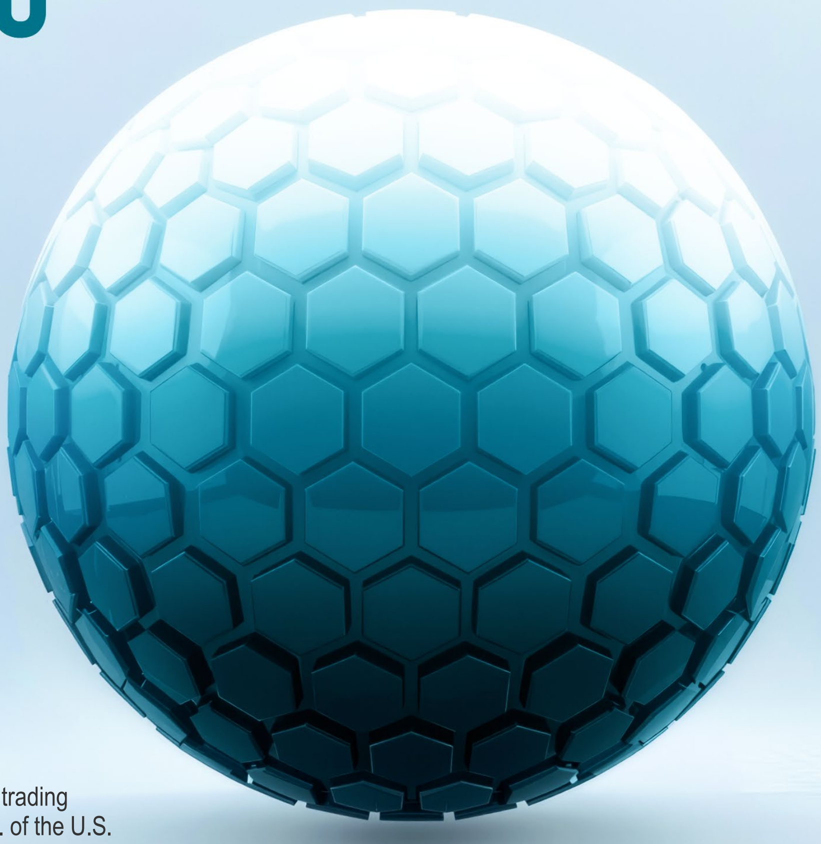
GLOBAL ECONOMIC OUTLOOK

Q1 2026



KEY THEMES & ECONOMIC INDICATORS

Our Q1 2026 Outlook assesses the impact of key themes across global economies and markets:

The Era of Fiscal Dominance (and the End of Central Bank Innocence)

Geopolitical rivalry is expensive (see our insights on Venezuela here). Record defense budgets, expanding industrial policy, and rising populism will compel major economies to run historically high deficits. Accompanying demands for low monetary policy rates erodes central banks' inflation-fighting credibility. Repriced term premia will increasingly determine the level of long-term rates.

Carry On: Lean Into Structural Growth

Steeper yield curves, stretched market valuations, and economies reconfigured for structural growth warrant diversified portfolios constructed for carry and income.

Productivity Boost Redux

The $7 trillion global AI-buildout threatens near-term over-investment risks. Yet, historical precedent suggests it will ultimately seed a productivity boost that determines growth trajectories, debt dynamics, and the future winners and losers across global industries and corporations.

The Convergence of Public and Private Markets

As the delineation between public and private markets fades, expanding sources of capital can support borrowers' credit profiles. As risk and return profiles converge, investors will benefit from assessing relative value across the public and private credit continuum.

