Bank of Nassau
SINCE 1982

2026 Outlook

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"It's tough to make predictions, especially about the future."

Yogi Berra

INTRODUCTION

Despite a strong showing for the US economy in 2025, we will begin 2026 with many unanswered questions. Can this US outperformance continue? Or will US exceptionalism fade? In this 2026 outlook piece, we identify what we believe to be the six most important themes for global financial markets. What will emerge from this exercise is a story that is largely bullish for equities, bearish for the dollar, and a mixed story for fixed income that should continue to feed the curve steepening trade.

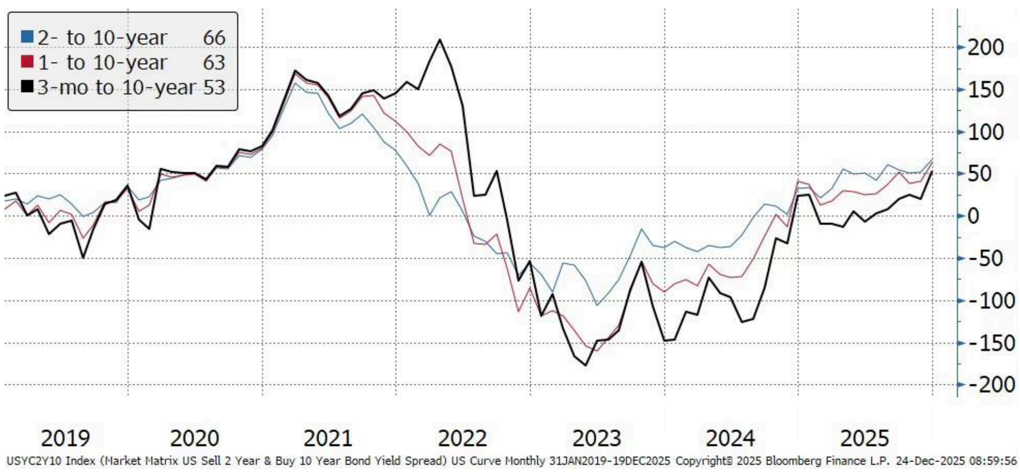
When all is said and done, we expect events in 2026 to add to market volatility but they should not derail the current market trends. As such, we would use any event-related price action as opportunities to recommit to our current macro calls. For global investors, our FX views suggest that local currency returns from investing in Europe, Japan, and Emerging Markets will outperform those in the US, just as they did in 2025.

1. Tariff Legality

As of this writing, the US Supreme Court has yet to deliver its ruling on whether the Trump administration's reciprocal tariffs are legal or not. Oral arguments began in November and we were hoping for a relatively quick decision before year-end. However, that decision appears to have been pushed out to 2026.

Given the current Supreme Court's deference to executive authority, we expect it to rule in favor of a continuation of the current tariff regime. That is also what markets have priced in. If we were to get a surprise rejection of President Trump's reciprocal tariffs, then we would expect the dollar to weaken significantly as the Fed would likely cut rates more aggressively in the absence of upside tariff-related inflation risks. Furthermore, yields at the long end of the US curve would likely rise sharply to reflect the fiscal risks of losing $300 bln of tariff revenue annually. Curve-steepening would thus accelerate.

