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SCÉNARIOÉCO

Société Générale Economic & Sector Studies

Prolonged strains amidst limited growth engines

- The newly signed memorandum of understanding between the US and Iran to end the conflict still leaves several thorny issues to future talks. While energy prices have eased, uncertainty remains.
- Consumer "resilience" appears increasingly fragile given pressure from higher headline inflation, softening labour markets and elevated interest rates.
- AI resilience is also being tested with elevated costs and tighter financing conditions. We see still investment ahead, but with softer dynamics ahead.
- Europe has significant upside opportunity from addressing the resilience and competitiveness gap, but lack of political resolve remains a drag.
- Inflation is set to be transitory, but we see a high risk of policy error, not least with already high bond yields tightening financial conditions. We expect ECB rate hikes to be reversed by the turn of the year 2027.
- El Niño conditions are already present and several major weather agencies have warned of a "very strong" El Niño. On the commodity front, food prices are a key transmission channel adding upside risk to inflation, not least in emerging economies where food makes up a major share of consumer baskets.
- Election risks are set to become increasingly present on financial market radars, not least ahead of US mid-terms in November 2026 and French Presidential elections in Spring 2027.

SOCIETE GENERALE

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EDITORIAL

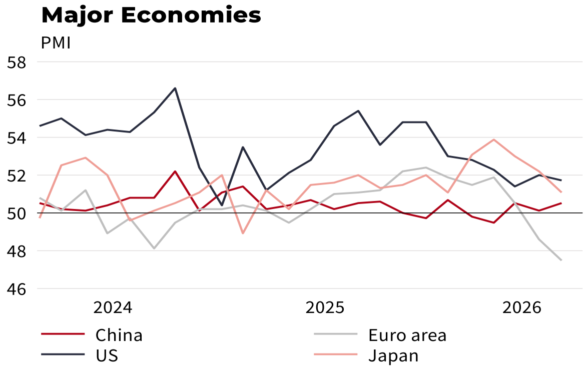
A FRAGILE DE-ESCALATION, NOT A FULL RESOLUTION

The newly signed memorandum of understanding between the US and Iran to end the conflict still leaves several thorny issues to future talks. While energy prices have eased, uncertainty remains. Our working assumption is that a gradual normalisation of conditions by year-end, albeit with some potential volatility along the way.

So far, the global economy has continued to display a degree of resilience since the outbreak of the conflict in the Middle East. More broadly, as we have highlighted in recent quarters, global activity has held up relatively well despite a succession of headwinds, be it significantly higher interest rates, protectionist trade measures, geopolitical threats or conflicts, most recently with the US-Iran conflict.

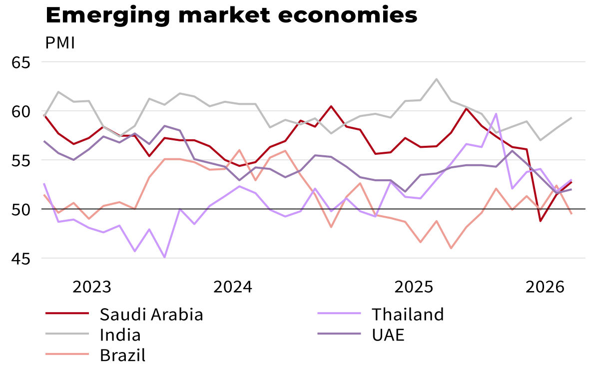
This resilience is visible in business surveys. PMI indicators have, in most regions, remained in expansion territory, suggesting that the conflict has so far not triggered a broad-based collapse in activity. Europe remains the main exception, where the shock appears to have been more pronounced

A confidence shock mainly in Europe…



Source: SG Economic and Sector Studies, LSEG

…and resilience in Gulf countries



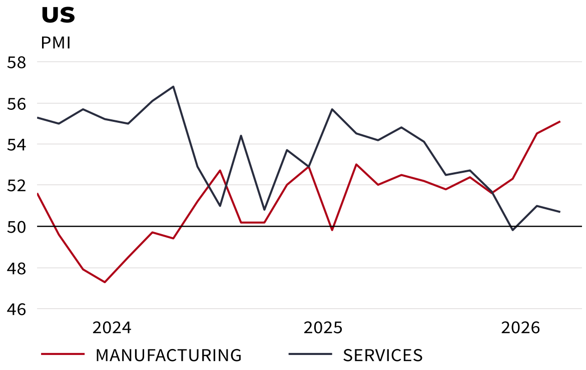
Source: SG Economic and Sector Studies, LSEG

EUROPE BEARS THE BRUNT THROUGH SERVICES, WHILE MANUFACTURING REMAINS MORE RESILIENT

Europe's services sector has been hit by the impact of the Middle East conflict, due to a combination of already weak disposable income growth, the energy prices shock and the increased uncertainty. Transport, tourism, hospitality and leisure services have registered the impact, being often the first option for households to control spendings.

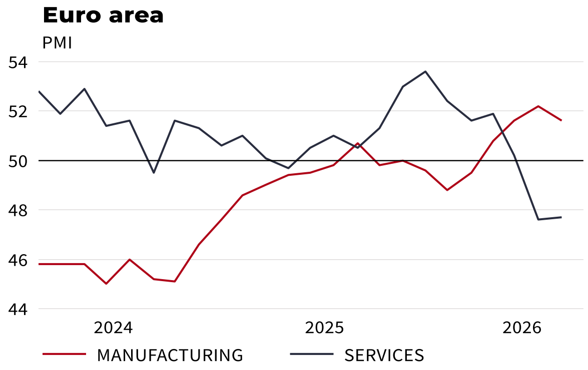
By contrast, Europe's manufacturing sector has remained relatively resilient. Activity has continued to benefit from inventory rebuilding, persistent support from the AI-driven investment cycle, and stronger demand for goods linked to electrification and power infrastructure. In other words, while services have absorbed the immediate geopolitical shock, manufacturing has so far been cushioned by structural and cyclical support factors.

Manufacturing recovery…



Source: SG Economic and Sector Studies, LSEG

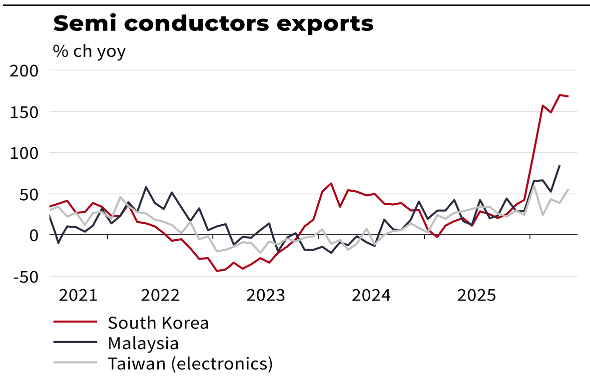
…and services shock in the euro area



Source: SG Economic and Sector Studies, LSEG

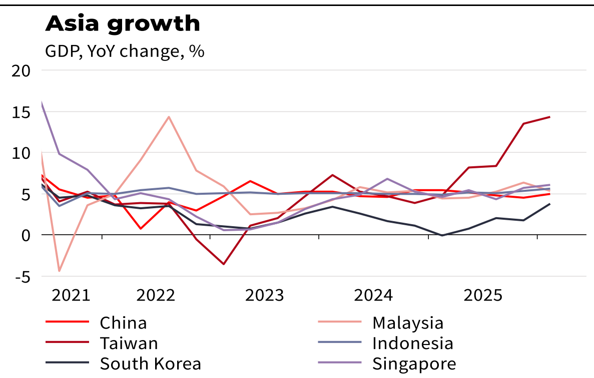
An impressive pattern has been visible across Asia, where manufacturing has also remained well supported. This was especially evident in first-quarter GDP data, which showed stronger growth across much of the region, driven largely by exports. Shipments of semiconductors, batteries and electric vehicles have continued to provide a meaningful boost to industrial output.

AI driven boom…



Source: SG Economic and Sector Studies, LSEG

…partly driving growth in Asia



Source: SG Economic and Sector Studies, LSEG

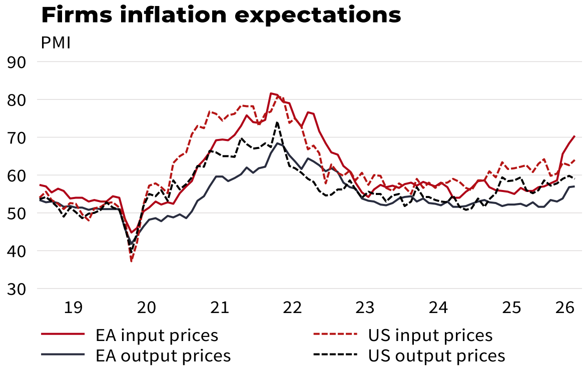
As the conflict settles and households gradually recover lost purchasing power, we expect the services sector to regain some of the lost ground in Europe over the coming quarters. Industry is likely to continue to benefit from firm demand from the tech sector and from a progressive normalisation in trading routes. That being said, most sectors will be affected by higher input costs with limited ability to reflect them on final prices. Combined with still high financing costs this should weigh on investment dynamics over the forecast horizon. Suming up, these factors combined entail a downgrade to our 2026 outlook for the euro area to 0.6%.

HIGHER COSTS SHOULD WEIGH MORE ON MARGINS THAN ON FINAL PRICES

One of the key questions for the outlook is whether the conflict-induced rise in costs could trigger a more persistent inflation shock. At this stage, our assessment remains that the price shock will remain contained with respect to second round effects.

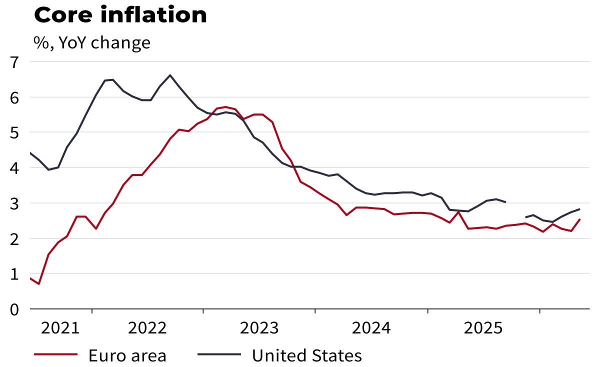
In the euro area and the United Kingdom, high energy import dependency and low levels of inventories have pushed firms to revise up expected input costs. It is less the case in the US which is more insulated especially for gas prices. In Asia, the energy mix in China and India remains dominated by coal, which has dampened the price shock. China and Japan are very dependent on oil imports from Gulf countries but started the crisis with a high level of inventories and public subsidies have smoothed upward pressures on retail prices.

Euro area firms more worried on costs…



Source: SG Economic and Sector Studies, LSEG

…sticky inflation but not major acceleration



Source: SG Economic and Sector Studies, LSEG

Central banks are now confronted with a difficult trade-off between the conflict's negative implications for growth and its upward impact on prices. On the inflation side, we continue to see limited evidence, at this stage, of a risk of a self-sustaining inflationary spiral.

Overall, the rise in cost pressures is more likely to translate into lower profit margins than into a renewed, self-sustaining inflation cycle. At the time of writing, oil prices have fallen significantly, while inflation expectations have also eased, as indicated by swap market pricing.

That said, central banks still face a difficult balancing act. The conflict weighs on growth while simultaneously pushing up costs, complicating the policy mix. In some cases, and notably the US, core inflation remains sticky enough to justify caution, but the evidence so far does not point to a renewed inflation acceleration. In the euro area in particular, cost pressures remain more visible than elsewhere, yet core inflation has stayed broadly persistent rather than substantially re-accelerating.

This stands in contrast to the dynamics observed three months after the February 2022 shock, when core inflation accelerated more visibly, and can be partly explained by the fact that European gas prices have remained relatively contained since March. Several other factors also weighed in, with pent-up demand and pent-up savings supporting consumption following the Covid lockdowns. Back then, both monetary and fiscal policy were highly accommodative. Finally, we observe greater protectionism, not least with elevated US tariffs.

ALREADY TIGHT FINANCIAL CONDITIONS CALL FOR CAUTION

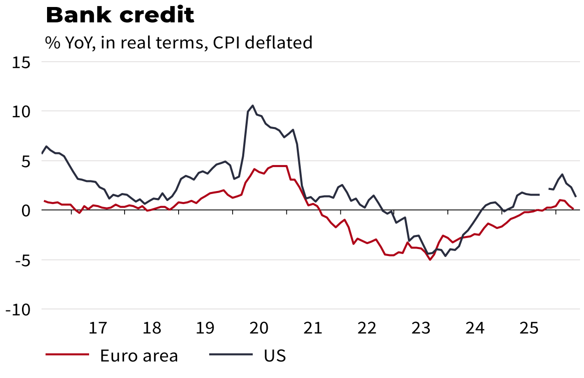
Indeed, unlike in 2022, the present shock is hitting an economy in which financial conditions are already restrictive.

Bank lending had already been slowing in real terms on both sides of the Atlantic before the outbreak of the conflict, reflecting weaker confidence, more cautious corporate behaviour and tighter lending standards. The latest bank lending surveys in both the euro area and the United States confirmed that standards had already tightened in late 2025, while demand for credit — particularly in the euro area — had softened materially.

In parallel, real interest rates have continued to rise, and they could move higher still if term premia increase further in response to persistent uncertainty, including fiscal concerns. This matters because even if inflation expectations remain broadly stable, the combination of high real rates, tighter credit supply and weakening loan demand points to a continued drag on private investment and broader domestic demand.

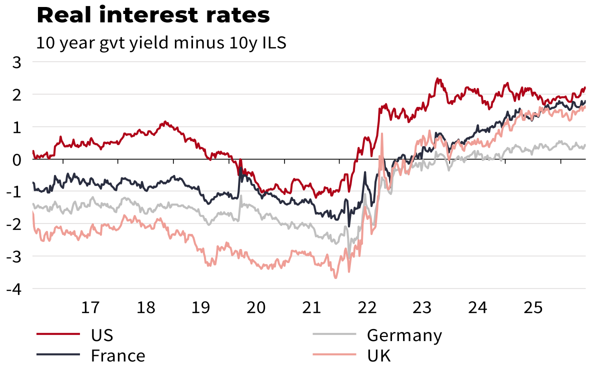
Against this backdrop, high equity valuations in the tech sector are likely to be tested should earning expectations, presently at historical high levels, prove disappointing. This could lead to higher risk premia which compounded with higher real interest rates could lead to significant market correction and add downside risk to our expected growth slowdown.

Bank credit is scarcer…



Source: SG Economic and Sector Studies, LSEG

…and real funding costs are higher



Source: SG Economic and Sector Studies, LSEG

Against this backdrop, after the ECB rate hike our scenario envisages a rate cut in the coming months. Similarly, after a prolonged hold, we expect the Fed to start cutting rates towards the end of the year, as the gradual normalisation of trade flows and energy prices, together with weakening demand signals should limit the risk of a persistent inflationary shock.

Resilience is real, but it should not be mistaken for immunity

Overall, the global economy continues to show a remarkable capacity to absorb successive shocks, with manufacturing activity still supported by inventory rebuilding, AI-related investment and strong export momentum in Asia. However, this resilience should not be interpreted as immunity to downside risks.

The trajectory of tensions in the Middle East remains the most immediate source of uncertainty. Even under our gradual normalisation scenario, the outlook remains vulnerable to renewed disruption through three main channels: energy prices, maritime trade routes and global supply chains. A more prolonged than expected closure of the Strait of Hormuz, or disruptions affecting other strategic chokepoints, could quickly reignite inflationary pressures and weigh more materially on confidence and activity.

More fundamentally, geopolitical fragmentation is becoming a structural risk driver for the global economy. Military tensions, trade restrictions, sanctions and increasingly interventionist industrial policies are likely to generate recurring friction in global production networks. These developments may not always trigger an immediate downturn, but they are steadily eroding the efficiency and predictability of global trade and investment flows.

Climate-related shocks also deserve close monitoring, especially given their potential impact on food prices, energy demand, logistics and insurance costs. NOAA updates confirm El Niño conditions have developed with a significant probability of strengthening into a strong or very strong event. Episodes of extreme heat, droughts, floods or hurricane activity could amplify existing supply-side pressures and create regional divergences in growth performance. These risks are particularly relevant for emerging markets, where external balances, food security and financing conditions can deteriorate rapidly.

The current environment is one in which the global economy is becoming more shock-prone, more fragmented and more margin-constrained. In that context, macroeconomic resilience must be assessed alongside a rising set of risks (geopolitical, financial, climate…) which are no longer peripheral risks.

Towards lower growth and lower inflation in 2027

Our central scenario remains one of gradual normalisation by year-end 2026

- with global activity slowing rather than breaking.
- inflation landing towards targets in 2027 with limited second round effects.
- central banks starting cuts by end 2026-early 2027.