Key Economic Indicators

	GDP	Consumer Prices	Unemployment Rate	Latest Monetary Policy Rate
	Latest Quarter, 12-month change (%)	Latest Reading, 12-month change (%)	Latest Reading (%)	%
U.S.	2.3 (Q3)	2.6 (Nov)	4.6 (Nov)	3.75
Euro Area	1.4 (Q3)	2.1 (Nov)	6.4 (Oct)	2.00
China	4.8 (Q3)	0.7 (Nov)	5.1 (Nov)	3.00
Japan	1.1 (Q3)	2.9 (Nov)	2.6 (Nov)	0.75
UK	1.3 (Q3)	3.2 (Nov)	5.1 (3-months to Oct)	3.75

Source: Bloomberg

GLOBAL MACROECONOMIC OUTLOOK

WHEN SECULAR AND CYCLICAL FORCES COLLIDE

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A new year may prompt investors to rationalise the intersection of major secular themes—such as a global era of fiscal dominance and a potential productivity boost—with near-term cyclical developments. The following global economic outlook addresses this relationship by providing regional context to key secular themes as well as their impact on our global scenarios for the coming 12 months.

U.S.—Two Sides of AI-related Capex

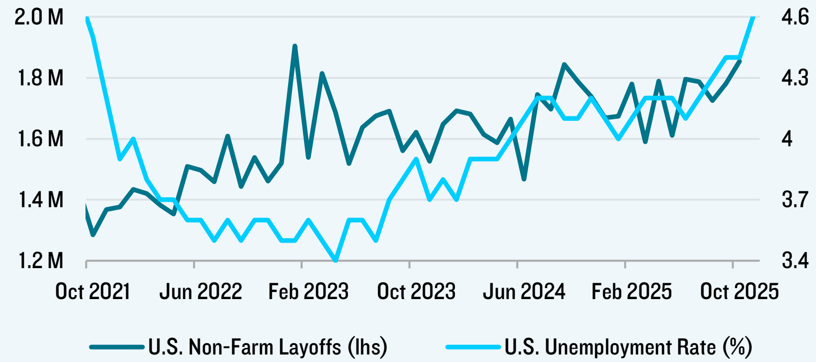
The intersection of secular and cyclical themes is readily apparent across the U.S. economy. As the fog begins to clear from the record-long shutdown of the federal government, the emerging data indicate further softening in the labor market (Figure 1). One takeaway from the delayed November payroll report was an average payroll addition of only 22,000 over the prior three months, below our estimated "steady state" level needed to maintain a stable unemployment rate.

The moderation in labor conditions is occurring against—and perhaps partially caused by—the boom in AI-related capex as the technologies are integrated into workplaces. In addition to the resiliency of high-end consumers, AI-related capex has also provided a solid contribution to GDP growth. **In the first half of 2025, the AI-capex impact on U.S. GDP growth amounted to about 60 bps, and we expect that trend to continue in 2026 (Figure 2).**

In the near term, the intersection of secular and cyclical forces paints a mixed picture for the U.S. economy (which we'll return to below). The longer-term effects may be better viewed from the relationship between these two trends.

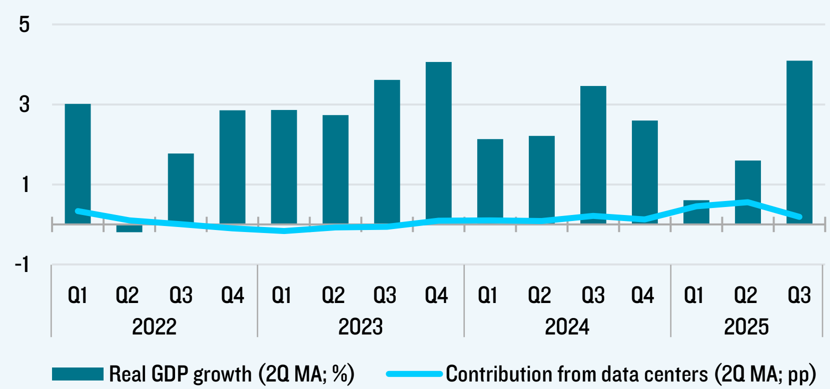
With about 40% of global jobs exposed to AI, one of the first-order effects for the most exposed U.S. sectors, such as technology and data processing, is faster productivity growth relative to the pre-existing trend.[1]

Figure 1: Fewer payroll additions may place upward pressure on the U.S. unemployment rate



Source: Macrobond

Figure 2: Data center-related capex should continue to support U.S. GDP in the quarters ahead.