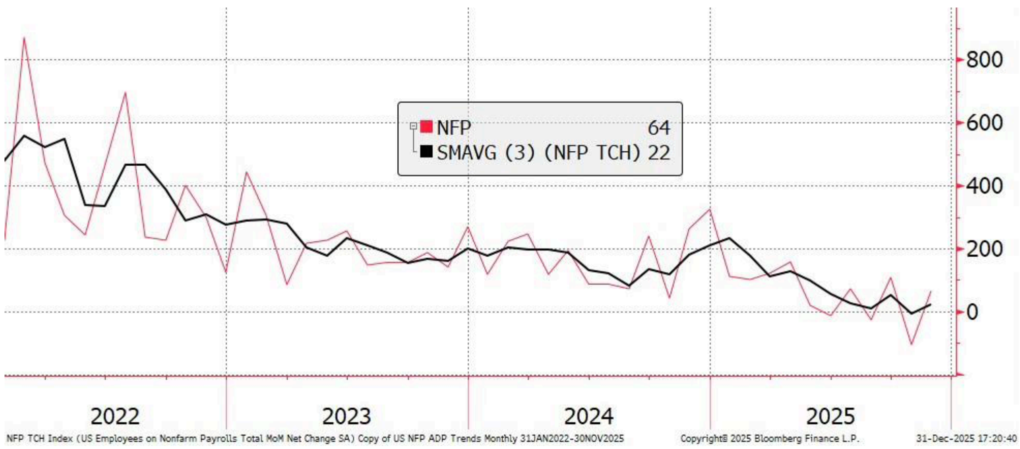
US Curve, bp



2. US Economic Outlook

US GDP growth was strong in 2025, due in large part to massive investment in Artificial Intelligence. Personal consumption also remained surprisingly strong. For 2026, we anticipate a significant consumption slowdown due to further softening of the labor market. US job growth has basically slid to a standstill, with NFP gains totaling only 119k since May. In the seven months leading up to May, total NFP gains were a full million higher at 1.119 mln. If one agrees with Fed Chair Powell's assertion that monthly NFP is being overstated by 60k, then the US has likely shed over 300k jobs since May.

US NFP, 000s



The Fed expects growth to pick up to 2.3% in 2026 from an estimated 1.7% in 2025. Is that possible? Recall that consumption makes up about 70% of the US economy. Compare this to fixed asset investment, which accounts for around 20% of GDP. While strong AI investment can help cushion the blow, it's hard to see how it could totally offset the expected weakness in consumption as unemployment rises.

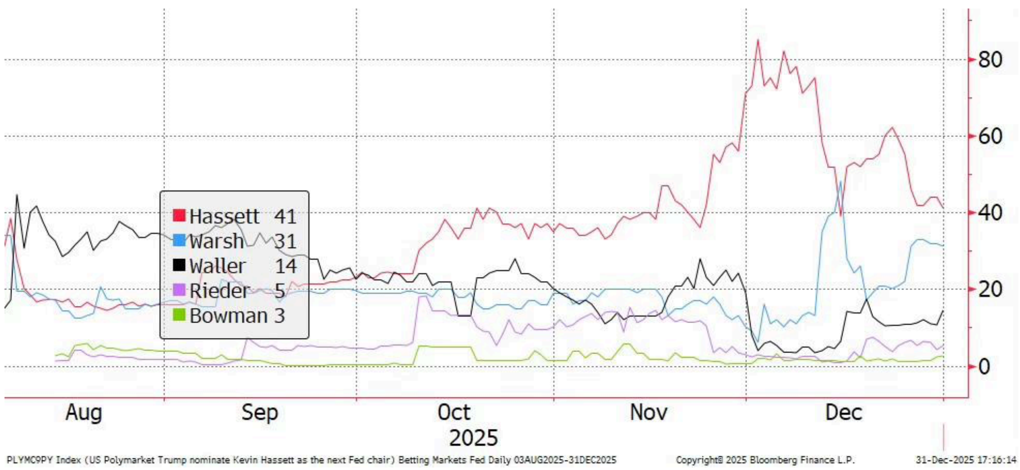
Recession remains a tail risk. Bloomberg consensus sees 30% odds of a recession in 2026. While we remain concerned about a slowdown, we think these odds overstate the risk of a deep downturn this year. Furthermore, if recession risks do materially rise, then we would expect the Fed to ease policy more aggressively. That's because when all is said and done, we continue to believe that the Fed will put more emphasis on meeting its full employment mandate than its price stability mandate. That is behind our call for 75-100 bp of Fed easing in 2026, which compares to market pricing for 50 bp and the Fed's Dot Plot for only 25 bp. With the long end of the curve likely to underperform due to above-target inflation and Fed independence concerns (see below), the US curve is likely to continue steepening.

3. Fed Independence

We should find out who will be nominated to be Fed Chair Jerome Powell's replacement in early 2026. Powell's term as Chair ends in May and so it's likely that we will have a "shadow Chair" for nearly six months who will be second-guessing Powell at every turn.

After President Trump said he knew who his choice was in November, betting market odds that it would be NEC Director Kevin Hassett shot up to around 80%. However, reports emerged in December that interviews were ongoing, with Trump saying both Hassett and former Governor Keven Warsh were "great candidates." Warsh's odds jumped while Hassett's odds slumped, but both have since reverted and Hassett remains the frontrunner. We believe most market participants would probably prefer Governor Christopher Waller over both Kevins, but we still believe Trump will ultimately choose Hassett, who like Governor Stephen Miran has shown himself to be an uber-dove that will cut rates aggressively, just as Trump wants.

Polymarket Betting Odds



There is an unlikely possibility that Powell stays on until his term as Governor ends in January 2028. While this would be highly unusual, it has happened before. If Powell does stay on, it would complicate matters as the Fed Chair must be chosen from the Board of Governors. As a result, we expect President Trump to nominate Hassett to replace Governor Miran when Miran's term ends this January. That way, Hassett can be named Chair if Powell decides to stay on as a Governor. If Powell does step down from the Board, then Miran is waiting in the wings to take that Governor slot.