ECONOMIC FORECASTS

GDP, % YoY	2025	2026f	2027f	2028f
Developed Markets	**1.7**	**1.2**	**1.1**	**1.5**
United States	2.1	1.7	1.4	1.8
Japan	1.1	0.6	0.5	0.6
United Kingdom	1.4	0.8	1.0	1.2
Euro area	1.5	0.6	0.8	1.1
Germany	0.3	0.5	1.0	1.4
France	0.9	0.5	0.7	1.1
Italy	0.7	0.3	0.3	0.6
Spain	2.8	1.7	1.3	1.6
Emerging Markets	**4.3**	**3.3**	**3.6**	**3.6**
Asia	5.3	4.2	4.3	4.3
China	5.0	4.2	4.0	3.8
India	7.7	6.6	6.3	6.5
Central and Eastern Europe	2.0	1.3	1.5	1.5
Latin America	2.5	2.3	2.0	2.1
Brazil	2.6	1.5	1.5	2.0
Middle East and Central Asia	3.2	1.0	4.0	3.3
Africa	4.5	4.0	3.8	3.8
World (PPP weighted)	**3.4**	**2.6**	**2.7**	**2.8**

CPI, % YoY, avg	2025	2026f	2027f	2028f
Developed Markets	**2.5**	**3.1**	**2.2**	**2.0**
United States	2.7	3.5	2.2	2.6
Japan	3.2	2.8	1.3	1.8
United Kingdom	3.4	3.2	2.6	2.1
Euro area	2.1	3.0	1.5	1.9
Germany	2.3	3.0	1.9	1.9
France	0.9	2.3	1.5	1.7
Italy	1.6	3.3	1.4	1.9
Spain	2.7	3.5	1.7	2.2
Emerging Markets	**5.2**	**5.3**	**4.4**	**4.3**
China	0.3	1.2	1.4	1.7
India	2.0	5.0	4.5	4.5
Brazil	5.0	4.4	3.5	3.5

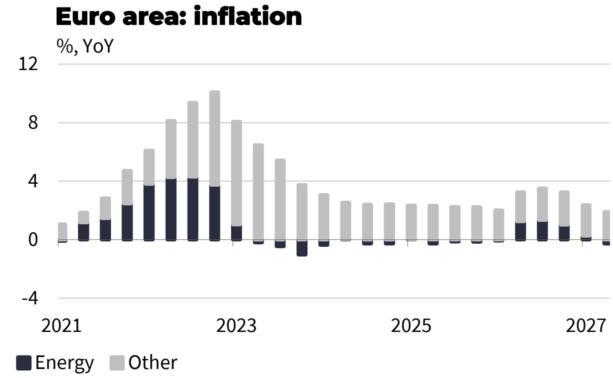
%, EoP (unless otherwise indicated)	Latest 22/06	2026f	2027f	2028f
Fed Funds target (high)	3.75	3.50	2.75	3.00
Gov 10y, US	4.46	4.15	4.25	4.25
ECB Deposit facility rate	2.25	2.00	1.75	2.25
Gov 10y, Germany	2.98	2.75	3.00	3.25
Gov 10y, France	3.74	3.55	3.70	3.85
Gov 10y, Italy	3.71	3.55	3.80	4.05
Gov 10y, Spain	3.46	3.25	3.55	3.75
BoE, Bank rate	3.75	3.75	3.25	3.75
Gov 10y, United Kingdom	4.84	5.00	4.50	4.50
BoJ, Bank rate	1.00	1.25	1.25	1.50
Gov 10y, Japan	2.65	2.50	2.30	2.50
EUR / USD	1.15	1.20	1.20	1.15
EUR / GBP	0.87	0.88	0.89	0.90
USD / JPY	161	155	150	145
USD / CNY	6.8	6.7	6.7	6.6
Oil Brent (USD/b)	80	85	70	70
European Natural Gas (TTF, EUR/MgW/h)	42	40	35	30
EU ETS carbon (EUR/Metric ton)	79	100	110	120

EURO AREA

- **Euro area resilience is fading into renewed vulnerability, as weak cyclical drivers expose the bloc's structural issues.**
- **The labour market is caught between softness and structural tension, stemming from its persistent duality and demographic pressures.**
- **The ECB's position has become difficult as it deals with a policy trade-off between energy price pressures and weaker growth.**

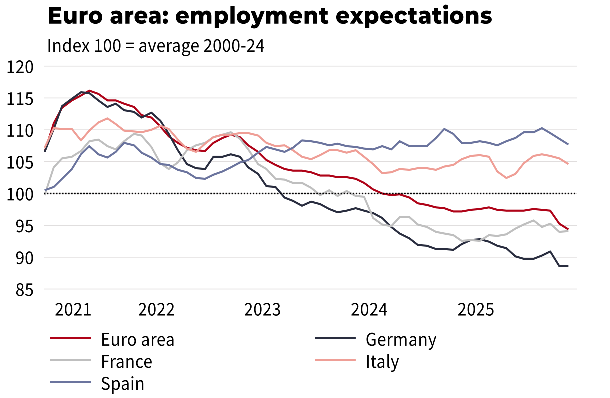
The geopolitical shock reignited vulnerabilities. Our central scenario sees the fallout from the Middle East conflict shaving around 0.5pp off euro area headline growth in 2026, leaving it at 0.6%. The impulse from cyclical growth drivers, such as fiscal expansion in Germany, an acceleration of exports in France, and dynamic investment in Italy and Spain, is set to soften. Meanwhile, structural challenges are being exposed: high energy prices, strong foreign competition (most notably from China) and sluggish productivity. These dynamics will further strain corporate margins which, together with already softening labour demand, are likely to limit nominal wage growth and push unemployment higher. This makes for a difficult economic backdrop, as France, Italy and Spain head into elections in 2027, while the German government continues to face political challenges even without national parliamentary elections.

Energy prices will temporarily push inflation, with second round effects to remain small



Source: Eurostat, SG Economic and Sector Studies

The duality of the labour market is expected to persist following the shock

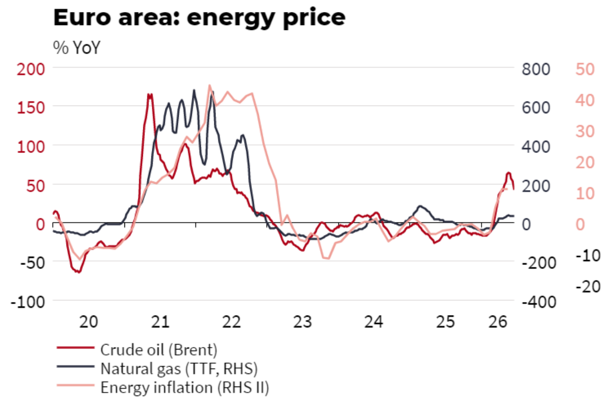


Source: European Commission, SG Economic and Sector Studies

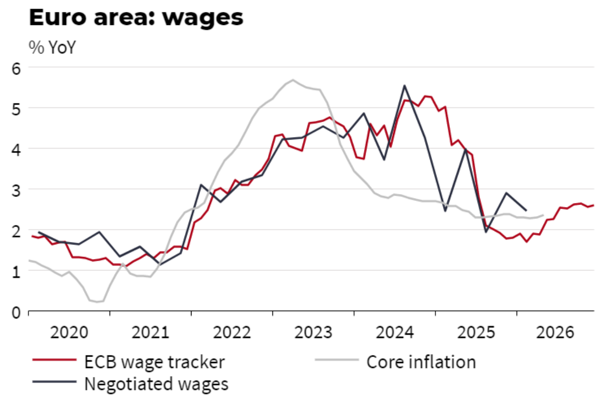
Inflation is expected to reach 3% in 2026 but to fall thereafter in the absence of second-round effects. The euro area had only just seen inflation return close to target after the major price shock of 2022-23, when higher energy prices on the back of the Middle East conflict pushed headline inflation higher again. The energy-price shock is, however, milder than in 2022 as illustrated below, and not least for gas. There is today also far less pent-up demand and labour markets are notably softer.

As such, while higher energy prices will temporarily lift headline inflation, we believe that the absence of major second-round effects should moderate the amplitude and duration of the impact.

The 2026 price shock is not the same as in 2022, be it on energy or wages



Source: ECB, Eurostat, LSEG, SG Economic and Sector Studies



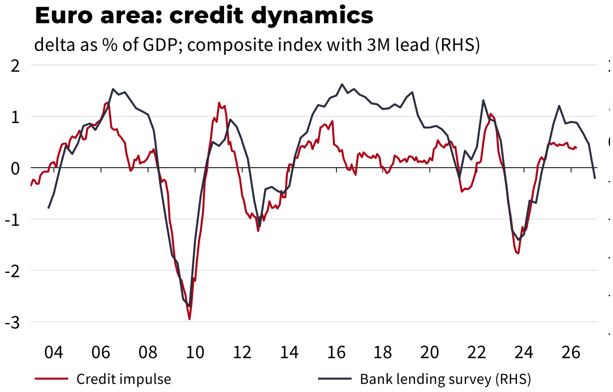
Source: ECB, Eurostat, SG Economic and Sector Studies

Headline labour-market softening masks persistent structural tensions and significant geographical duality. Despite unemployment hovering near historic lows, at around 6.3%, the euro area labour market has softened over recent quarters. Part of this reflects pressure on corporate margins, which have fallen by 8pp since their 2023 peak, alongside weaker activity momentum across the bloc. We expect the fallout from the Middle East conflict to push unemployment to 6.6% in 2026, as tight margins, wage growth just above pre-pandemic levels and softer labour demand weigh on growth. Beneath the headline numbers, however, structural tensions remain acute, driven by demographic pressures and persistent sectoral labour shortages. At the same time, duality in the euro area labour market is likely to persist, with momentum remaining more robust in Italy and Spain than in Germany and France.

Tightening credit standards and weak demand are expected to weigh on investment. While the credit impulse in the euro area has slowed, it remained surprisingly resilient over recent quarters despite already tighter credit conditions. As standards continue to tighten for businesses and households, as foreshadowed by the April ECB Bank Lending Survey, this impulse is set to slow more notably. This is largely driven by higher risk perceptions and lower risk tolerance, which are likely to persist independently of the monetary policy response to the war in the Middle East. Similarly, borrowing costs for governments are rising as well, with the Bund 10-year yield has reached a 15-year high.

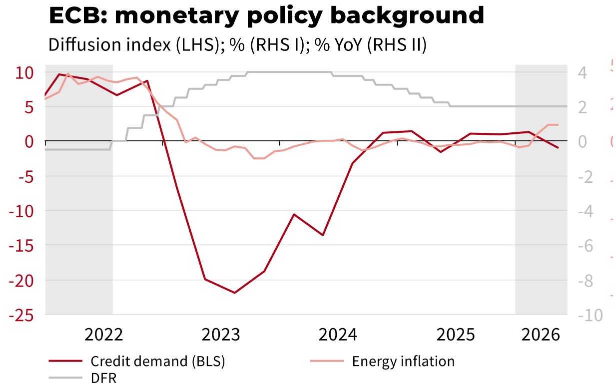
We expect the ECB to reverse its hawkish course. After several months of describing policy as being in a “good place”, the fallout from the war in the Middle East has created a more difficult policy trade-off. On the one hand, euro area growth is weak, credit conditions have tightened, and long-term yields have risen. On the other, persistently high energy prices are pushing headline inflation and near-term inflation expectations higher. In June, the ECB reacted by hiking rates. Despite the looming likelihood of another hike, we expect the ECB to reverse course around the turn of the year, as new data will reveal the lack of resilience of the euro area economy.

Tightening credit conditions should slow the credit impulse



Source: ECB, SG Economic and Sector Studies

A policy rate around neutral and tight credit conditions as key differences compared to 2022



Source: ECB, Eurostat, SG Economic and Sector Studies

The fiscal response to the energy-price shock is expected to remain limited, but the big election year in 2027 warrants caution. The memory of large-scale fiscal support in 2022, amounting to 1.8% of GDP in the euro area, according to the ECB, is still fresh. As budgets remain tight across the bloc, support, which is negligible as of 1H26, is not expected to strain budgets materially. However, as the euro area heads into a major election year for three of the EMU4 economies, fiscal risks loom. France is the key fiscal risk, as an already fragile consolidation path meets a highly open 2027 presidential race, with both extremes showing political momentum. In Italy, a political continuity scenario appears most likely according to the latest polls, but the next government would still operate within a narrow fiscal corridor, given high debt, and the EU's Excessive Deficit Procedure limiting room for manoeuvre. Spain is less exposed to immediate fiscal-rule pressure, but persistent parliamentary fragmentation could continue to complicate budget formation. Overall, the risk is not fiscal rupture, but a gradual slippage in which consolidation is delayed, spending pressures are accommodated, and political uncertainty keeps risk premia sensitive.

Risks are tilted to the downside, as spillovers from the Middle East conflict dominate the risk landscape. The most immediate geopolitical risk factor remains a renewed deterioration in the Middle East with spillovers to energy prices. Higher-for-longer energy prices would not only further dampen growth but also raise the likelihood of second-round effects, which would push inflation higher. Equally, a rapid resolution would be an upside risk to the scenario. A further downside risk involves unfavourable outcomes in the 2027 elections, including parliamentary fragmentation, fiscal indiscipline or heightened uncertainty. An acceleration of structural reforms at the EU level remains a key upside risk. Finally, there is the risk of a sharp correction of risky asset prices, not least if AI disappoints.

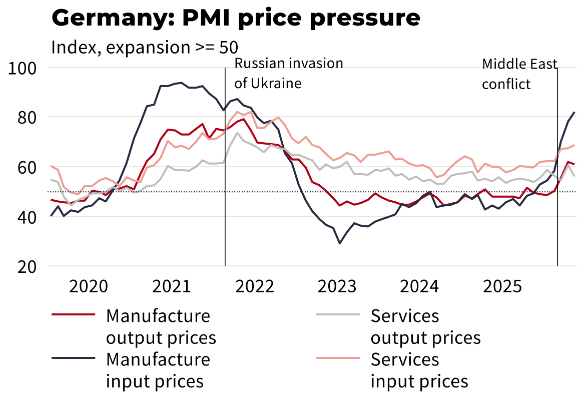
Euro area	**2025**	**2026f**	**2027f**	**2028f**
Real GDP, % YoY	1.5	0.6	0.8	1.1
Household consumption	1.5	0.5	0.7	1.0
Public consumption	1.6	1.0	0.8	1.0
Investment	3.1	1.0	1.5	2.0
Exports of goods & services	2.2	0.7	1.8	2.3
Imports of goods & services	3.7	1.3	2.0	2.6
Inflation, % annual average	2.1	3.0	1.5	1.9
Core inflation, % annual average	2.4	2.2	1.7	1.9
Real gross disposable income (GDI), % YoY	1.0	0.2	1.0	0.8
Households saving rate, % of GDI	14.9	14.6	14.8	14.6
Unemployment, % of labour force	6.3	6.6	6.8	6.7
Fiscal balance, % of GDP	-3.1	-3.2	-3.0	-2.9
Public debt, % of GDP	89	91	93	95
Current account balance, % of GDP	1.7	1.4	1.4	1.2

GERMANY

- **Transmission of a renewed energy shock face thinner buffers on households' balance sheets and softer labour market dynamics limiting second-round effects at the cost of margins and investment.**
- **Resilience to the price shock pends on contained precautionary behaviour from consumers and pursued fiscal impulse.**
- **Medium-term outlook remains constrained by secular challenges not least from demographics and foreign competition.**

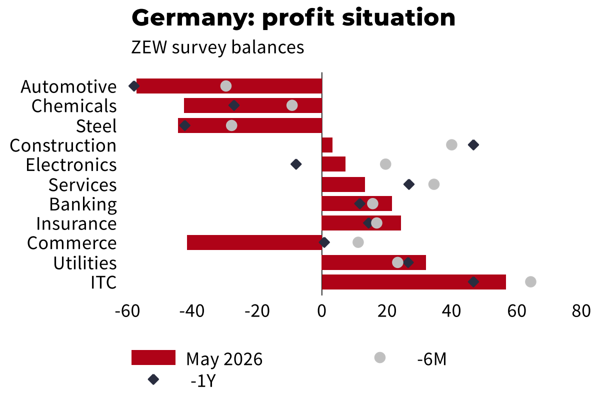
The fallout from the Middle East conflict weakens the near-term outlook (GDP growth seen at 0.5% in 2026, 1.0% in 2027), as higher energy prices weigh on agents' balance sheets. While headline inflation is set to average 3% in 2026, largely driven by energy, second-round effects should remain contained. Corporates are facing renewed cost pressures in a context where, unlike in 2022–23, household liquidity buffers have largely normalised. At the same time, cyclical softening in the labour market is containing wage growth, even as underlying structural labour shortages continue to support income resilience over the medium-term. This combination should limit firms' pricing power, leading to a compression in margins and weighing on private investment. Monetary conditions and ongoing bond market volatility will further restrain credit dynamics, remaining a headwind for interest-sensitive sectors, notably construction, which is expected to bottom out this year. Meanwhile, delayed transmission, particularly in food prices through higher fertiliser costs and stock depletion, will partly offset base effects as input prices normalise in 2027.