Source: Macrobond

[1] Data on global jobs exposure is from the IMF and the International Labour Organisation

At this point, AI is augmenting the productivity in those positions, rather than displacing workers.

Augmentation is also accelerating wage growth—and possibly contributing to sticky inflation conditions—within the sectors that are most affected by AI adoption.

However, some tentative evidence indicates that early-career workers in vulnerable sectors are absorbing a bigger hit. For example, the recent increase in the unemployment rate for tech workers in the 20- to 30-year cohort is far greater than the industry's overall rate. Such displacement may also contribute to rising inequality, particularly if augmentation is more likely to apply to high-skilled workers or if higher returns from AI investment accrue to a relatively small cohort of the population.

With that context, a potential productivity boom—a market-friendly combination of accelerating growth and low inflation—remains further out on the horizon and is not our base case for the U.S. economy in 2026. **However, signs of a potential boost exist as observed in the stronger-than-expected Q3 GDP report. Accelerating growth amid weak employment indicates that the economy is expanding through efficiency gains rather than labor accumulation.** Yet, further confirmation will be needed before heralding the arrival of a productivity boom.

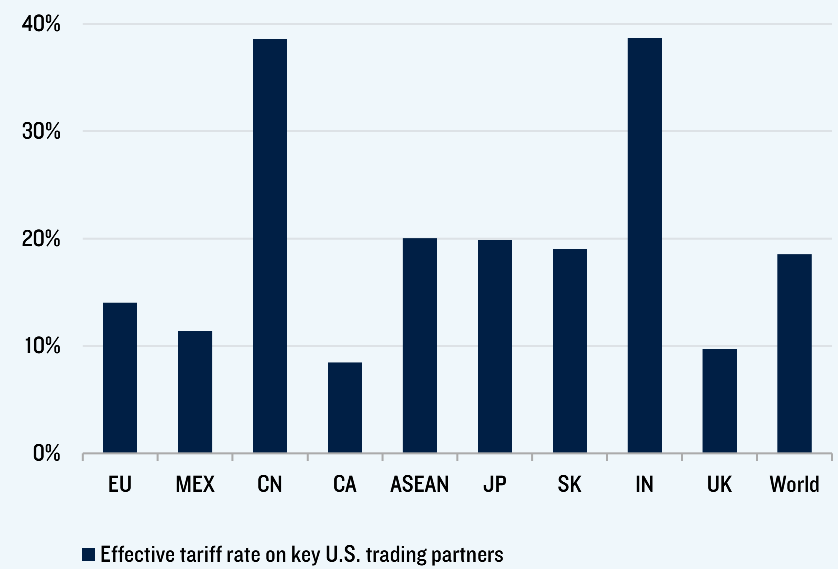
Over the coming 12 months, our "Muddle Through" base case for the U.S. sees further weakening in the labor market against a backdrop of stubbornly high inflation between 2.5-3.0%. The Fed, torn between the conflicting signals of its dual mandate, will likely chart a patient path to the estimated neutral range of monetary policy (i.e., 3.0-3.25%) in 2026. The combined prospect of a more dovish FOMC and further fiscal expansion points to our key risk scenario of "Overheating" where accelerating growth lifts inflation above 3.5%.

Euro Area—Tailwinds May Forestall Looming Risks

Euro area growth of 1.4% through late 2025 approached potential with inflation essentially at target. This leaves the ECB in a good place early in 2026. **Europe's shock from higher tariffs was less damaging than feared, perhaps partially alleviated by the relatively low effective tariffs rates applied on EU exports to the U.S. (Figure 3) as well as the lack of EU retaliation.**

Momentum in periphery economies, such as Spain, Portugal and Greece, is expected to remain through 2026, even as the deadline for post-pandemic EU funds expires. Spain remains a star performer, with strong employment growth, low energy costs, and increased diversification into non-tourism professional services. **As a result, we see continued fiscal discipline in the periphery driving further improvements in credit ratings, which in turn should support further compression of periphery sovereign bond spreads over bunds.**

Figure 3: A relatively low effective tariff rate on EU exports to the U.S. likely contributed to the region's resiliency.



