may deliver modest additional rate cuts, though less aggressively than the Federal Reserve. Market pricing understates this risk.

European fixed income markets offer steep yield curves, generating attractive carry and rolldown opportunities with some insulation from global volatility. At the sovereign level, spreads between peripheral and core markets may continue to compress, supported by improving debt metrics in parts of Southern Europe and persistent fiscal strains in countries such as France and Germany.

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