Limited pass-through of higher prices…



Source: PMI, SG Economic and Sector Studies

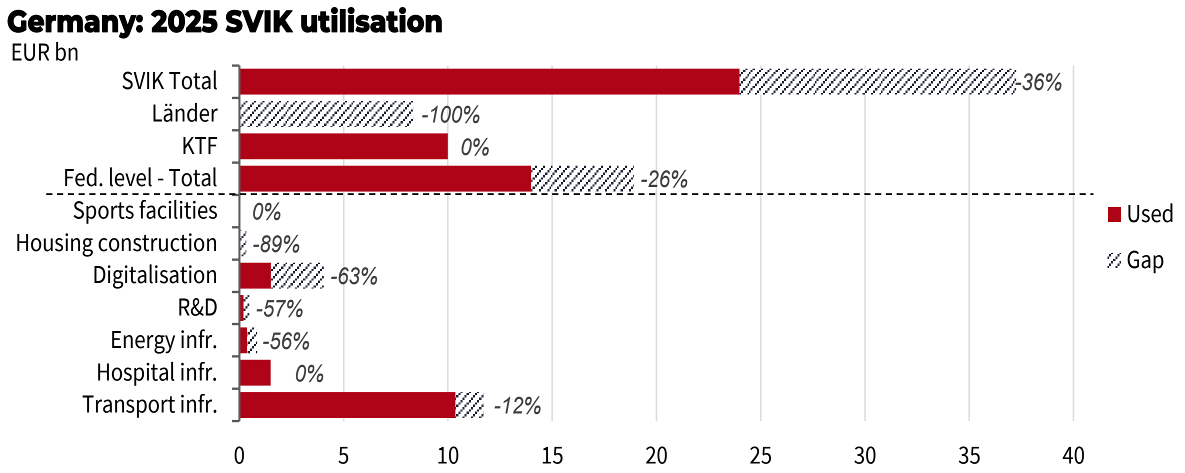
…adds further pressure to corporate profits



Source: ZEW, SG Economic and Sector Studies

Consumer behaviour will once again be a key determinant of the economy's resilience. The German household saving rate remains around 1.5pp above its 2010s average, and its gradual normalisation is central to rebalancing growth towards domestic demand. However, elevated uncertainty related to the Middle East conflict is set to slow the drawdown of excess savings. While this should weigh on the pace of consumption recovery, several mitigating factors remain in place: the limited magnitude of the price shock, and the continued income support from a still relatively tight labour market in some sectors and supported by structural changes notably on the demographic front.

The deployment of the fiscal plan has faced a slow start as the funds absorption gaps appear



Source: BMF, SG Economic and Sector Studies

The deployment of the fiscal package is set to accelerate, supporting growth through a higher contribution from public spending. In 2025, significant underspending emerged in funds earmarked under the SVIK[1], with around 36% not spent. Such delays were partially expected, reflecting administrative bottlenecks, the need to establish legal frameworks, particularly at the Länder level, and the time required to operationalise investment plans. As these constraints gradually ease, we expect absorption to pick up over the forecast horizon, boosting the public contribution to economic growth. The pace of deployment may be constrained by supply-side bottlenecks, notably labour shortages, as well as heightened political uncertainty. Fiscal deficits are projected to remain close to 4% of GDP over the forecast period, reflecting increased sovereign issuance to finance investment plans and a rising interest burden amid higher long-term rates.

External demand and the manufacturing sector will continue to drag on the outlook. German producers face a marked deterioration in competitiveness, driven by rising unit labour costs, which further pressure margins, and by the erosion of comparative advantages in historically strong sectors, weighing on demand. This is particularly evident in the automotive sector (~4% of GVA and 17% of goods exports), where protectionist measures and intensifying competition, notably from Asian manufacturers, are dampening demand.

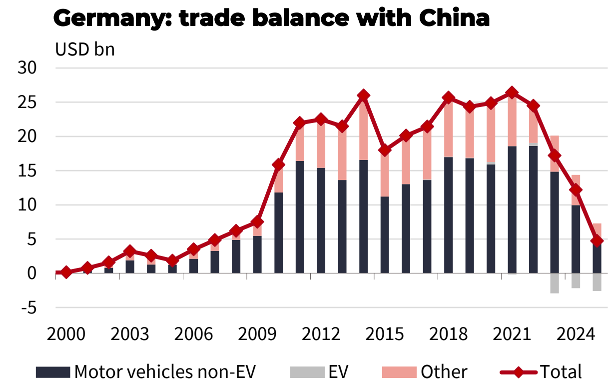
German automakers have been losing market share, including in the premium and luxury segments that sustained the industry in the 2010s, at a time when structural

[1] *Special Fund for Infrastructure and Climate Neutrality (Sondervermögen für Infrastruktur und Klimaneutralität)*

shifts in the industry are further undermining their positioning. The reintroduction of incentives to purchase EVs in several European countries (Germany, France, Italy, Spain and Portugal) may provide some short-term support. However, delays in catching up with competitors notably from Asian brands benefiting from lower production costs and greater vertical integration in key technologies (EVs) and evolving consumer preferences (software-first vehicles) are likely to weigh durably on the sector. Moreover, the expansion of production capacity within the EU by Asian manufacturers, aimed at circumventing protectionist measures, is intensifying competition and is likely to favour lower-cost regions in the continent.

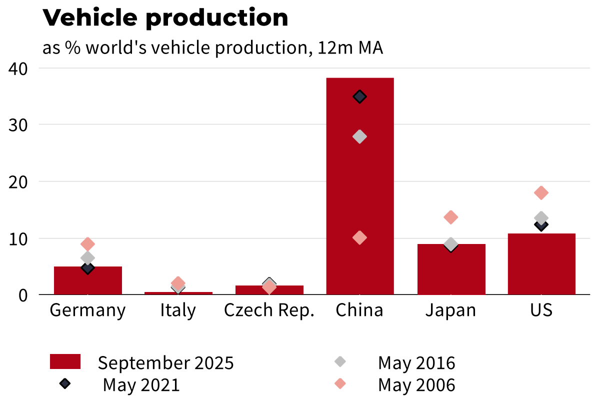
Over the medium term, a structural weakening of the national automotive sector will weigh on potential growth, given its central role in manufacturing investment and its contribution of around one-third of total R&D expenditure. The increase in defence spending should provide a partial offset, supporting the reallocation of resources as the economy adjusts its structure.

Auto makers are losing ground in the Chinese market facing competition by local brands…



Source: COMTRADE, SG Economic and Sector Studies

… rapidly gaining market shares across markets and segments



Source: Wards Intelligence, SG Economic and Sector Studies

Risks remain tilted to the downside. Rising political fragmentation could lead to greater polarisation and policy inaction, exacerbating absorption gaps in the deployment of the SVIK programme and delaying much-needed structural reforms. This is particularly relevant in areas such as statutory health insurance, where rising costs, driven by population ageing, advances in medical technologies and stagnant efficiency, require significant reform to preserve both household and public finances. A stronger inflation shock could revive precautionary behaviour, weighing further on consumption. Finally, a sharper tightening in financing conditions, whether through monetary policy or market volatility, would further constrain credit and depress both real estate and productive investment.

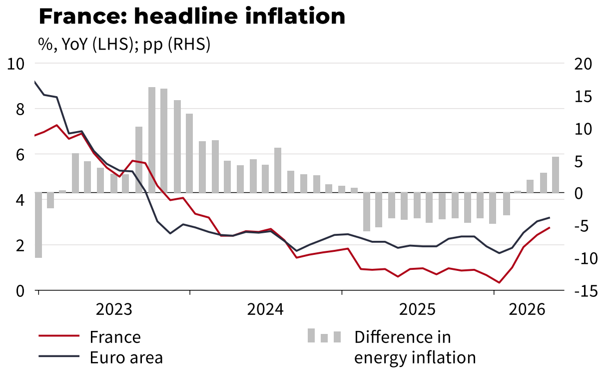
Germany	2025	2026f	2027f	2028f
Real GDP, % YoY	0.3	0.5	1.0	1.4
Household consumption	1.5	0.4	0.9	1.2
Public consumption	1.5	3.4	2.3	2.1
Investment	0.0	0.8	2.6	3.0
Exports of goods & services	-0.7	0.9	0.4	1.4
Imports of goods & services	3.2	1.7	2.0	2.1
Inflation, % annual average	2.3	3.0	1.9	1.9
Core inflation, % annual average	2.8	2.5	2.2	2.2
Real gross disposable income (GDI), % YoY	0.6	0.1	0.9	0.9
Households saving rate, % of GDI	19.2	18.9	18.8	18.5
Unemployment, % of labour force	6.3	6.5	6.5	6.3
Fiscal balance, % of GDP	-2.4	-4.6	-4.2	-3.9
Public debt, % of GDP	63	67	71	75
Current account balance, % of GDP	4.5	3.1	3.0	2.8

FRANCE

- **France's already modest growth drivers are coming under renewed pressure from the fallout from the war in the Middle East.**
- **As firms' margins remain under strain, soft wage growth and a correction in the labour market are expected to weigh on household consumption.**
- **The medium-term outlook is dominated by the 2027 presidential election, with a wide range of possible policy outcomes.**

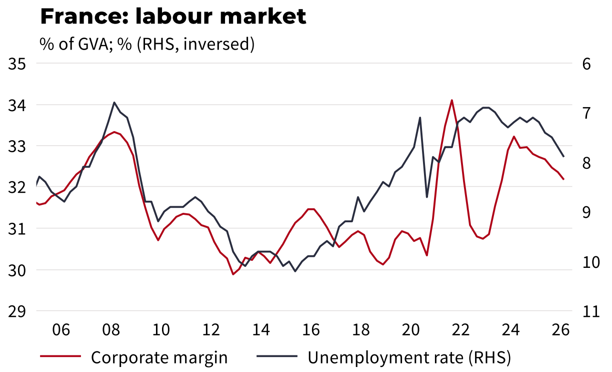
With external demand and household consumption both constrained, growth is expected to slow to just 0.5% in 2026. France is particularly vulnerable to the fallout from the war in the Middle East, as the energy-price shock comes on top of already negative purchasing power growth of households, while softer global momentum and renewed supply-chain strains weigh on external demand. This leaves little support from the two channels that could have sustained the 2025 upside growth surprise. Strained corporate margins add to this challenging backdrop, delaying the recovery of real income growth and putting upward pressure on unemployment. As domestic momentum weakens and borrowing costs rise, the already fragile fiscal consolidation is expected to slow. We expect France to recover only gradually from the shock, with the outlook contingent on a rebound in external demand, a recovery in purchasing power, and a 2027 political outcome that avoids policy uncertainty and fiscal tensions with the EU.

Inflation accelerates faster than in the euro area, given the stronger jump in energy prices



Source: Eurostat, SG Economic and Sector Studies

Constrained corporate margins will continue to weigh on the labour market

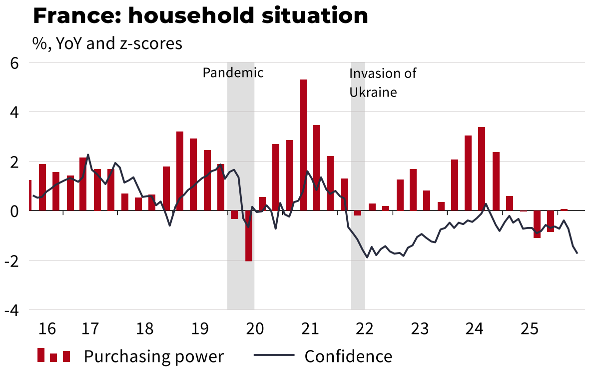


Source: INSEE, SG Economic and Sector Studies; Note: 12M-MA for corporate margin

The price shock is expected to lift headline inflation only moderately, given the low starting point. After a sizeable negative contribution from energy prices in January 2026, the energy-price shock is expected to drive 2026 inflation to 2.3%, up from 0.9% in 2025. The fading energy drag reflected favourable base effects from the fall in regulated electricity tariffs in February 2025 and was supported by the normalisation of French electricity wholesale prices. This created a low base from which the Middle East shock triggered a rapid rebound in energy inflation, averaging 12.8% y/y in the first three months after the shock. Core inflation, however, is expected to remain more contained, as weak demand, subdued wage growth and limited pricing power prevent a broader pass-through into underlying prices. As a result, French inflation is set to accelerate faster than the euro area aggregate in the near term, while still remaining below the aggregate headline level as second round effects remain small.

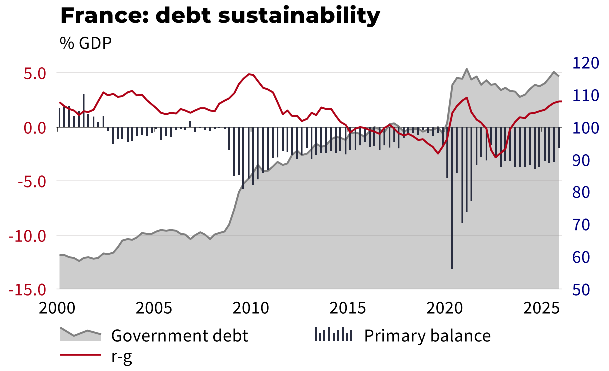
Persistent pressure on corporate margins is expected to lead to a labour-market correction. Against a backdrop of tight margins, softer labour demand and weak activity momentum, we expect unemployment to continue rising through 2026, peaking at 8.2% in 4Q26 - a level last seen during the pandemic. Corporate margins have declined in recent quarters and are now converging towards their 2010-20 average, reflecting weaker pricing power, persistent wage pressures and subdued productivity growth. Labour-market conditions have already started to adjust, with unemployment up around 1pp from its post-pandemic low. The adjustment has been especially pronounced among young workers: unemployment for under-25s averaged 20.6% in 1Q26, exceeding rates in Italy, Portugal and Greece, partly reflecting recent changes to apprenticeship policy.

Historically low confidence since 2022 now coincides with negative real income growth



Source: INSEE, SG Economic and Sector Studies

Continued slow growth and rising borrowing costs will push debt further upwards



Source: INSEE, SG Economic and Sector Studies

Households face a triple squeeze of a sustained confidence crisis, negative real income growth, and rising unemployment. Although households were a key driver of the post-pandemic rebound, their contribution to growth has weakened materially, standing at only around half of its pre-pandemic average in 2025. Confidence has remained persistently below its historical average since early 2022, limiting consumers' willingness to spend. At the same time, real income growth has turned negative and is expected to remain under pressure in 2026, while rising unemployment should further weigh on labour income expectations. As these factors reinforce one another, we expect household consumption growth to slow to 0.3% in 2026.

Weak growth and higher borrowing costs are set to push public debt higher. France's debt ratio is expected to exceed 120% of GDP in 2027, more than twice the Maastricht criterion and the third highest in the euro area. With the primary deficit still sizeable and limited consolidation expected this year, weak growth and rising interest costs are set to keep the debt ratio on an upward path. Market conditions have become less supportive, with OAT yields reaching levels last seen more than 15 years ago. Volatility is likely to remain elevated, not least given the upcoming budget process and elections. With the debt-stabilising primary balance estimated at 1.2% of GDP, the adjustment required remains substantial, leaving debt sustainability a central concern for the medium-term outlook.

Risks remain tilted to the downside, driven by spillovers from the war in the Middle East and uncertainty ahead of the 2027 presidential election. As across most economies, the duration of the war remains the main external downside risk, as a more persistent shock would further erode purchasing power and tighten borrowing conditions. Domestically, the key risk is that the 2027 election amplifies political fragmentation and weakens policy visibility. A wide field of contenders spanning the political spectrum could make the parliamentary landscape more fragmented, complicating legislative processes, particularly the adoption of credible budgets. In such a scenario, fiscal slippage, renewed tensions with EU fiscal rules, or delays to structural reforms could weigh on confidence, raise deficits, and keep the sovereign risk premium elevated.