Having two sitting cabinet members move over to the Fed clearly blurs the lines of central bank independence, to state the obvious. One need only look at Governor Miran's votes to cut 50 bp at each meeting in September, October, and December to get an idea of what Hassett would likely push for as Chair. However, the reason we believe Fed independence will ultimately survive is that the Fed Chair is only one member of the decision-making Federal Open Market Committee. Another reason why independence should survive is that Trump appointees from his first administration (Christopher Waller and Michele Bowman) have not dissented along with Miran, which we took as an explicit show of independence. Lastly, we are heartened that the Board of Governors just unanimously confirmed the twelve regional Fed Presidents for new 5-year terms rather than attempting to change their makeup.

That said, we believe there will be a dovish shift at the Fed in 2026. Not only from the arrival of Hassett, but also among the regional Fed Presidents that will become voters in 2026. The incoming FOMC voters are split between two hawks (Hammack and Logan) and two doves (Kashkari and Paulson), while the outgoing voters (Goolsbee, Collins, Musalem, and Schmid) are all hawks. This is another reason behind our more dovish Fed rate cut expectations for 2026.

While the Trump administration still tries to chip away at Fed independence, the Supreme Court has allowed Fed Governor Lisa Cook to remain in her post until her case is heard in January. Of note, former top economic officials (including former Fed Chairs Greenspan, Bernanke, and Yellen) who served presidents of both parties submitted an amicus (friend of the court) brief that argued that allowing Trump to fire Cook "would expose the Federal Reserve to political influences, thereby eroding public confidence in the Fed's independence and jeopardizing the credibility and efficacy of U.S. monetary policy." We concur and are hopeful that the Supreme Court will too. If not, the explicit loss of Fed independence would likely lead to massive curve steepening as well as intensified dollar weakness.

4. More Cockroaches

After several subprime lenders linked to private credit went belly up last year, JP Morgan Chase CEO Jamie Dimon quipped that "My antenna goes up when things like that happen. And I probably shouldn't say this, but when you see one cockroach, there are probably more… Everyone should be forewarned on this." We wholeheartedly agree.

Much of this nervousness stems from the fact that private credit is by nature quite opaque. Furthermore, it is not regulated and so the scale and amount of leverage can unknowingly grow to dangerous levels. There have also been reports that the major banks themselves are investing in private credit, which opens up the avenue through which a private credit event can work its way into the wider financial system.

The growth in private credit has been noteworthy. Industry estimates suggest private credit has already doubled in size from under $1 trln in 2010 to over $2 trln currently. It's worth noting that the use of private credit took off significantly after the Great Financial Crisis, as stricter regulations for banks were implemented, which in turn opened the door for non-bank lenders to fill the ensuing gaps in lending.

In its latest Global Financial Stability Report from October, the IMF warned that "Nonbank lenders, especially private credit funds, have grown rapidly in recent years, adding to financial stability risks because they are less transparent and not as firmly regulated." Specifically, the agency stressed that "Unlike banks, nonbanks, for the most part, operate under lighter prudential regulation. In addition, many provide limited disclosure of their assets, leverage, and liquidity—making vulnerabilities and interconnections harder to detect."

Neither we nor the IMF are condemning private credit as an asset class. However, private credit has never been tested by an extended economic slowdown or downturn. The COVID downturn was relatively brief as the Fed injected massive amounts of liquidity even as the world reopened quickly. If the US does experience a slowdown this year, then we would expect further stresses in private credit. If that slowdown is deeper than expected, then we should all be prepared for a stampede of cockroaches.

5. Geopolitical Tensions

We knew we were likely to see ongoing bursts of heightened geopolitical risks in 2026. We just didn't expect it on Day Three.

After escalating rhetoric, threats, and limited military actions against Venezuelan boats, tankers, and other sites, the US launched a full-scale attack and removed President Maduro. He and his wife are being taken to the US to face criminal charges that include narco-terrorism. President Trump said the US would "run" the country during a transition period but is not clear to what extent the US is willing to commit forces to actually maintain control of the country.

There is no consensus on who might succeed Maduro as president. Vice President Delcy Rodriguez is constitutionally next in line and Trump said that she would lead as long as she "does what we want." However, she is a Maduro loyalist and has already accused the US of invading Venezuela under false pretenses whilst claiming that Maduro is still the president. While Rodriquez and other top leaders have vowed to defy the US and remain in power, it's not clear yet whether they have the backing of the Venezuelan military.