Source: Macrobond and WTO

As Germany seeks an economic renaissance through industrial policy, its substantial fiscal boost is expected to contribute to euro area growth given the positive spillovers for Italy as well as interconnected central and eastern European economies. **All told, we see relatively solid euro area growth of 1.2% in 2026 against a backdrop of benign inflation.** A relatively resilient "no hire, no fire" labour market, a high savings rate, and a recovery in real wages should continue to support domestic demand.

Whilst the euro area macro picture appears benign from the top down, cracks remain below the surface: private sector dynamism remains weak with rising unemployment in Germany and France. The German fiscal boost comes in the absence of major reforms, curtailing its potential to generate higher endogenous growth. Reform at the EU level, including regulatory simplification, has underwhelmed, with minimal progress on the Draghi proposals.

France remains a prime example of the effects of an era of fiscal dominance as political divides prevent it from reining in large budget deficits and a rising debt-to-GDP ratio. **Political fragmentation is not unique to France, with Spain unable to agree a budget for the third year running.** But these are problems for another day, potentially resolved in the next round of consequential regional elections in 2027. For now, the combination of inertia in the periphery and Germany's pending fiscal impulse (contributing to steep yield curves) should support investor interest in the region.

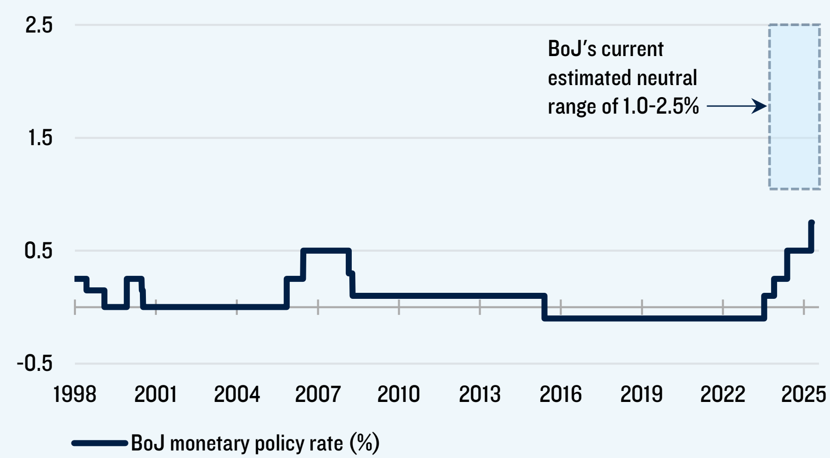
Japan—Reassessing Neutral?

While Japan is certainly part of an era of fiscal dominance, the Bank of Japan re-asserted itself on the monetary policy front in 2025. The BoJ raised its policy rate to 0.75% in December, marking its highest level in nearly 30 years. As in other relatively open developed markets, the Japanese economy has been more resilient to the U.S.-tariff shock than expected. This was likely a key factor behind the BoJ's decision to raise rates sooner than initially expected. In particular, the squeeze on corporate profits due to higher U.S. tariffs was far more benign than some feared. Such a squeeze would have been a threat to nominal wage growth in the crucial Spring wage negotiation round, potentially short-circuiting a virtuous wage-price spiral underpinning a return to the 2% inflation target.

Multiple questions accompanied the BoJ's December rate hike. **Was the BoJ simply pulling a policy decision forward as certain risks failed to materialise? Or, in the face of greater economic resilience and the limited effects from policy normalization to date, has the BoJ re-assessed its estimated neutral policy range?** Such a reassessment would rhyme with other increases in estimated global neutral rates since 2020. It would also be consistent with a more robust fiscal outlook under new PM Takaichi.