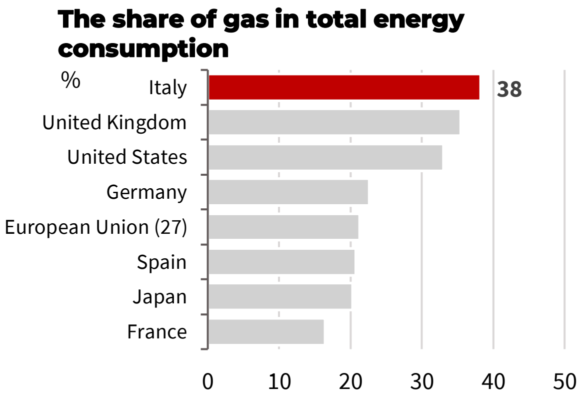
France	2025	2026f	2027f	2028f
Real GDP, % YoY	0.9	0.5	0.7	1.1
Household consumption	0.5	0.3	0.7	1.2
Public consumption	1.6	1.0	0.8	1.0
Investment	0.8	0.5	1.0	1.7
Exports of goods & services	2.3	0.8	2.6	2.7
Imports of goods & services	4.3	0.9	2.7	2.9
Inflation, HICP, % annual average	0.9	2.3	1.5	1.7
Core inflation, HICP, % annual average	1.6	1.6	1.6	1.8
Real gross disposable income (GDI), % YoY	0.6	-0.4	0.4	0.6
Households saving rate, % of GDI	18.4	17.5	17.2	16.6
Unemployment, % of labour force	7.4	8.1	8.0	7.8
Fiscal balance, % of GDP	-5.2	-5.2	-4.8	-4.3
Public debt, % of GDP	116	119	121	122
Current account balance, % of GDP	-0.3	-0.7	-0.4	-0.4

ITALY

- **Growth is expected to remain weak as energy costs drag on household consumption and uncertainty clouds the outlook.**
- **Italy is particularly sensitive to an increase in oil and gas prices due to its high fossil fuel dependency.**
- **A substantial cost overrun of the 2026 Energy-Bills Decree risks undermining the anticipated debt reduction from 2027 onward.**

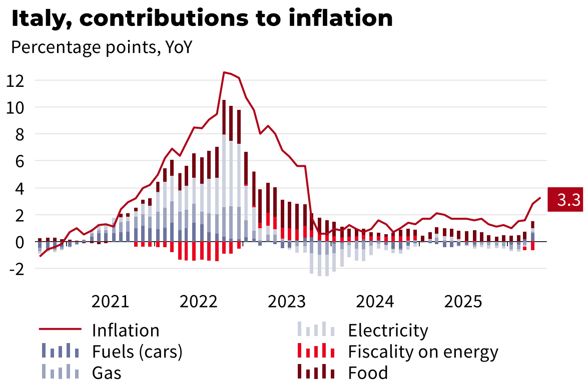
The conflict in the Middle East will erode growth by around 0.3pp of GDP in 2026 and is expected to affect all components of demand. Private consumption is set to decelerate, owing to a reduction in real disposable income, and despite a slight drop in the saving rate. Investment growth is projected to slow compared to 2025, as housing construction falls slightly. The NGEU continues to support investment in infrastructure and equipment, although the latter is set to be dampened by geopolitical tensions and rising interest rates. The impact of US tariffs and disruptions in some export markets due to the conflict in the Middle East is anticipated to further upset the goods export outlook while reducing imports. Net exports are thus expected to subtract from GDP growth, albeit less than in 2025.

Italy is particularly vulnerable to gas prices



Source: IEA, SG Economic and Sector Studies

Inflation has surged to 3.3% from 1% in Jan.



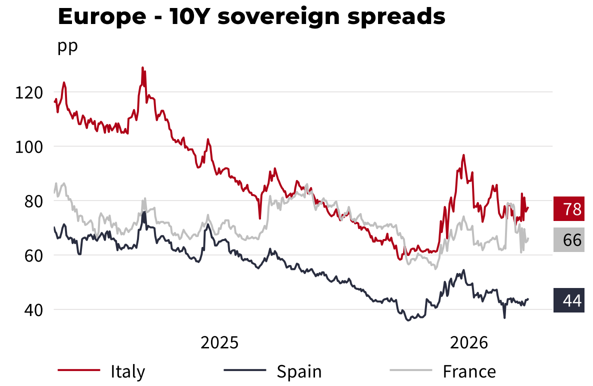
Source: Eurostat, LSEG, SG Economic and Sector Studies

Italy is particularly sensitive to an increase in oil and gas prices due to its high fossil fuel dependency, amounting to 76% of its total energy supply (versus 46% in France). The share of gas in total energy consumption is the largest is Europe (38% versus 21% on average in the EU) and particularly strong in households' consumption (58%). However, the country has reduced its global energy dependency by increasing the share of renewable energy sources to 44% in power generation, from 16% 20 years ago.

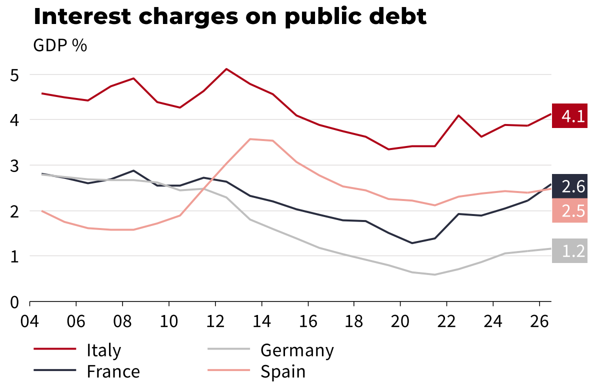
The energy shock is weighing on the fiscal outlook, further constraining already limited budgetary space. The government's response, announced on 19 March, combined temporary fuel-duty cuts (EUR 417 million, later extended to 1 May with an additional EUR 500 million) with anti-speculation measures. While Finance Minister Giorgetti ruled out immediate corrective measures, he left open the possibility of coordinated action at the EU level under the general safeguard clause.

Market reactions have remained relatively subdued. Ten-year sovereign yields rose by around 70bp in March to 4% before easing back to 3.8%, while spreads widened by roughly 15bp since the onset of the conflict. Equities, by contrast, have remained resilient, with the stock market up about 12% since the start of the year. Interest expenditures now amount to 4.1% of GDP—almost double that of France and Spain, and four times that of Germany—and total debt exceeds EUR 3,095 billion. Even modest declines in growth caused by higher energy prices could impact revenues and further reduce the limited fiscal margin available to absorb shocks without resorting to corrective measures.

Market reactions have remained subdued, but the public debt dynamic is still a concern



Source: LSEG, SG Economic and Sector Studies



Source: DG-ECFIN AMECO, LSEG, SG Economic and Sector Studies

The labour market is still very tense due to demographic pressures and new employment needs. The working age population started to decline ten years ago, and Italy has seen a one million person decline in people aged 15 to 64 since 2018, marking a shrinkage of 2.6% to the working age population. During that period, however, employment increased by 760 000 persons, thanks to a sharp decline in both unemployment (-920 000 persons) and inactivity (-820 000 persons). Today, the unemployment rate stands at a record low of 5.1% (April). Despite labour market tensions, wage increases have remained muted, in the 2-2.5% range. Households are set to be the most affected by the energy crisis, with a contraction of real income this year, translating into a loss of purchasing power.

The fiscal deficit is projected to remain at 3.0% of GDP in 2026 and edge up to 3.1% in 2027 as revenue growth softens, jeopardising Italy's exit from the EU excessive deficit procedure in 2026. The primary surplus is expected to stabilise at about 1.1% of GDP in the coming two years—just sufficient to stabilise the public debt ratio at 138% of GDPexplanation.

Risks are tilted to the downside. A resurgence of the Middle East crisis—through additional increases in oil, gas and electricity prices—would exert further downward pressure on growth and public finances. A reversal of recent gains in fiscal sustainability—particularly if accompanied by a renewed widening of sovereign spreads—or a prolonged slowdown in key trading partners would weaken the outlook. Conversely, stronger-than-expected improvements in investment conditions could support growth. Additional risks stem from a potential weakening of EU support, raising refinancing pressures on Italy's high public debt; a deterioration in fiscal dynamics leading to slower consolidation or a rising debt-to-GDP ratio; and a softer medium-term growth trajectory in the event of delays in NGEU-related investment and reforms. Persistent geopolitical tensions and elevated energy prices represent further downside risks.

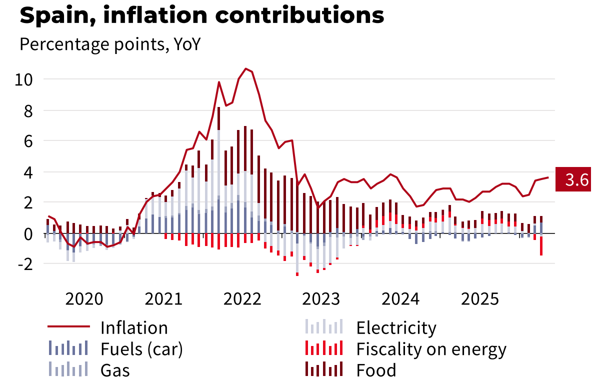
Italy	**2025**	**2026f**	**2027f**	**2028f**
Real GDP, % YoY	0.7	0.3	0.3	0.6
Household consumption	1.1	0.2	0.2	0.7
Public consumption	0.6	0.4	0.4	0.4
Investment	3.8	2.4	-0.3	0.2
Exports of goods & services	1.4	1.4	2.0	2.4
Imports of goods & services	3.9	2.4	1.5	2.1
Inflation, % annual average	1.6	3.3	1.4	1.9
Core inflation, % annual average	1.9	2.2	2.2	2.0
Real gross disposable income (GDI), % YoY	0.9	-0.2	0.4	0.5
Households saving rate, % of GDI	11.0	10.7	10.9	10.8
Unemployment, % of labour force	6.1	5.6	5.9	5.9
Fiscal balance, % of GDP	-3.0	-3.0	-3.1	-3.1
Public debt, % of GDP	136	138	138	138
Current account balance, % of GDP	1.1	0.0	0.3	0.4

SPAIN

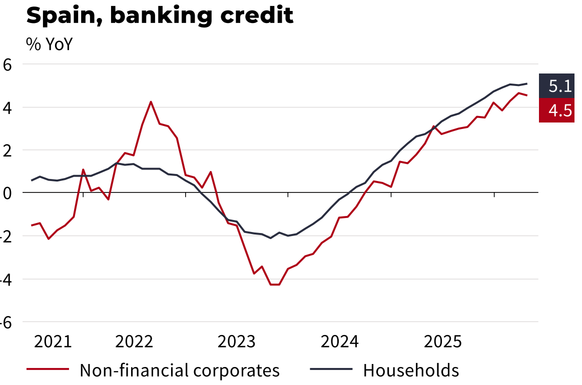
- **The Middle East conflict is expected to weaken the economy, despite the early adoption of a Royal Decree-Law to limit fuel price hikes.**
- **Inflation is projected to climb to 3.5% in 2026, eroding households' purchasing power and increasing production costs.**
- **International tourism will continue to expand, but revenues from domestic travel are already plateauing.**

The Middle East conflict is expected to weaken Spain's economic outlook, mainly through higher energy prices and increased uncertainty. As oil and gas costs rise due to disruptions in global supply routes, inflation is projected to climb to 3.5% in 2026, eroding households' purchasing power and increasing production costs. This reduces consumption and investment, leading to slower GDP growth, namely 1.7% in 2026 and 1.3% in 2027, a sharp deceleration from 2.8% in 2025. In addition, weaker external demand from slower-growing European partners and tighter financial conditions—due to delayed interest-rate cuts or possible hikes—will further weigh on activity. However, Spain remains relatively resilient, supported by strong domestic demand, employment growth, and tourism. Overall, the conflict does not derail growth but creates a more inflationary and uncertain macroeconomic environment, with risks tilted to lower growth if tensions persist.

The energy shock is adding pressure to inflation, already fuelled by dynamic credit allocation



Source: Eurostat, LSEG, SG Economic and Sector Studies



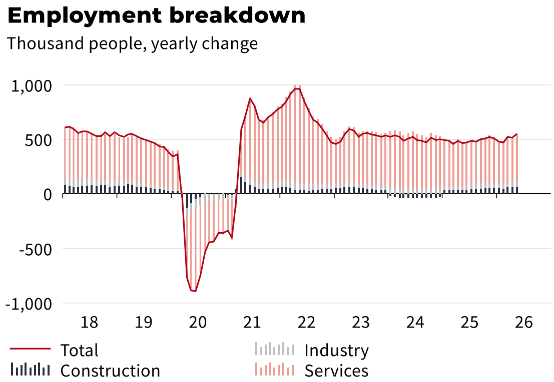
Source: ECB, LSEG, SG Economic and Sector Studies

Spain's resilience to an energy shock is stronger today than a decade ago, reflecting structural changes in its energy system and supply structure. First, the electricity mix has been largely decarbonised, with renewables accounting for 57% of power generation in 2025, compared with 35% in 2015 and 15% a decade earlier, which reduces the pass-through of fossil-fuel price shocks to electricity prices. It also increases energy self-sufficiency and reduces marginal reliance on imported fuels. Second, although Spain remains highly import-dependent (around 70% of primary energy), its gas sourcing is more diversified and geopolitically proximate, with

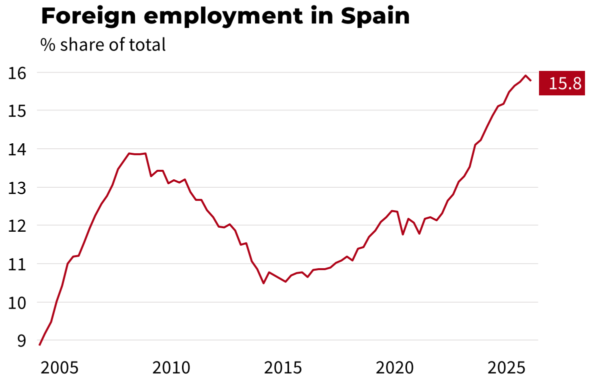
Algeria supplying about 35–40% of imports via pipeline and the remainder largely as flexible LNG from the US and others, supported by Europe's largest regasification capacity. Regarding crude and refined petroleum, only 12% of Spain imports are transiting via the Strait of Hormuz (mainly Saudia Arabia and Iraq), limiting the country's exposure to oil shortages. And finally, the gradual decline in energy intensity of GDP reduces the macroeconomic impact of a given energy price shock.

In response to the energy shock, the Spanish government adopted a fiscal package on 20 March (Royal Decree-Law 7/2026) combining short-term price relief with structural energy measures. The initial package was estimated at EUR 5.8bn (0.3% of GDP), but the government has explicitly stated that measures can be extended or scaled up if the crisis worsens. The package relies heavily on indirect energy subsidies through tax cuts: VAT on electricity, gas and fuels was reduced from 21% to 10%, the tax on electricity generation was suspended, and excise duties on hydrocarbons were cut to EU minimum levels, lowering fuel prices by up to EUR 0.30 per litre. In addition, the government introduced targeted transfers and sectoral support, including a EUR 0.20/litre fuel rebate for transport, farmers and fisheries, subsidised credit for agri-food sectors, and an 80% discount on network tariffs for electro-intensive industry. For households, the "energy social shield" was strengthened through expanded electricity discounts for vulnerable consumers, extension of the social energy bonus, a freeze on butane/propane prices, and a ban on disconnections for vulnerable users. The package also includes forward-looking subsidies and tax incentives for energy transition, such as support for solar panels, EV charging infrastructure, storage and energy communities, as well as regulatory measures to accelerate renewable deployment.

Job creation shows no sign of softening, fuelled by services and an influx of migrants



Source: INE, LSEG, SG Economic and Sector Studies



Source: INE, LSEG, SG Economic and Sector Studies

Spain's labour market remains robust and dynamic in 2026, supported by strong job creation and a decisive contribution from immigration. Foreign workers now account for nearly 16% of total employment (over 3.1 million workers) and have played a strong role in labour market expansion, contributing nearly two-thirds of net job creation since the pandemic. This reflects both demographic pressures and persistent labour shortages. In terms of sectoral composition, employment growth remains heavily concentrated in services, consistent with Spain's economic structure. Tourism-related activities—particularly hospitality, retail and accommodation services—account for a large share of employment and foreign workers are strongly represented in these segments (with nearly 29% employed in hospitality). At the same time, job creation has broadened to include higher value-added sectors such as information and communications, energy and professional services, which have shown some of the fastest growth rates. Overall, the labour market expansion combines continued strength in low-productivity service sectors with gradual diversification into more knowledge-intensive activities, although productivity differentials between domestic and foreign workers persist.

The outlook is subject to a combination of short-term cyclical risks and medium-term structural constraints. In the near term, the main downside risks stem from geopolitical tensions and energy price volatility, which are pushing inflation up and weighing on household purchasing power, investment and tourism demand. At the same time, persistently high inflation could keep interest rates elevated, tightening financial conditions and slowing growth. Fiscal vulnerabilities remain significant, with public debt close to 100% of GDP and increasing pressure from age-related spending, limiting room for stimulus in case of shocks. Domestically, risks are building in the housing market, with rising prices and affordability concerns potentially creating financial imbalances. Over the medium term, rapid population ageing and structurally low productivity weigh on potential growth, while heavy reliance on tourism and low-productivity services increases exposure to external shocks. Overall, the balance of risks is tilted toward lower growth and higher inflation, with structural reforms needed to sustain long-term resilience.