Of note, Trump has also said that the country should not be led by opposition leader Maria Corina Machado, who has not yet returned to Venezuela after accepting the Nobel Peace Prize last month. In turn, she has said that her endorsed candidate for 2024 election Edmundo Gonzalez should assume power, but he is in exile in Spain.

Political analysts have been predicting the return of the Monroe Doctrine for several years, and we are now seeing that in action. Recall that the Monroe Doctrine of 1823 was meant to halt any foreign influence in the Western Hemisphere, giving the US carte blanche to impose its will on Central and South America for centuries. While originally meant to limit the European colonial powers in this hemisphere, the current interpretation of the Monroe Doctrine is likely a response to China's growing presence in the region. Indeed, there have been reports of several Chinese projects in the Venezuelan oil, mining, and infrastructure sectors.

In the meantime, Trump said US oil firms would be going in. If so, we can expect a burst of investment in Venezuela's aging oil extraction and refining infrastructure that could return the nation to its peak production levels of nearly 4 mln barrels/day during its OPEC glory days of the early 1970s vs. less than 1 mln barrels/day currently. While this would likely take years to complete, a significant rise in output would eventually help push oil prices lower, which has always been one of Trump's hallmark pledges.

We note that the Trump administration has already acted to support Argentine President Milei after it punished Brazil for prosecuting former President Bolsonaro. Trump has already accused Colombian President Petro of involvement in the drug trade and just warned President Sheinbaum that "something will have to be done about Mexico." Cuba is also in focus as Secretary of State Rubio warned "Look, if I lived in Havana and I worked in the government, I'd be concerned." On the other hand, Chile and Peru appear to be safe since both are led by right-wing governments.

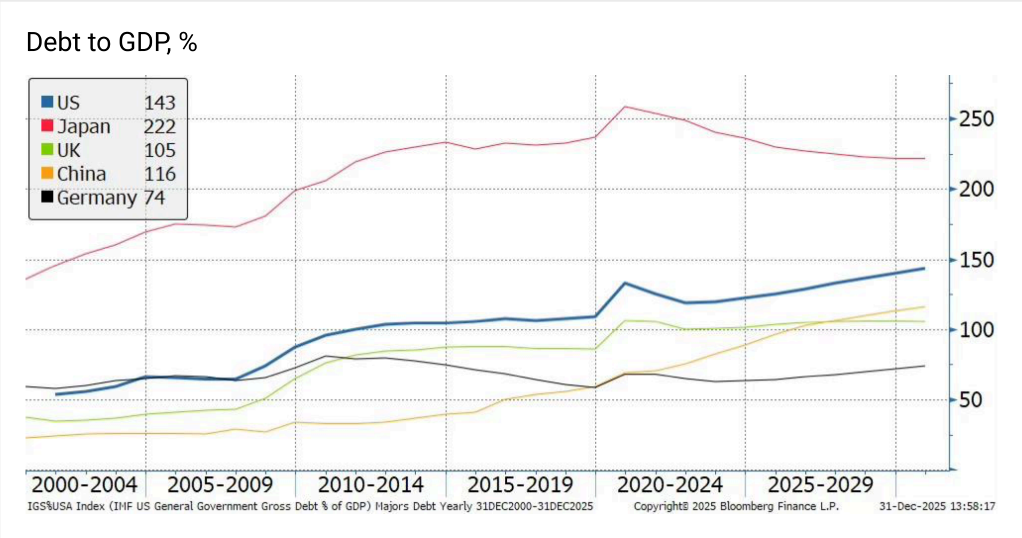
Looking beyond just the Western Hemisphere, many have already raised the likelihood that the world would be fractured into spheres of influence. There is an argument that this is already happening as the US asserts growing influence over the Americas whilst ceding influence over Europe to Russia and ceding influence over Asia to China.

We believe that the most important takeaway from the US actions in Venezuela is that it could usher in a prolonged period of hostilities worldwide. While markets are always braced for ongoing saber-rattling in the Taiwan Strait, we fear that President Xi may be emboldened to take Taiwan by force rather than by diplomacy. Elsewhere, Russia's President Putin may be more emboldened to keep the areas in Ukraine that he has already seized and perhaps even set his sights on the other countries in Eastern Europe as he seeks to forcibly claw back the old USSR. As a result, we do not see much likelihood of any other major diplomatic wins for President Trump in 2026 and instead see geopolitical risks remaining quite high.

Yet despite the myriad geopolitical risks piling up, we do not expect any lasting economic or investment impact from such tensions. Instead, we simply acknowledge that these types of risk-off events are likely to lead to periodic dislocations in global financial markets. If so, investors should be prepared to take advantage of any counter-trend movements in order to add to existing positions based on underlying economic fundamentals.