Despite last year's rate hikes, recent bank communications highlighted the continued accommodative stance of monetary policy and the wide estimates around the neutral rate. **Moreover, references to strong capex, including in AI, would potentially support an upward revision to the top end of the Bank of Japan's current estimated range of neutral between 1-2.5% (Figure 4).** All of which suggests that the current policy rate may be some distance from neutral. But with rate hikes seemingly restricted to a bi-annual cadence

Figure 4: As it normalises policy, the BoJ may reassess its estimated neutral policy rate.



Source: Macrobond

(at the most), the gradual approach could hardwire the BoJ to be behind the curve, perhaps as indicated by recent weakness in the yen and bear steepening along the JGB yield curve.

China and Emerging Markets—Global Trade Powers Ahead

Despite the U.S.-imposed increase in tariffs, global trade rose in 2025 with China and other emerging economies largely fuelling the improvement (Figure 5). Much of the increase in Chinese exports reflects trade redirected from the U.S. towards Asia, Africa, and Europe as authorities adapt to higher tariffs via export diversification. This has supported Chinese growth, even as domestic demand remains sluggish.

China's doubling down on export-led growth comes at the cost of increased competition for other manufacturing exporters. German manufacturing, which produces many goods that globally compete with Chinese goods, offers a particularly poignant example.

As in developed economies, inflation across the emerging markets has generally stabilised near target. **This has allowed most EM central banks to conclude their easing cycles.**

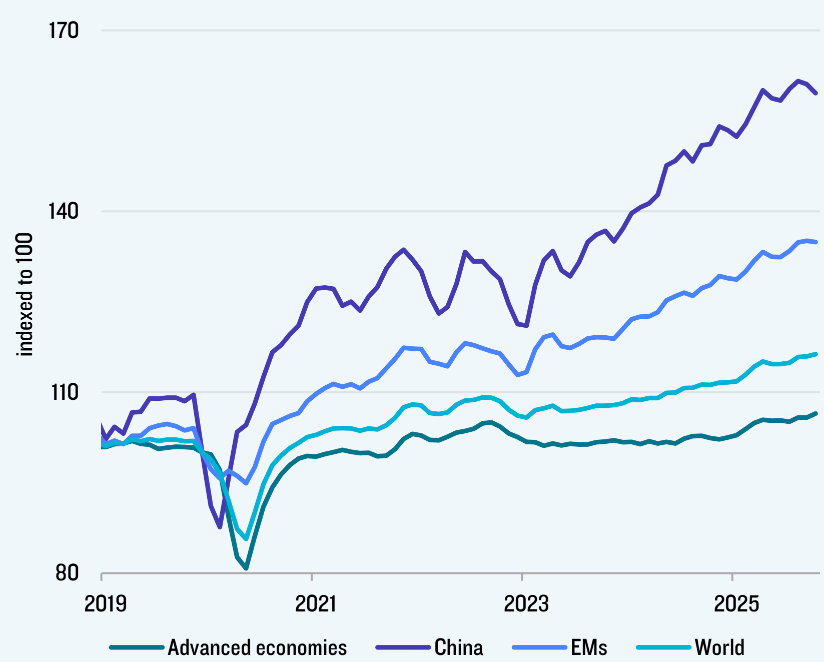
Fiscal weakness and populist policy tendencies, in part related to the upcoming EM election calendar, underscore a few vulnerabilities to the outlook. Brazil and Colombia have upcoming elections, and both have polarised political policy outlooks coupled with large fiscal risks. While there are ratings risks to both countries, we do not anticipate downgrades that lead to major upheaval. Peru, Hungary, and Costa Rica are also set for elections this year. **Elections in 2025 saw a shift to the right (e.g., in Ecuador, Chile, Argentina, Romania).**

When viewed through the lens of geopolitical dynamics (including the broader U.S./China strategic competition and the focus on regional "spheres of influence"), election outcomes may result in investment opportunities. This is particularly true for U.S./Latin America relations, where U.S. policy priorities related to immigration, trade, security (i.e. narco-trafficking) enabled some Central and South American countries to benefit (see the following sidebar, Viewing Venezuela Implications from Four Categories).