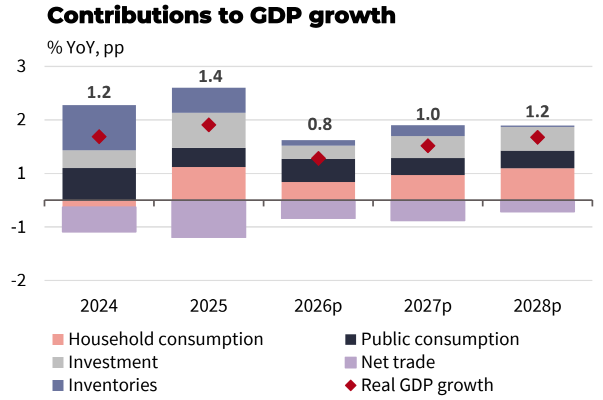
Spain	2025	2026f	2027f	2028f
Real GDP, % YoY	2.8	1.7	1.3	1.6
Household consumption	3.4	1.9	1.8	2.0
Public consumption	2.4	1.5	0.8	0.8
Investment	5.8	3.8	0.3	0.6
Exports of goods & services	3.6	1.8	2.6	2.7
Imports of goods & services	6.2	2.4	2.1	2.4
Inflation, % annual average	2.7	3.5	1.7	2.2
Core inflation, % annual average	2.6	2.8	2.2	2.2
Real gross disposable income (GDI), % YoY	2.5	2.4	1.8	1.4
Households saving rate, % of GDI	12.0	12.0	12.0	11.5
Unemployment, % of labour force	10.5	10.7	11.0	11.0
Fiscal balance, % of GDP	-2.5	-2.3	-2.5	-2.5
Public debt, % of GDP	100	99	99	98
Current account balance, % of GDP	2.9	1.9	2.3	2.3

UNITED KINGDOM

- **The 1Q26 rebound is unlikely to last, as higher energy prices, uncertainty and tighter financial conditions stall momentum, slowing growth to 0.8% in 2026 and 1.0% in 2027.**
- **Headline inflation is set to spike above target, but a weak labour market should contain second-round effects.**
- **A tougher growth-inflation trade-off should keep the BoE on hold through 2026, while high gilt yields expose the UK's fiscal vulnerabilities despite ongoing fiscal consolidation.**

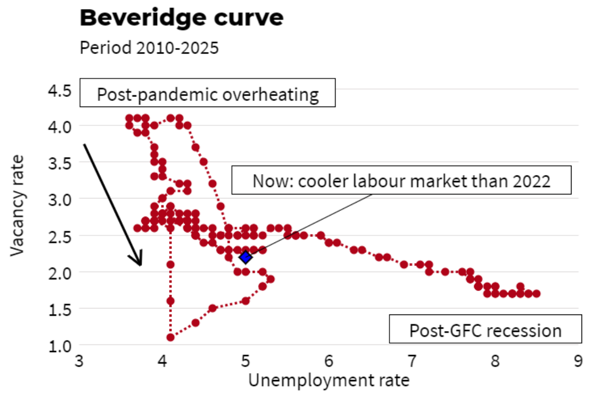
The 1Q26 rebound is unlikely to last, as higher energy prices and uncertainty stall momentum. The economy started the year on a stronger footing, with GDP rising 0.6% in 1Q26, up from 0.2% in the previous quarter, reinforcing the tendency for growth to outperform at the start of the year. Domestic demand did the heavy lifting, supported by household and public consumption, while firms rebuilt inventories. But the energy shock will drag on activity through the rest of the year. Higher energy costs, uncertainty and tighter financial conditions will weigh on private consumption and investment. The May composite PMI has already fallen into contractionary territory. Government spending will remain the main buffer, but its support will fade as fiscal consolidation progresses. We expect real GDP growth to slow to 0.8% this year and stay subdued at 1.0% in 2027.

ETU forecast: subdued short-term growth



Source: ONS, SG Economic and Sector Studies

The labour market is weaker than post Covid



Source: ONS, SG Economic and Sector Studies

Headline inflation is set to spike... A fossil-fuel-heavy energy mix, with oil and gas accounting for 75% of supply, and high net energy import dependence, at 44% of consumption, make the UK economy exposed to global energy price shocks. July's 12% rise in Ofgem's household energy price cap, adding GBP 260/year to the average household bill, alongside higher fuel prices, will feed directly into energy inflation. Food inflation should also rise, driven by supply disruption and higher fertiliser costs.

We expect energy and food inflation to reach around 7% by year end, lifting average annual headline inflation to 3.2%. Inflation expectations have moved sharply higher across households, firms and markets since the Middle East conflict began.

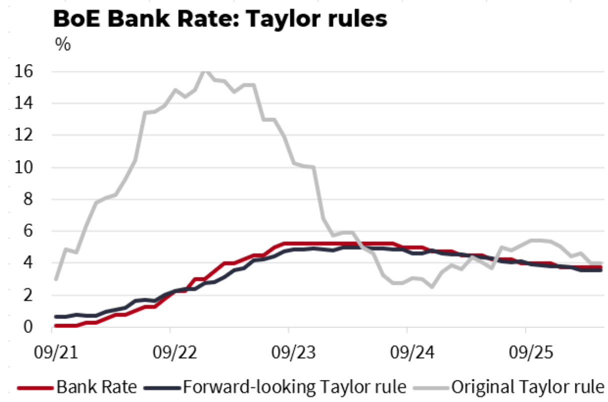
...but a weak labour market should contain second-round effects. Unemployment reached 5.0% in March and we expect it to average 5.3% this year. Vacancies, firms' labour shortages and recruitment difficulties are all at five-year lows. Wage momentum is already cooling, with real pay growth flat in March. As the labour market softens further, weaker bargaining power should push real wage growth in negative territory this year, with nominal pay growth lagging inflation. Moreover, almost half of annual pay settlements had already been agreed before the energy price shock hit, reducing the scope for wage catch-up. Without a wage-price spiral, second-round effects should stay limited.

Firms face a margin squeeze as costs rise into weak demand, with investment set to take a hit. Higher energy prices add to an already heavy cost burden after increases in employer National Insurance Contributions and the minimum wage. Uncertainty over the Middle East conflict also comes on top of tariff-related policy uncertainty. With domestic demand weak, firms have limited pricing power and are unlikely to fully pass through higher costs. They are likely to respond by cutting other inputs, especially labour, slowing hiring and weakening labour demand further. Even so, margins should take a hit, as they have in past energy price shocks. Lower profits, weaker demand and tighter financial conditions point to a fall in investment. Business optimism has dropped to its lowest level since the Covid lockdowns.

Higher energy prices will erode households' purchasing power and hit consumption. Rising energy and food bills, a softer labour market and stagnant wages will weigh on real incomes, while higher mortgage refinancing costs add another drag. The shock comes just as real disposable incomes had recovered from the 2022 cost of living crisis. Households should absorb part of the hit by drawing down savings, but consumption will still suffer. In this context, surveys of consumer confidence and personal financial expectations have dropped since the war began.

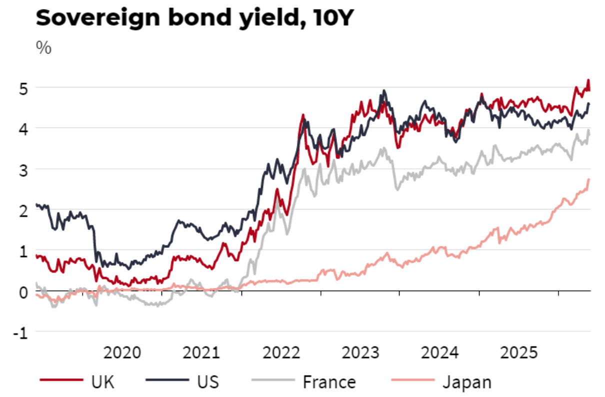
The BoE's trade-off has worsened, with weaker growth and higher headline inflation. We expect Bank Rate to stay on hold through 2026, versus two cuts we expected before the Middle East conflict. This is in line with a forward-looking Taylor rule that looks through temporary inflation spikes and has best matched the post-Covid evolution of Bank Rate (see figure below). The BoE should look through the near-term rise in headline inflation, provided second-round effects remain limited. Monetary policy cannot affect global energy prices, so offsetting the shock would require an excessive hit to domestic demand, core inflation and wages, which are already weak. As disinflation resumes in 2027, we see scope for two 25bp cuts, bringing Bank Rate to 3.25% by year end, in line with neutral.

BoE has looked through temporary inflation



Source: BoE, SG Economic and Sector Studies

Gilt yields highest in the G7



Source: LSEG, SG Economic and Sector Studies

Highest gilt yields in the G7 expose the UK's vulnerabilities The 30Y Gilt yield rose to the highest since 1998, while the 10Y is near its post-GFC highs. US spillovers explain part of the move, with higher Treasury yields and a steeper US curve feeding through to Gilts. But UK-specific drivers have amplified the sell-off. Markets have repriced the BoE rate path sharply after the Middle East conflict began, and inflation risk premia rose given the UK's exposure to imported energy shocks and already high inflation. Political risk also adds to the pressure, amid concerns that a change in Labour leadership could weaken fiscal consolidation and raise borrowing. These cyclical pressures sit on top of structural vulnerabilities: no US dollar privilege, no euro-area-style institutional backstop like France or Italy, and a lasting risk premium from the 2022 mini-budget crisis. Gilts therefore remain more vulnerable to bond market volatility, despite the UK's ongoing fiscal tightening. QT adds a further headwind, with active BoE gilt sales increasing market supply and weighing on prices.

Risks remain skewed to the downside. Prolonged effects from the Middle East conflict would keep energy prices high, fuel second-round effects, delay disinflation and keep the BoE on a higher-for-longer path.

United Kingdom	2025	2026f	2027f	2028f
Real GDP, % YoY	1.4	0.8	1.0	1.2
Household consumption	1.0	0.6	0.8	1.0
Public consumption	1.7	2.1	1.5	1.6
Investment	3.4	1.3	2.1	2.2
Exports of goods & services	2.1	0.7	1.2	2.0
Imports of goods & services	4.1	1.7	2.2	2.4
Inflation, % annual average	3.4	3.2	2.6	2.1
Core inflation, % annual average	3.5	2.7	2.3	2.0
Real gross disposable income (GDI), % YoY	1.0	0.6	0.7	0.5
Households saving rate, % of GDI	9.8	9.4	9.2	8.7
Unemployment, % of labour force	4.8	5.3	5.1	4.7
Fiscal balance, % of GDP	-5.3	-4.7	-4.2	-3.5
Public debt, % of GDP	95	97	99	100
Current account balance, % of GDP	-2.4	-3.7	-3.3	-3.6

UNITED STATES

- **Growth is expected to slow to 1.7% in 2026 and 1.4% in 2027 as energy-driven inflation further erodes real income growth forcing households to curb their consumption.**
- **Margin compression from rising input prices could delay hiring and increase layoffs leading to sluggish wage growth, though reducing the risk of second round inflation effects.**
- **AI-related capex is expected to partly offset softer consumption and residential investment, but risks increasing distributional tensions.**
- **Energy-driven inflation should delay Fed cuts until late 2026, while higher defence spending and a policy pivot under new Fed Chair Kevin Warsh could push term premia higher.**

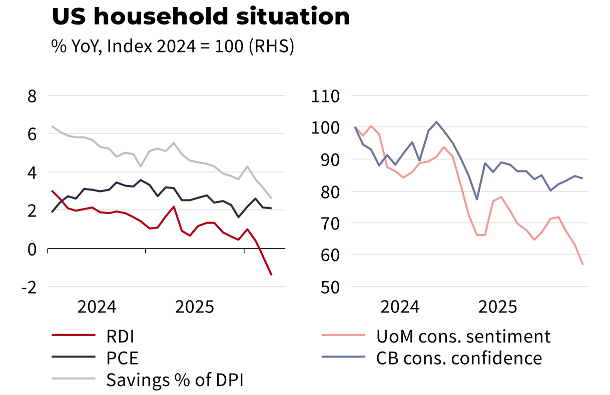
US growth is set to slow more than previously expected, due to stretched resilience of household demand and increasing dependence on a narrow set of capital investment drivers. We expect real GDP growth of 1.7% in 2026, down from 2.1% in 2025, before easing further to 1.4% in 2027. This outlook reflects a weaker consumption profile, with household spending now expected to grow by only 1.4% in both 2026 and 2027. This remains a slowdown rather than a recession scenario, but the composition of growth is narrowing. Investment should continue to expand by around 2.5% over 2026-27, supported by AI-related capex and associated power and data-centre infrastructure, while residential investment is expected to contract.

The consumer balance sheet is more fragile than during the 2022 inflation shock. Higher energy and food prices are squeezing real purchasing power while households have lower savings buffers. Beyond the temporary boost from tax refunds in 1H26, households will face limited space to absorb price pressures before cutting discretionary spending. This comes against a backdrop of weak consumer confidence and a labour market that is no longer generating the same income impulse as post-COVID. As a result, real disposable income is projected to slow sharply to 0.5% in 2026. The knock-on effect on the labour market could become a key channel reinforcing the slowdown. The “low hire, low fire” environment risks deteriorating as companies, facing margin compression, could delay hiring or increase in layoffs. Even so, the unemployment rate is expected to rise only gradually to 4.7% in 2026 and 5.0% in 2027, due to constrained labour supply growth. In our view the risk of a wage-price spiral is limited despite the increase in short term inflation expectations.

AI-related investment is expected to prevent a sharper slowdown, but anticipated labour market effects may be contributing to weak consumer

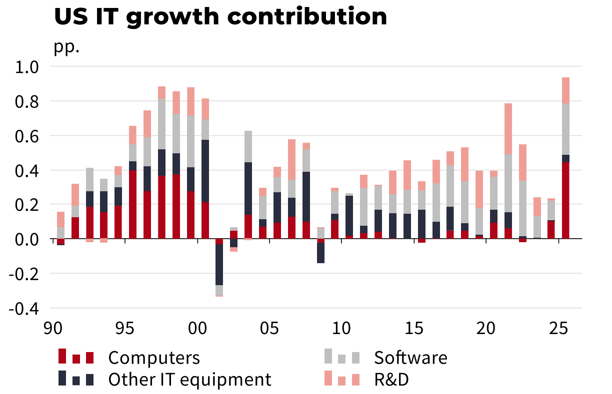
confidence. Capex from hyperscalers is now expected to reach USD 725bn in 2026 after upwards revisions, which will drive earnings growth for providers of semi-conductors, data centres and power generation. As a result, private fixed investment is expected to grow by around 2.8% in 2026–27, offsetting weakness in residential investment. However, productivity gains remain gradual, and early labour-market effects are uneven. Suggestive evidence to date points to a modest slowdown in hiring for junior roles in highly exposed sectors[2]. More structurally, the positive correlation between automation exposure and wage levels suggests downward pressure on upper-income earners could build over time, likely contributing to the sharp decline in confidence among this group. While new task creation should partly offset automation, there may be mismatches in skills, timing and seniority. Over the medium term, the investment boom should support strong corporate margins, but a rising capital share of income risks reinforcing inequality and political polarisation, with potential spillovers into policy volatility and investment uncertainty.

Household budgets are increasingly stretched…



Sources: US Bureau of Economic Analysis, University of Michigan, Conference Board, LSEG Datastream, SG Economic and Sector Studies

…while IT (gross) growth contribution in 2025 surpassed the Dot-Com peak



Sources: US Bureau of Economic Analysis, LSEG Datastream, SG Economic and Sector Studies

The FY27 budget request, if passed by Congress, would raise defence spending, further degrading the fiscal deficit. Nearly USD 500bn is sought in additional budget authority for defence priorities including the "Golden Dome". Net of proposed cuts, this would amount to 1% of GDP, although actual spending increases would take place over several years. Defence outlays would be expected to peak at around 3.7% of GDP in 2028, up from 3.0% in 2026. The near-term growth impulse is expected to be modest, while the increase in deficits will increase financing needs and debt servicing costs.

Impending Section 301 tariffs on trading partners (representing close to 99% of US goods imports) for alleged forced labour import prohibition failures should effectively replace the Section 122 universal 10% tariff which is set to expire on

[2] *Anthropic (2026), "Labor market impacts of AI: A new measure and early evidence" https://www.anthropic.com/research/labor-market-impacts*

24 July 2026 as Congress appears unlikely to ratify. Further Section 301 “unfair trade practice” investigations are still ongoing which could provide the administration with a backstop in case the forced labour tariffs are struck down by courts. The average effective tariff rate is expected to remain around 8-12%, close to its current level, with scope for episodic increases and heightened volatility around policy deadlines. The new Section 301 tariffs would provide similar levels of discretion as IEEPA with no need for Congressional approval, reinforcing the administration’s leverage with USMCA renewal talks underway.

Surging inflation driven by the Iran conflict complicates the monetary policy equation in the short term. We expect headline inflation to average 3.5% in 2026 driven by sharp increases in energy and food prices which will likely cause the Fed to delay rate cuts until late 2026. The combination of weaker consumption, limited risk of second-round effects and rising downside risks to the labour market should provide a clearer disinflationary signal for restarting the cutting cycle in 4Q26.

New Fed Chair Kevin Warsh’s reform agenda is likely to be constrained initially by the inflation shock. If enacted, the proposals to cut rates, shrink the balance sheet and end forward guidance could have important implications. Faster balance-sheet reduction would push more duration risk back into the private sector, likely raising the term premium and steepening the Treasury curve. Ending forward guidance tools including the dot plot could help reduce the Fed’s commitment problem but may weaken policy transmission and lead to higher rate volatility in a crisis when expectations management becomes especially important.