6. Too Much Debt

Concerns about fiscal policy worldwide are likely to keep global sovereign yields elevated at the long end. All of the major economies are awash in debt and the ongoing question is: how much is too much? As the chart shows, most of the major economies have debt/GDP ratios well north of 100% and rising. The notable exception here is Japan, but it has only seen modest improvements from the high above 250%.



Despite strong economic growth and added revenues from tariffs, the US is likely to see ongoing deterioration in the fiscal outlook given rising interest costs and ballooning mandatory payments. Bloomberg consensus sees the budget deficit as a share of GDP increasing to -6.4% in 2026 from an expected -6.0% in 2025 despite nominal GDP growth that's likely to be close to 5%. If US economic growth were to slow significantly in 2026, the deficit would widen even further. There are also heightened fiscal risks from the potential Supreme Court reversal of President Trump's reciprocal tariffs, which would blow an additional $300 bln hole in the annual budget.

China is embarking on another round of fiscal support for the economy in 2026. It announced plans to increase government spending. Finance Minister Lan stressed that "More proactive fiscal policy will be reflected not only in the scale of funding, but more importantly in improving the efficiency and effectiveness of how funds are used." In a nod to existing debt concerns, Lan vowed to accelerate efforts to resolve risks associated with "hidden" off-balance-sheet borrowing by cities and provinces.

The eurozone's fiscal outlook has been clouded by political uncertainty in France, where the current government was again unable to pass a budget for 2026. In order to avert a US-style shutdown, the government was forced to rely on a special bill that allows it to roll over existing tax and spending amounts. France will still have to pass a budget next year and so the fiscal strains are certain to reappear. The good news is that despite the ongoing problems in France, we see little evidence of contagion risk to the rest of the eurozone as peripheral spreads to Germany remain quite tight.

Another full-blown Liz Truss moment for the UK was avoided in the Autumn budget. Chancellor Reeves did little to address the long-term fiscal problems but did just the bare minimum to placate markets. As some point in 2026, we believe the UK fiscal weaknesses will once again be exposed. It's worth noting that UK borrowing costs are already higher than they were during the Truss selloff, which is a big reason why the fiscal sustainability is being called into question.

Lastly, Japan Prime Minister Takaichi may also face her own Liz Truss moment. In her short time in power, she has already introduced an extraordinary fiscal plan made up of JPY17.7 trln of spending within a total stimulus package of JPY21.3 trln. Officials acknowledged that this would require additional JGB issuance to finance the plan. Furthermore, Takaichi is doubling down on fiscal expansion as reports suggest she will announce a record budget totaling JPY122.3 trln for FY2026. This is up over 6% from the JPY115.2 trln budget for FY25 and will be partially funded by a planned JPY29.6 trln increase in JGB issuance.

With the world awash in debt, it's quite easy to see why the long end of the curves are likely to underperform. Dovish central bank policies should anchor the short end and so curve steepening is likely to continue in 2026. This so-called bull steepening is typically positive for equity markets, especially for banks and other financial institutions. Lower short-term US rates are also likely to boost equities and help offset the likely drag from the softening labor market. Lower rates should also keep downward pressure on the dollar.

We have one last word of warning that ties in with our earlier concerns about opaque private markets: it's not just government debt that we have to worry about. That's because much of the AI investment is being funded by corporate debt issuance. AI infrastructure firms have issued nearly $125 bln of new debt this year, with more to come next year. The massive amounts needed to build this infrastructure is more than the free cash flow for these companies and so they have no choice but to issue debt. We must also take into account the off-balance-sheet financing that many of these AI companies have relied on. One popular method is for those firms to create so called Special Purpose Vehicles (SPVs) that enter into partnerships with private equity firms and take on that debt. This is yet another example of why we remain concerned about opaque private markets.

2- to 10-Year Yield Curves, bp

FORECAST MATRIX

	Current	End-2026	Change
Equities			
S&P 500	6846	7500	9.6%
NASDAQ	23242	25000	7.6%
DAX	24490	27000	10.2%
Nikkei	50339	55000	9.3%
MSCI EM	1404	1600	13.9%
Fixed Income			
2-Year UST	3.473	2.75	-0.72
10-Year UST	4.17	3.75	-0.42
2- to 10-year Curve	0.69	1.00	0.31
Currencies			
EUR/USD	1.17	1.23	4.8%
USD/UPY	156	150	-4.1%
EUR/CHF	0.9307	0.9400	1.0%
Commodities			
Gold	4319	4750	10.0%
Brent Crude	61	55	-9.6%