Similarly, changing trade/tariff dynamics will unfold in 2026. **While effective tariff rates will remain higher than before, other factors will limit their growth impact.** EM supply chain and trade diversion tactics will evolve and impact tech exports, such as those in Asia.

Commodity-rich countries are beneficiaries of changing geopolitics. Fragmentation is a risk, but many EMs are less vulnerable as they typically have multiple trading partners, are diversified in what they trade, and have differing levels of exposure to the U.S.

Figure 5: China leads the resilience in global trade after the increase in U.S. tariffs.



Source: Macrobond. Based on trade volumes, indexed to 100; December 2019=100

SPOTLIGHT

Viewing Venezuela Implications from Four Categories

The recent ousting of Nicolás Maduro from Venezuela underscores the geopolitical competition and uncertainty across the global investing landscape. We segment our views on Venezuela into the following categories: energy markets; inflation, central banks, and interest rates; geopolitical implications; and the regional/EM implications.

Energy Markets

Venezuela possesses the world's largest proven crude oil reserves at more than 300 billion barrels (**see Figure 6**). From a short-term perspective (i.e., days or weeks), Maduro's removal as Venezuela's president may apply upward pressure on crude prices, especially heavy sour crude, which comprises most of Venezuela's reserves.

Longer term (i.e., months to years), the prospect of higher output from Venezuela and more U.S. supply control could exert downward pressure on crude prices, especially the long end of crude futures curves. However, Venezuela's ultra-heavy crude oil requires significant cost to extract and requires extensive processing.

Inflation, Central Banks, and Interest Rates

In general, spikes in crude oil prices from geopolitical events tend to be short lived, and major central banks will likely continue looking through any near-term price increase.

At this point, global oil supply is plentiful, and U.S. support for Venezuelan production could equate to an increase of 500,000 to 1 million barrels per day (bpd) over the next few years and potentially 1-2 million bpd by 2035. Hence, prices should decline over the intermediate to long term, pushing inflation lower and supporting front-end rates. However, the effects at the back of yield curves are less clear, as indicted by the geopolitical implications.

Geopolitical Implications

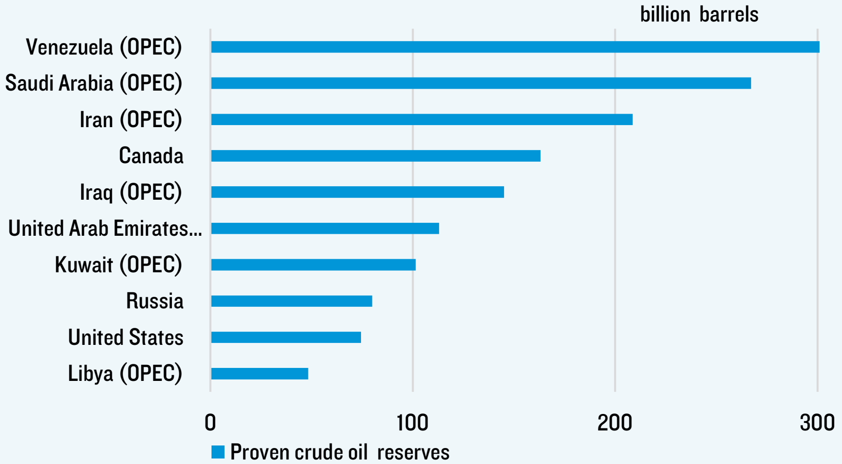
Maduro's ousting has advanced the United States' bid to assert its dominance in a region vital to the country's national interests.

Eventual U.S. control over Venezuela's oil reserves would significantly increase its leverage over global oil supplies, threaten OPEC+ cohesion, and potentially weaponize its dominance of global oil production to propagate its national security goals. In such a scenario, Russia's global strategic interests will suffer another setback, and the appeal of its touted joint energy projects with the U.S. will diminish accordingly.