The US economy is moving towards a phase of narrowing growth drivers, increasing the fragility of the expansion. Risks are skewed to the downside: a sharper fall in consumer confidence, a faster softening of the labour market, or a correction in AI-driven equity valuations could amplify the slowdown. The risks of extreme weather events caused by El Niño-La Niña add further uncertainty to the medium-term outlook.

United States	2025	2026f	2027f	2028f
Real GDP, % YoY	2.1	1.7	1.4	1.8
Household consumption	2.6	1.4	1.4	1.8
Public consumption	0.6	2.1	1.4	1.4
Investment	2.7	2.5	2.6	2.6
Exports of goods & services	1.6	1.4	1.4	2.4
Imports of goods & services	2.7	0.5	2.5	3.4
Inflation, % annual average	2.7	3.5	2.2	2.6
Core inflation, % annual average	2.9	2.8	2.6	2.7
Real gross disposable income (GDI), % YoY	1.7	0.5	1.6	1.7
Households saving rate, % of GDI	4.6	3.8	4.0	4.0
Unemployment, % of labour force	4.3	4.7	5.0	5.1
Fiscal balance, % of GDP	-5.8	-6.4	-6.5	-6.8
Public debt, % of GDP	100	102	106	108
Current account balance, % of GDP	-3.7	-3.8	-3.8	-3.9

JAPAN

- **Despite a supplementary budget of JPY 3tr (0.5% of GDP) linked to the Middle East conflict, the growth outlook is now weaker.**
- **Energy subsidies and real wage gains are set to mitigate the oil price surge for households and fiscal stimulus is to support investment.**
- **The Bank of Japan is set to purse rate hikes as inflation expectations anchor, but it might pause its bond taper plan in 2027.**

Growth under downward pressure due to the Middle East conflict. Energy supply constraints and stagnation in logistics are expected to trigger production adjustments, and worsening terms of trade caused by surging crude oil prices will weigh on corporate profits and households' real purchasing power. Growth in the next two quarters is expected to remain close to zero. The extensive fiscal stimulus package will support consumption and investment through cost-of-living support measures for households and SMEs. The stimulus includes a supplementary budget of 0.5% of GDP that will finance energy subsidies, replenish depleted reserve funds and create a new buffer in case the conflict persists. Meanwhile, heightened policy and trade uncertainties will weigh on business sentiment. Assuming that tensions in the Middle East now gradually normalise, real GDP growth is projected at 0.6% in 2026 and 0.5% in 2027.

Japan is highly sensitive to the Middle East conflict. Should the situation be resolved within our working assumption timeframe, the economy is expected to growth at a moderate pace in 2026 due to fiscal support and a recovery in private consumption. A longer duration of the conflict would affect both household consumption and business profitability, Japan being a large importer of fossil fuels with a strong reliance on the Strait of Hormuz passage.

Strong business conditions so far…

Japan - business conditions, Tankan survey

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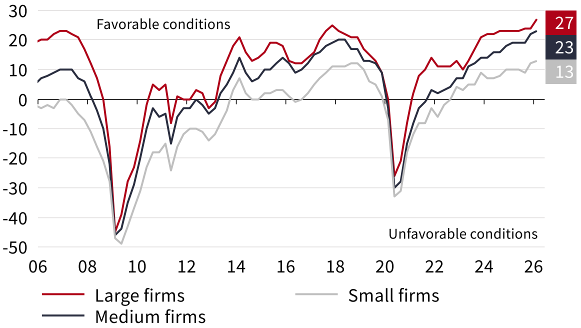
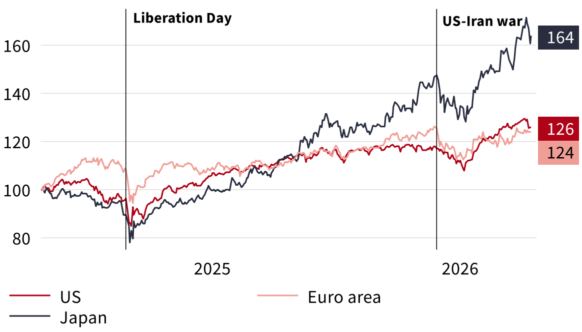


Sources: Bank of Japan, LSEG, SG Economic and Sector Studies

… illustrated by a buoying equity market

Equity markets

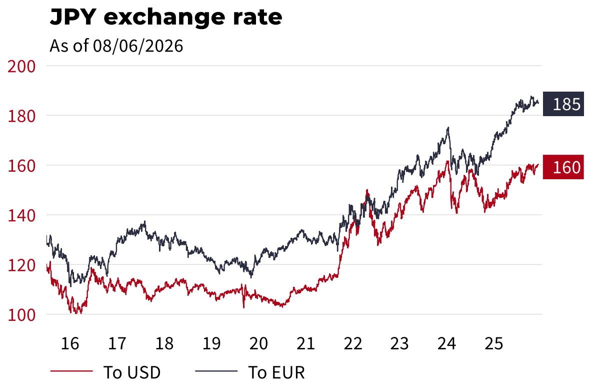
Index 100 = 01/01/2025



Sources: NIKKEI, STOXX, S&P, LSEG, SG Economic and Sector Studies

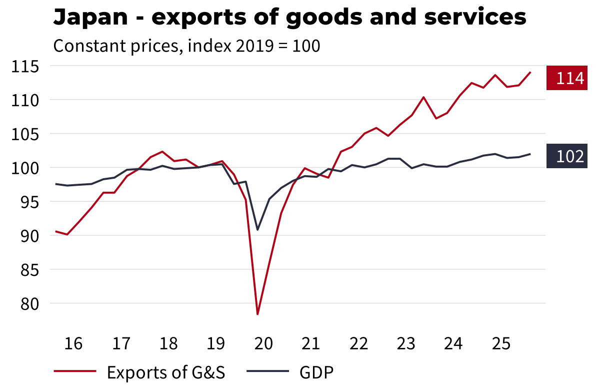
Business conditions have remained up to now resilient, reflecting a combination of supportive domestic and financial factors. The economy continues to grow moderately, with solid corporate profits, resilient domestic demand, and ongoing wage gains limiting downside risks. Fiscal policy has played a key cushioning role, with energy subsidies and supplementary spending mitigating the shock to households and firms. At the same time, a relatively weak yen is boosting exporters' earnings, while rising yields are supporting financial sector profitability. Global investors are also reallocating toward Japan, attracted by structural changes such as policy normalization and improved corporate governance. The structural need to increase productivity in the face of labour constraints should also boost corporate investment in the medium term. Overall, markets are pricing a temporary slowdown rather than a recession, with medium-term fundamentals remaining intact.

The weakness of the JPY …



Sources: Tokyo Financial Exch., LSEG, SG Economic and Sector Studies

… is boosting Japan export performance



Sources: Cabinet Office Japan, LSEG, SG Economic and Sector Studies

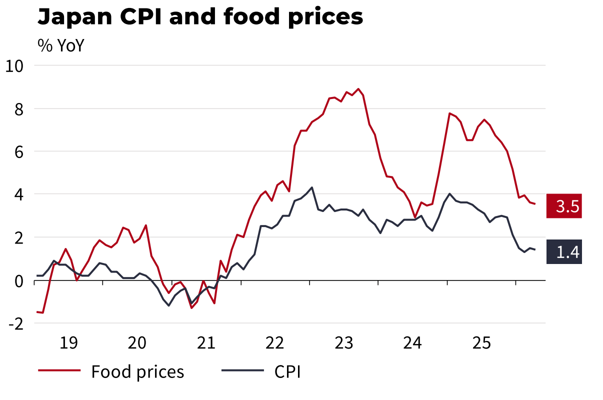
Consumer price inflation slowed to below 2% in 1Q26 due in part to measures aimed at reducing energy-related burdens, and also to the easing of food prices. However, rising import prices associated with surging crude oil prices are expected to spread to a broad range of items, including food products and daily necessities, pushing inflation into the 3% range by the end of 2026. Consumer price inflation is projected at 2.8% in 2026 and 1.3% in 2027, as energy prices ease.

The Bank of Japan is expected to gradually normalize monetary policy over the next two years and raise its policy rate to 1.5% by the end of 2028. The central bank will remain cautious throughout this period to ensure that policy normalization does not cause an economic slowdown or jeopardize its success in the recovery.

The pace of further rate hikes will depend on inflation data and real wage growth. A persistent JPY depreciation might add pressure for more rate hikes. We expect the BoJ to continue its quantitative tightening. The central bank has scaled back its purchase of ten-year government bonds and exchange-traded funds, which is reducing the size of its balance sheet. The BoJ would slow or suspend this tapering if the bond's market volatility is considered too high. Due to its history of deflation, we expect the BoJ to err on the side of caution.

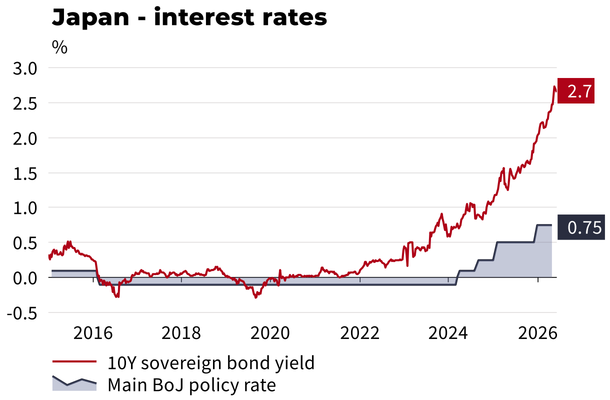
A prolonged supply shock could shift the BoJ's approach. Rising costs and uncertainty from an oil shock may curb private spending and investment, leading to slower growth and higher inflation that will complicate decisions for the BoJ. If the rise in inflation is mostly driven by supply shock (which eventually curbs the recovery of real wages and consumption), the BoJ may have to slow the pace of rate hikes.

Inflation is contained so far, as food prices decelerate and gasoline prices are subsidised



Sources: Ministry of Internal Affairs & Comm. Japan, LSEG, SG Economic and Sector Studies

Policy rate expected to reach 1.5% by 2028



Sources: Bank of Japan, LSEG, SG Economic and Sector Studies

The fiscal stance will be expansionary in 2026 and 2027, with a stimulus package injecting more than 1.5% of GDP in the economy, including a supplementary budget announced in May and worth 0.5% of GDP. Public deficit will continue to increase as interest charges become more pronounced, with 10Y JGB now exceeding 2.5%. However, the average debt maturity of over 9 years creates some breathing room. In the medium term, ageing-related spending, particularly in the health sector, will continue to put pressure on the fiscal deficit. The planned increase in defence spending by 2027 is significant, to align with a new benchmark of 2% of GDP. While we expect the fiscal deficit to average close to 3% of GDP in 2027, the gross public debt-to-GDP ratio is projected to remain on a declining path, as nominal GDP still exceeds the average interest rate on debt service.

Risks are tilted to the downside. Trade frictions and geopolitical uncertainties could weigh on growth and delay the pace of monetary policy normalisation. A large appreciation of the yen could reduce corporate profits and weigh on wage increases. Interest rates on long-dated Japanese government bonds are rising and a loss of confidence in Japan's fiscal sustainability could increase the sovereign risk premium. The large fiscal stimulus increases the risk of fiscal slippage if measures are maintained over several years.

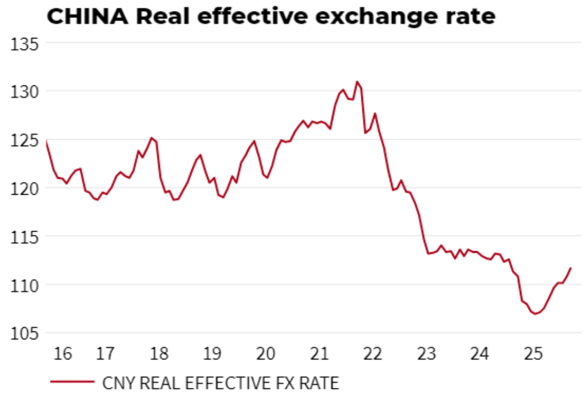
Japan	2025	2026f	2027f	2028f
Real GDP, % YoY	1.1	0.6	0.5	0.6
Household consumption	1.3	0.6	0.5	0.6
Public consumption	1.0	0.8	0.4	0.4
Investment	0.9	1.0	0.5	0.6
Exports of goods & services	2.5	1.9	1.7	2.0
Imports of goods & services	3.8	1.9	2.0	1.8
Inflation, % annual average	3.2	2.8	1.3	1.8
Core inflation, % annual average	3.1	2.0	1.3	1.7
Real gross disposable income (GDI), % YoY	-0.4	1.0	0.7	0.6
Households saving rate, % of GDI	-0.8	-0.6	-0.5	-0.6
Unemployment, % of labour force	2.5	2.7	2.7	2.6
Fiscal balance, % of GDP	-0.6	-2.4	-2.9	-3.3
Public debt, % of GDP	207	203	201	200
Current account balance, % of GDP	4.8	4.0	4.2	4.2

CHINA

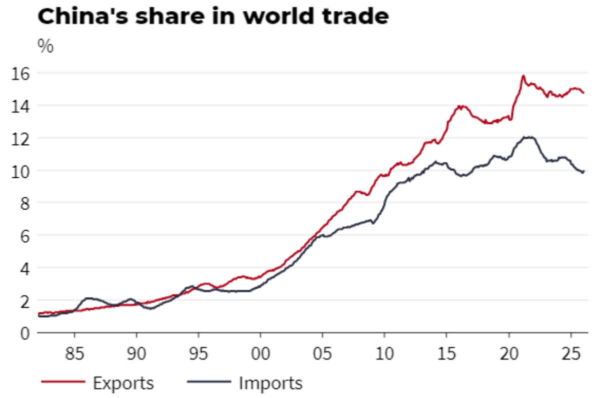
- **The growth pattern is increasingly export led, fuelling rising trade imbalances and the risk of further trade frictions.**
- **The energy price shock is hitting internal demand. GDP growth for 2026 is now seen at 4.2%, i.e. below the government's 4.5-5.0% target range.**
- **Overall resilience remains firm, but it will be tested by industrial overcapacities, depressed confidence and further trade frictions. Policy mix will be of moderate support.**

Exports are resilient, and the growth pattern is increasingly export led. In the short term this strength partly compensates for the energy price shock as exports have remained strong despite the trade tariffs; Asean, EU and emerging markets have more than compensated for the contraction with the US and China has seen a rapidly rising trade surplus (+ 19% in 2025 reaching USD 1.2trn), only adding to global imbalances. The concern, and not least in Europe, is that this is the result of a deliberate mercantilist policy, or even industrial dumping. Exports should soften after the front-loading, with the rise of protectionism worldwide.

Significant CNY depreciation….



is coincident with a rising trade surplus

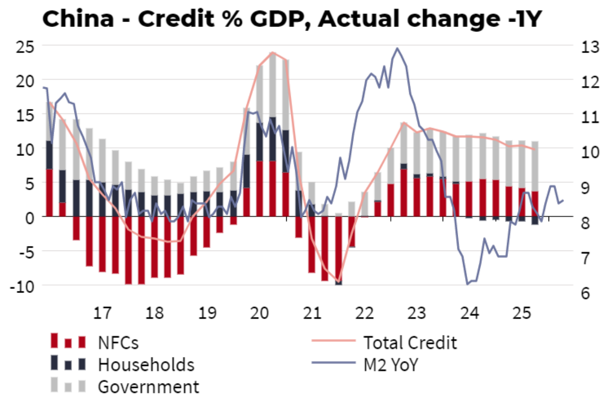


The gains in export share are increasingly criticized by partners beyond the US. They are coincident in the past three years with significant depreciation of the CNY in reals terms. According to a report published in June by the OECD Chinese industrial companies have also received significantly more state support than their international competitors in the OECD: 3 to 8 times more subsidies (depending on sectors) relative to their turnover over the past two decades, explaining around 60% of their global market share gains during the period. China provides wide-ranging support to its self-defined priority sectors. The fiscal costs of these measures were estimated by the IMF to reach about 4% of GDP in the February 2026 article 4 report. According to the IMF, EU state aid to its industries amounts in comparison to around

1.5% of its GDP. These recent reports are bound to give rise to international pressures from trade partners.

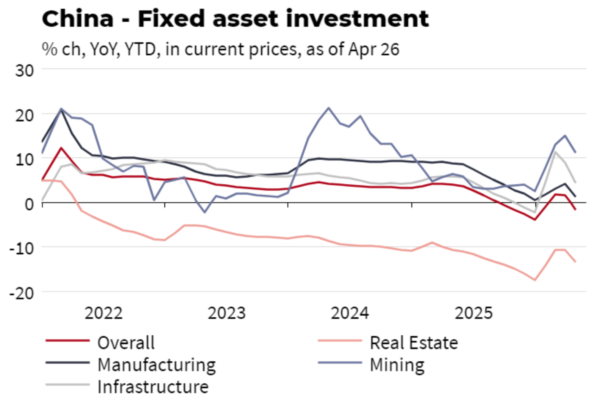
Internal demand is fragile. With the energy price shock linked to the war in Iran, the producer price index moved back into positive territory in March and reached 2.8% in April (after more than 3 years in negative territory). This is pushing up costs for corporations but the pass through is likely to remain limited. Domestic fuel pricing controls also smooth retail price increases. Household confidence remains close to historical lows. The property sector has not found a bottom. There is limited progress on inventory reduction, the speed of destocking is slow, and property price decline may have further to go. The bottom of the cycle unlikely to be reached before 2027-2028. Excess capacity in various sectors is depressing producer prices and industrial profits. Fixed assets investments are contracting. Youth unemployment (16.9% in March 2026) is elevated and rising. As social safety nets are fragile, propensity to consume is weak, preventing the rebalancing of the economy.

Credit remains supportive



Source: SG Economic and Sector Studies, LSEG

Investment pick up in Q1 was short lived



Source: SG Economic and Sector Studies, LSEG

Policy mix will be of moderate support. The 15th five-year plan is essentially a pursuit of present policies. Incremental support for consumption and for real estate sector is expected. But moral hazard and fiscal concerns persist. Credit has been reoriented in the past years from households to non-financial corporations. It remains relatively strong as China continues to seek to strengthen its position in various industries, but the depressed profitability of firms seems to be constraining their ability to invest. There is also little room to ease monetary policy, due to reduced bank profitability. The reduction of overcapacities has begun for basic industries. In more complex industries, the authorities have opted for market-based methods to promote consolidation, pointing to a much more gradual process. It is difficult to predict rapid success. The lack of effective bankruptcy laws remains an obstacle. Regional issues, particularly concerning tax contributions, remain very significant and will slow the process.

Financial stability risks will remain contained by the country’s closed capital account and net external creditor position. We do not anticipate a significant depreciation of the renminbi to boost export competitiveness, as the authorities remain committed to exchange-rate stability.

Geopolitical tensions will remain present and could intensify with the risks of overcapacity. China-US relations will remain fraught over the coming years amid tensions over trade, technology, and security. Disputes over tariffs and export controls with the US have temporarily de-escalated, but this is only a truce. The disagreements are too wide to be bridged, and any accord will not prevent periodic reignitions of bilateral tensions. China's dominance in critical minerals adds strategic leverage but also risk of retaliation. This will remain a source of uncertainty for exporters and supply chains.

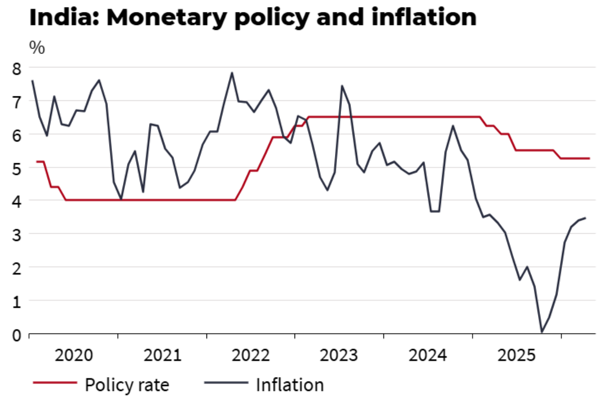
China	2025	2026f	2027f	2028f
Real GDP, % YoY	5.0	4.2	4.0	3.8
Household consumption	5.1	4.5	4.2	3.8
Public consumption	6.1	4.9	4.8	4.5
Investment	2.9	3.5	3.0	3.5
Exports of goods & services	4.7	3.0	2.1	2.5
Imports of goods & services	-0.3	2.7	2.0	2.2
Inflation, % annual average	0.3	1.2	1.4	1.7
Fiscal balance, % of GDP	-8.0	-7.8	-7.6	-7.6
Public debt, % of GDP	94	97	99	101
Current account balance, % of GDP	3.7	3.0	2.7	2.5

INDIA

- **India is sensitive to the conflict in the Middle East, importing a large share of its oil and fertilizers needs from Gulf countries.**
- **Higher inflation in 2026 will reduce monetary policy room.**
- **Growth momentum should nevertheless remain strong over 2026/27.**

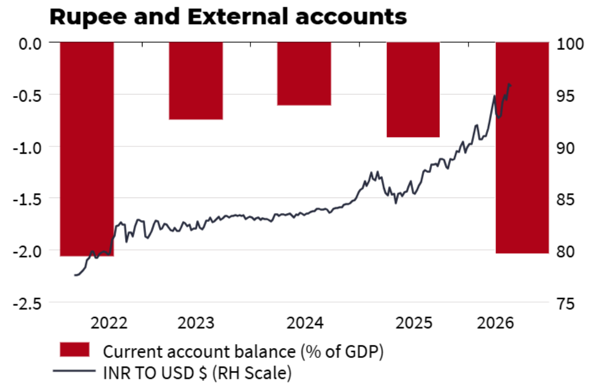
Higher inflation in 2026 due to India's energy dependence and its sensitivity to the Middle East conflict will prevent further easing of monetary policy. The energy price shock will feed higher inflation, that we now forecast around 5% in 2026. The revision also incorporates also an anticipated monsoon shortfall related to El Niño. The depreciation of the rupee precedes the energy price shock (due to lower capital inflows and US tariffs) and is likely to continue this year. It is, however, more manageable than in the past due to higher FX reserves and improved credibility.

Inflation has been rapidly increasing



Source: LSEG, SG Economic and Sector Studies

Also accelerating a slide of the rupee

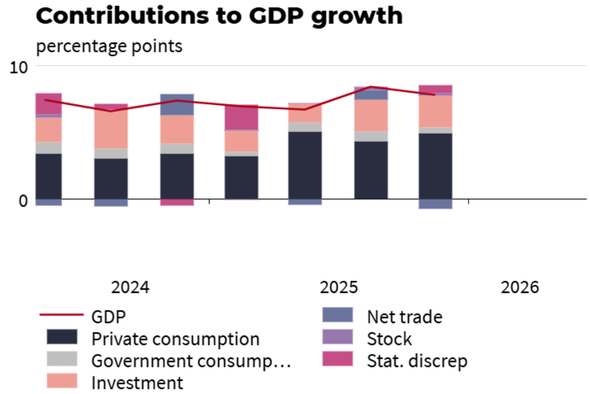


Source: LSEG, SG Economic and Sector Studies

Growth will nevertheless remain sustained, despite the reduced policy room and the ongoing fiscal consolidation. Growth is driven by the insular nature of the Indian economy, reforms for direct and indirect taxes, strong public investment, resilient services exports, strong rural demand and trade deals that will open new markets.

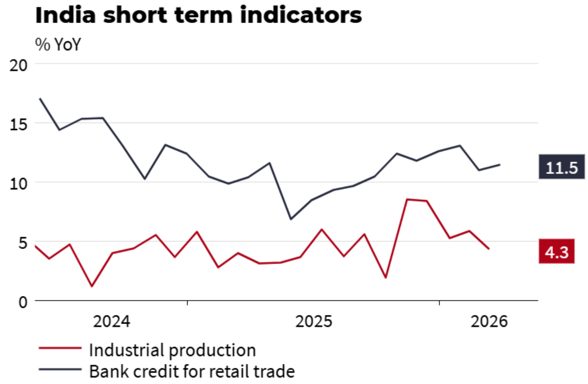
Private consumption remains a strong engine, supported by rising incomes, urbanisation, and favourable demographics. India's large working-age population continues to underpin medium-term demand, even as job creation remains uneven across sectors. Government capital expenditure has risen and reached around 4% of GDP in 2025, focusing on transport, logistics, energy and digital infrastructure. This also has a multiplier effect on construction, steel, cement, and services. The GST reform implemented progressively since 2017 has shifted tax from production to consumption, is already a success even if not yet completed. Together with continued infrastructure push, and relatively successful manufacturing scale-up, it should continue to ensure favourable prospects.

Growth is well balanced



Source: IMF, SG Economic and Sector Studies

Momentum remains strong



Source: SG Economic and Sector Studies, LSEG

Despite the rise in inflation, we do not expect the RBI to pivot to monetary tightening in 2026. Inflation will increase due to higher energy and fertilizers prices, as well as an evolving El Niño event that could lead to higher food prices, but inflation should remain within the central bank's target range.

The budget contemplates moderate fiscal consolidation, but stronger revenues should ensure a relatively stable level of public capex. The banking sector is in its healthiest position in decades, with low NPLs and strong capital buffers.

The BJP has won significant state elections in May, and this should bolster global policy coherence. BJP won state elections in Assam, Tamil Nadu, and most importantly its first ever term in West Bengal, a state that used to be a bastion of labour unions and has been recently marked by political violence and a poor business climate. The large BJP win is analysed as a political earthquake in India, and a strong mandate to implement changes.

Risks to this scenario are tilted to the downside, as India remains very sensitive to energy and food prices. Should these surprise to the downside, then domestic demand dynamics could positively surprise in a context of easing monetary policy and inflation stabilisation which would boost investment and consumption.

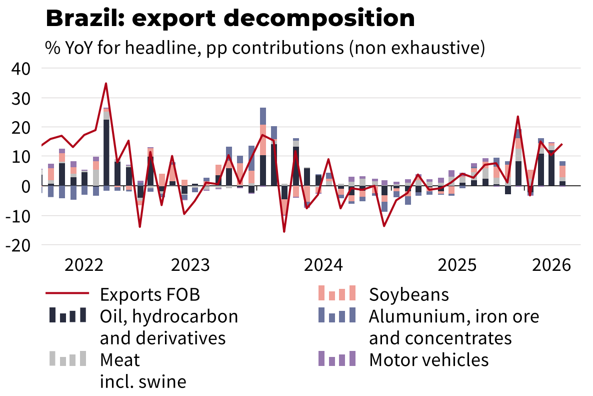
India (fiscal year from April to March)	2025	2026f	2027f	2028f
Real GDP, % YoY	7.7	6.6	6.3	6.5
Household consumption	7.7	6.4	6.4	6.6
Public consumption	5.5	5.2	5.0	4.8
Investment	8.2	6.8	6.5	6.7
Exports of goods & services	6.3	4.5	5.5	6.0
Imports of goods & services	5.6	7.0	6.0	6.5
Inflation, % annual average	2.0	5.0	4.5	4.5
Fiscal balance, % of GDP	-7.4	-7.4	-7.3	-7.2
Public debt, % of GDP	84	83	82	81
Current account balance, % of GDP	-0.9	-2.2	-2.5	-2.8

BRAZIL

- **External tailwinds will boost the near-term outcome, lifting growth to 1.5% in 2026 and further strengthening the BRL.**
- **The impact of higher global commodity prices on inflation will be partially offset by demand reduction and improved terms of trade.**
- **Fiscal policy is set to be slightly more accommodative ahead of the October elections while the BCB's easing cycle is set to be shallow.**

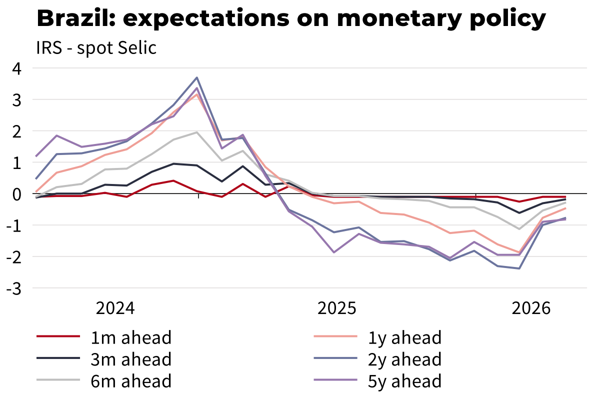
The fallout from the conflict in the Middle East makes the outlook more uneven. Exports continue to be supported by strong demand from Asia, higher commodity prices, and high production volumes in hydrocarbons and soft commodities. The latter have benefited from historically strong output, notably in soy and meat. Higher oil prices also provide support to fiscal revenues, not least through an improved outlook for Petrobras and together with the temporary introduction of 12% and 50% export taxes on crude oil and diesel respectively until July, create additional room for public spending ahead of the October elections. Private consumption should remain broadly resilient, supported by a still tight labour market, with the seasonally adjusted unemployment rate remaining below 6%, but it will face increasing headwinds from weaker credit dynamics as real rates remain high. The announcement of a new de-levering program (*Desenrola 2*) should help ease the burden of costly household debt and limit further deterioration in banks' NPL ratios.

Export growth continues to be sustained by commodities



Source: MDIC, SG Economic and Sector Studies

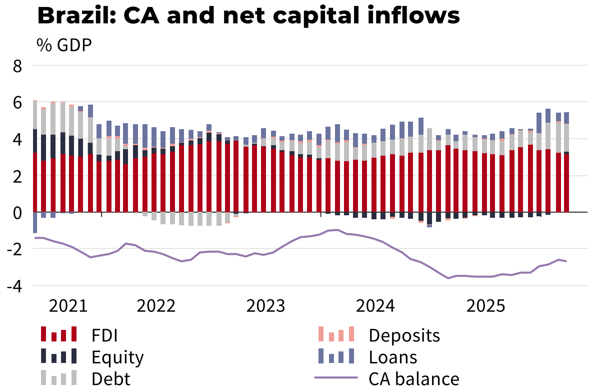
The economy faces the prospect of a shallow easing cycle from the BCB



Source: LSEG, SG Economic and Sector Studies

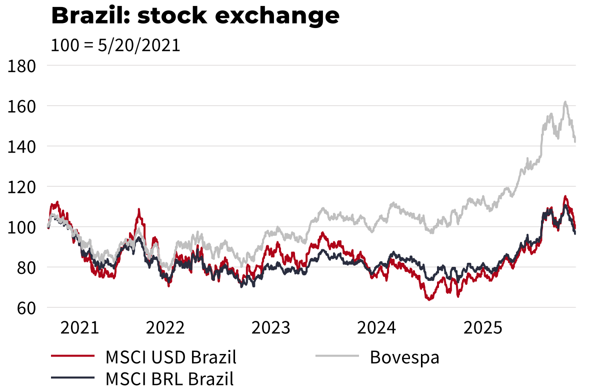
The BCB faces a more complex environment, leading it to pursue a shallow easing cycle. Higher energy prices have triggered some drift in inflation expectations as the shock gradually feeds through the economy. We expect inflation to average 4.4% this year, initially driven by energy prices and followed by food prices with a lag. The central bank has adopted a hawkish tone to strengthen its credibility and preserve the effectiveness of monetary policy and is therefore likely to maintain a less accommodative stance. Pass-through to core inflation should remain limited, however, owing to the restraining effects still tight monetary policy and a stronger BRL. We expect USD/BRL to end the year around 5, supported by solid capital inflows and a favourable interest-rate differential.

The county is benefiting from diverse capital inflows…



Source: BCB, SG Economic and Sector Studies

… supporting the BRL and local stock exchanges



Source: LSEG, SG Economic and Sector Studies

Brazil is benefiting from strong global risk appetite, which is supporting capital inflows, local assets and the recovery in investment. Portfolio inflows are approaching 3% of GDP in 1Q26, close to recent highs seen in 2014 and 2021, supporting both the appreciation of the BRL (pushing BCB FX intervention to partially offset it) and the rebound in local equity markets. FDI inflows should also remain robust, driven by export-oriented sectors such as beef, soy, energy (including green hydrogen) and critical minerals, and are approaching levels last seen more than a decade ago. The resilience of these inflows will depend on a global environment that remains supportive of risk-taking, on contained tensions with the US, the main source of FDI, and on a stable domestic environment. Political developments ahead of the October presidential and legislative elections nevertheless remain a key source of uncertainty for market sentiment.

The balance of risks is deteriorated by a potential onset of El Niño and by political uncertainty ahead of the October elections. El Niño is expected to emerge in late 2026 and typically lasts six to nine months. It tends to raise average temperatures, although its effects vary across regions. The North and Northeast would likely face drier weather, weighing on agricultural output, while the South could benefit from wetter conditions. The impact on the main agricultural areas in the Centre-West and Southeast is more uncertain and will depend on the duration and intensity of El Niño but could delay planting and reduce productivity. Lower agricultural output would weigh on exports and add to inflation, notably in 2027 as stocks are depleted. Other important transmission channels operate through energy, given the country's reliance on ethanol (as a reminder about 70% of cars run on ethanol) and on hydropower in the event of prolonged and geographically widespread droughts.

Political tensions ahead of the October presidential and legislative elections also warrant close monitoring. Electoral uncertainty could weigh on market sentiment, reduce policy efficiency and amplify volatility, particularly if it complicates fiscal management or weakens confidence. Importantly, the Banco Master financial scandal is fuelling corruption allegations notably for the right's candidate Flavio Bolsonaro (facing pressure to step down from the race given electability losses in recent polls) and among the *Centrão*, the main power brokers in Congress. Other risks include a sharper turnaround in the labour market and tensions in financial markets, not least due to continued fiscal tensions as consolidation efforts remain gradual, and debt-to-GDP ratios keep climbing as interest charges stay elevated.