Regional/EM Implications

The ousting of Maduro may add to the uncertainty across the region, which was already high amid U.S.-imposed tariffs, and in certain countries, such as Colombia, Mexico, and Brazil. Over the longer term, Latin American should benefit from U.S. demand for goods and resources, but that relationship will be complicated given China's extensive investments across the region.

Figure 6: Global Proven Crude Oil Reserves (2023)



Source: Oil & Gas Journal, 2023 Worldwide Reserves and Production, IEA

2026 Economic Scenarios—More Muddling with an Eye on Overheating

Given the preceding context, our 12-month economic scenarios generally remain intact from late last year with some updated probabilities across the distribution.

Indeed, we continue to see a "Muddle Through" base case for the U.S. (still 40%), the Euro Area (raised from 45% to 55%), and China (increased from 60% to 65%).

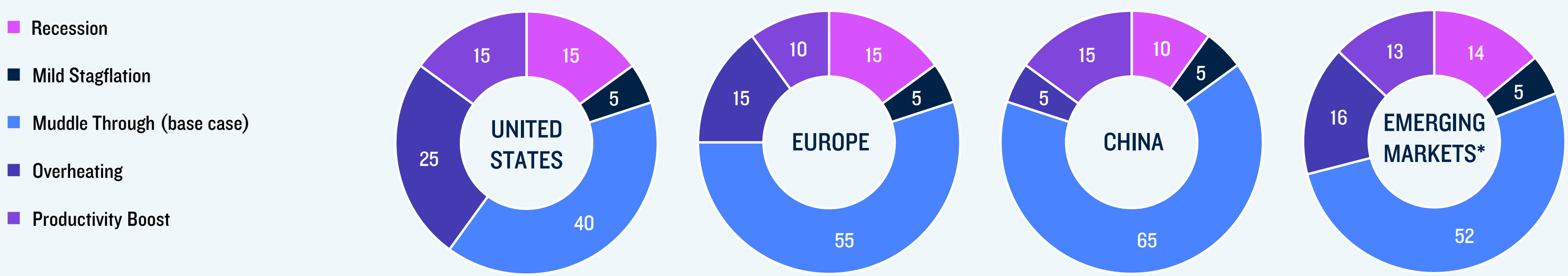
In the U.S., our base case assumes that growth of 1.7% remains close to trend amid AI-related capex and expenditures by high-income consumers. The scenario includes a Fed funds rate that gradually progresses towards neutral of ~3.0-3.25% as the labor market continues to cool while elevated inflation remains sticky. Our key economic risk resides in the right tail of the distribution with a 25% probability on an "Overheating" scenario amid the potential combination of accelerating monetary and fiscal stimulus that prompts a material, above-trend acceleration in growth while inflation exceeds 3.5%.

In Europe, our base case also anticipates near-trend growth (~1.2-1.4%) as rising real incomes and fiscal support underpin the consumer, while exports and investment remain challenged. A mild, but extended, period where inflation undershoots the ECB's 2% target may incentivise the ECB to implement another 25 bps rate cut to bring the deposit rate to the lower side of neutral at 1.75%. Our increased probability for the base case came from a 5 percentage point reduction in an "Overheating" scenario, with "Recession" remaining the key downside risk with a 15% probability.

Although we raised our base-case probability for China, we continue to see the balance of risks tilted to the upside (a 5 pp increase for the "Productivity Boost" scenario to 15%) considering productivity gains, policy easing, and potential for U.S. economic overheating. The main downside risk in China is through U.S.-China trade tensions.

For the emerging markets, we assume a "global growth" construct by taking a weighted average of the U.S. (35%), Europe (35%), and China (30%). As a result, "Muddle Through" remains the base case for EMs as well with nearly equal probabilities for the risks of "Overheating" and "Recession."

Figure 7: PGIM's 12-month global economic scenarios



Source: PGIM. *Probabilities for EM may not sum to 100% due to rounding. For EM we assume a 'global growth' scenario by taking a weighted average of the U.S., Europe, and China using the following weights: U.S. (35%), Europe (35%) and China (30%).

Source(s) of data (unless otherwise noted): PGIM as of January 2026.

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