Brazil	**2025**	**2026f**	**2027f**	**2028f**
Real GDP, % YoY	2.6	1.5	1.5	2.0
Household consumption	1.3	0.9	1.9	2.3
Public consumption	2.1	2.3	0.8	0.8
Investment	3.0	0.7	1.7	2.5
Exports of goods & services	6.5	8.0	2.1	2.3
Imports of goods & services	5.1	-0.4	2.0	2.3
Inflation, % annual average	5.0	4.4	3.5	3.5
Fiscal balance, % of GDP	-8.1	-8.4	-6.9	-6.2
Public debt, % of GDP	93	96	98	99
Current account balance, % of GDP	-3.1	-2.5	-3.0	-3.0

AFRICA

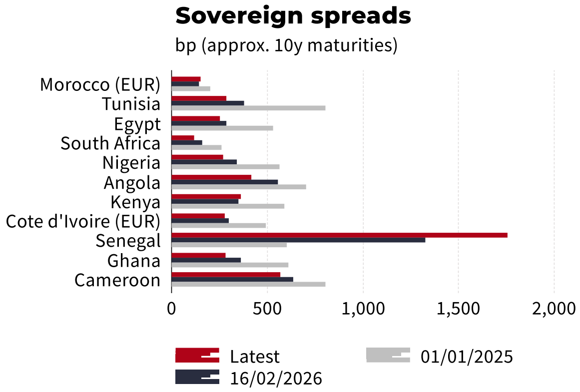
- **Regional growth is expected to slow in 2026, to around 4% (vs. 4.5% in 2025). For now, the conflict in the Middle East has not triggered a marked loss of market confidence towards Africa.**
- **Assuming the ongoing easing of tensions holds, the conflict should have a limited impact on the region, as several hydrocarbon exporters could benefit from higher prices.**
- **Downside risks are nevertheless increasing significantly, as this new exogenous shock compounds several pre-existing vulnerabilities.**

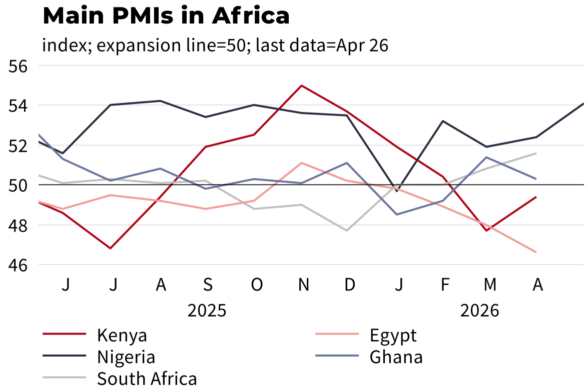
Regional African growth is expected to slow slightly in 2026, to around 4% (vs. 4.5% in 2025), before stabilising at around 3.8% from 2027 onwards. This deceleration reflects a combination of less favourable base effects (after 2025 delivered one of the strongest growth performances of the past fifteen years) and a less supportive international environment as a result of the Middle East conflict.

Although it remains too early to draw definitive conclusions, this new exogenous shock could have a relatively limited impact on Africa as a whole. First, the conflict has not, for now, undermined international investor appetite for frontier markets such as Africa. Regional sovereign spreads therefore often remain below their mid-February levels, except for a few countries that appear more vulnerable to the conflict (Kenya, Egypt) or are suffering from their own domestic crisis (Senegal). Second, despite strong heterogeneity, Africa remains, at the aggregate level, a net hydrocarbon exporter, with hydrocarbons accounting for around 35% of goods exports and 15% of imports. Nigeria (~20% of regional GDP), Algeria (~10%) — but also, to a lesser extent, Angola and several Central African countries — would therefore be well placed to benefit from higher international prices.

When these higher prices are combined with favourable local production dynamics — as is the case in Nigeria and Algeria — they would support public demand (with additional hydrocarbon revenues likely to finance new spending), and possibly external demand, if these countries were able to offset a prolonged reduction in hydrocarbon supply from the Gulf. More broadly, private demand should remain the main driver of growth in 2026/27, benefiting notably from i) favourable disinflation dynamics, which predated the conflict and should not be entirely reversed by it, and ii) still-dynamic foreign direct investment. In this respect, the resilience of the main regional PMIs in April is reassuring.

Markets and "sentiment" indicators have not suffered much from the conflict in the Middle East

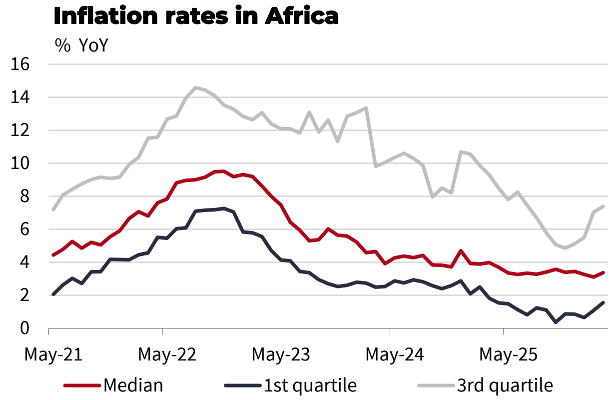




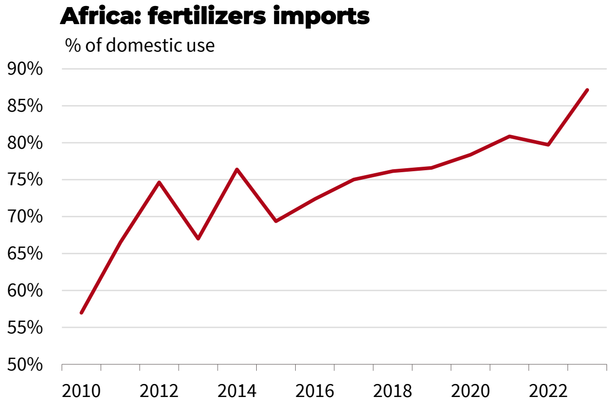
Source: LSEG, SG Economic and Sector Studies

This relatively reassuring overall picture should not, however, obscure the risks associated with the current crisis. First, many countries in the region remain importers of hydrocarbons, but also of fertilisers, whose prices have also been hard hit by the conflict. This increase would clearly add to inflationary pressures, as "food" and "transport" often account for a large share of consumer baskets in the region (around 40% on average, albeit with very strong heterogeneity). In these more fragile importing countries, external balances — current accounts, FX reserves, etc. — should also deteriorate. More concretely, difficulties in accessing fertilisers could affect African agricultural sectors, which remain among the most vulnerable in the world and whose dependence on imported inputs has increased significantly.

A favourable disinflationary trend predating the conflict, but a recent increase to monitor.



A growing dependency to fertilizers imports



Source: LSEG, FAO, SG Economic and Sector Studies

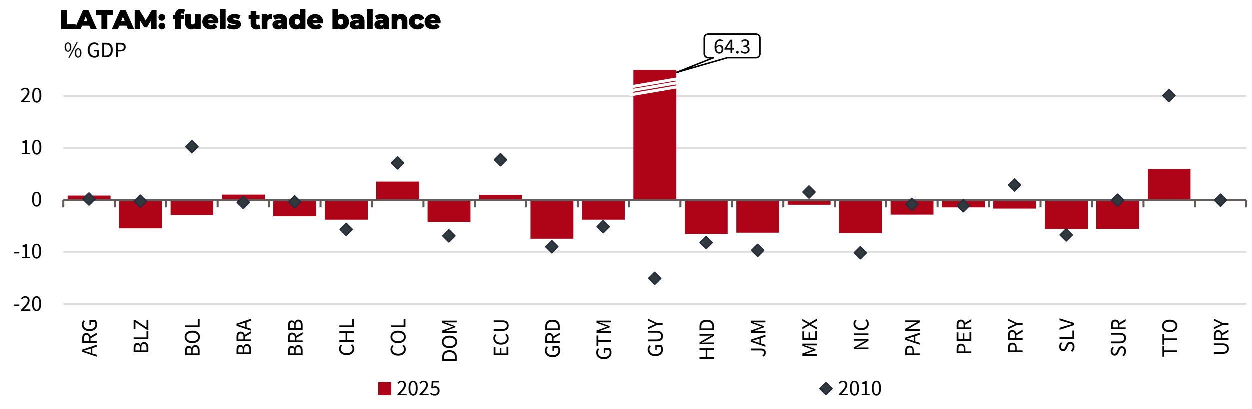
More generally, this new exogenous shock compounds several pre-existing vulnerabilities in the region. Fiscal positions of most African countries remain under pressure, while food and energy prices often remain subsidised and international aid flows continue to decline. In this respect, a more pronounced market shock would be particularly damaging, given the region's foreign-currency financing needs.

LATIN AMERICA

- **Higher energy prices represent a mixed shock: commodity exporters benefit, while fragile net importers face renewed external pressure.**
- **Inflation risks are rising through fuel, logistics and food channels, with more pronounced pressures likely in 2027 due to El Niño risks.**
- **Investment should remain supported by energy and transition needs, but tighter policy and political fragmentation will cap upside.**

The fallout from the Middle East conflict is affecting country outlooks across Latin America in different ways. Higher global commodity prices are set to lift inflation across the region, weighing on private demand as households' and corporates' balance sheets come under pressure. Some resilience can nevertheless be expected, supported by still-tight labour markets despite persistent informality, as well as still strong remittance inflows. Divergences are clearer on the external front. Hydrocarbon exporters, notably in South America (Brazil, Guyana, Venezuela, Colombia, Argentina, Ecuador), mechanically benefit from higher selling prices and rising production capacity, supporting exports and growth while creating some room for policy measures to limit energy inflation. Improved terms of trade and visible investment opportunities should also strengthen FX, offsetting part of the inflation shock. By contrast, fragile net fuel importers -notably Bolivia and parts of Central America and the Caribbean- will face the inflation shock fully, further straining their balance of payments and fiscal accounts.

National energy balances modulate the impact of the current shock on the outlook

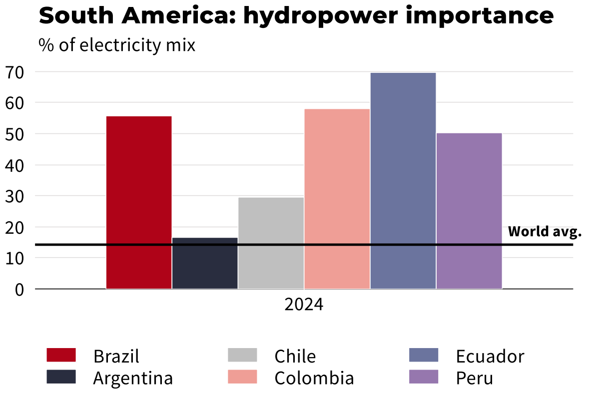


Source: COMTRADE, SG Economic and Sector Studies

NB: Trade balance for "27 - Mineral fuels, mineral oils and products of their distillation; bituminous substances; mineral waxes"

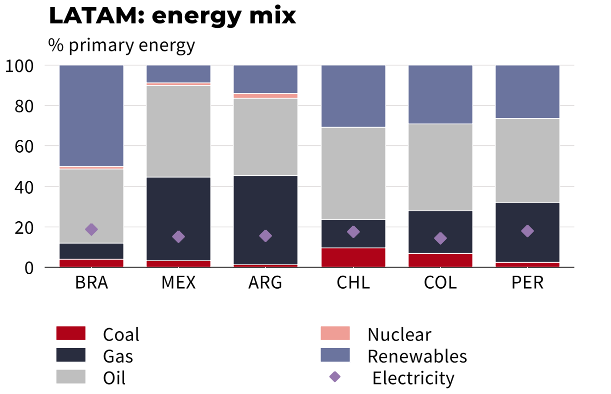
The inflation shock will also be shaped by the region's reliance on renewables, although the onset of an El Niño episode clouds the outlook and leaves risks tilted to the upside. Latin America relies heavily on renewables for electricity generation, reflecting abundant local resources and partly cushioning the immediate impact of higher global energy prices. The bulk of the transmission to inflation is driven by fuel prices (even if some supportive measures are deployed in some countries like Brazil, Argentina and Colombia) and through logistics costs, as merchandise transport relies heavily on trucks, air and waterways. Hydropower remains a key source of electricity generation across the region, albeit with significant cross-country differences, leaving several economies vulnerable to adverse climate conditions, particularly if El Niño intensifies, as suggested by NOAA for late 2026 and early 2027. Food price pressures are also likely to build with a lag as current stocks are depleted and could be exacerbated by weather-related disruptions. Below-average precipitation is expected across much of Central America and the Caribbean, as well as along the north Atlantic coast of South America, weighing on both agricultural output and electricity generation. This points to an inflationary environment in the near term, but with upside risks likely to become more pronounced in 2027, when the effects through food, logistics and energy supply constraints are likely to intensify.

Reliance to renewables offer a buffer to higher prices, and risks ahead of El Niño offset



Source: Our World in Data, SG Economic and Sector Studies

Energy sector to be a driver of investment including to address electrification shortfalls



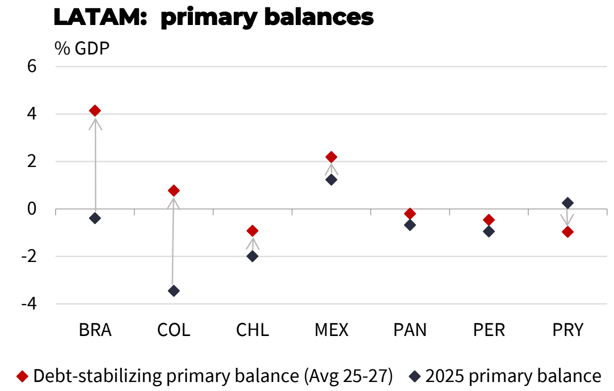
Source: Our World in Data, SG Economic and Sector Studies

The energy sector will remain a key driver of investment in the region, both in hydrocarbons and in the transition. Latin America's attractiveness in oil and gas is supported by abundant natural resources and relative geopolitical stability, which should strengthen its appeal for friendshoring, and nearshoring-related capital inflows. The region's endowment in minerals and critical raw materials (notably copper and lithium in the Southern Cone and Peru) is also increasingly strategic for the global transition, improving the medium-term outlook for exports, external balances and FDI. At the same time, the region is investing in its own energy transition, with a focus on addressing persistent electrification shortfalls, particularly outside urban centres, modernising grids, and expanding renewable capacity to secure sufficient energy supply for future growth. More broadly, these dynamics, and some pro-growth reform agenda in several countries (e.g. Mexico, Chile, Argentina, Venezuela) should support a recovering investment ratio. Mexico should also benefit from improved policy expectations and from the prospect of a

USMCA agreement, which would further support manufacturing FDI and reinforce its role in nearshoring value chains.

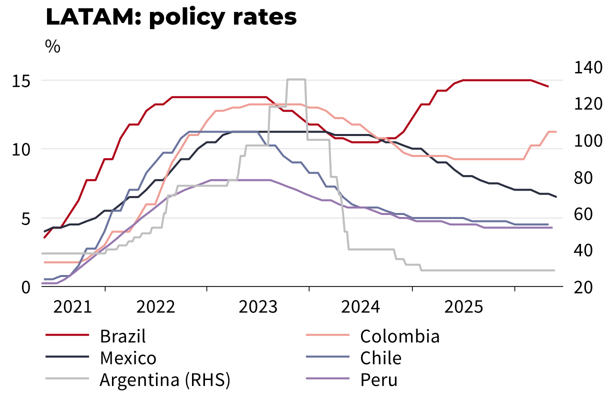
The policy mix is expected to tighten as central banks are pressured to adopt a more hawkish stance, and most countries need to credibly consolidate their fiscal accounts. Monetary authorities are expected to react to the inflationary shock to assert their independence and reduce the risks from second round effects stemming from tight labour markets, limiting credit impulse. On the fiscal side, gradual consolidation efforts are announced across the region to tame higher indebtedness following the Covid shock and the effects of higher interest burdens. These need to be better anchored and accelerating to preserve investor's confidence and recover fiscal buffers to face future shocks.

The region needs to credibly tighten fiscal policy



Source: IMF, LSEG, SG Economic and Sector Studies

Hawkish tone from central banks expected further tightening the policy mix



Source: LSEG, SG Economic and Sector Studies

As a new electoral cycle unfolds, a shift towards opposition leaders that are more closely aligned with the US administration is underway, albeit persistent polarisation and social risks. Recent elections have brought to power candidates in Ecuador, Chile and Bolivia who appear more willing to cooperate with Washington on policy priorities, notably in the area of security. This realignment does not seem to translate into willingness to isolate China, important market for regional exports and source of investment. However, rising political fragmentation is also fuelling social tensions and clouding the outlook for policy management and reform momentum. Future electoral milestones in Brazil and Argentina will be particularly closely watched, as the incumbent administrations currently stand on opposite sides of the region's evolving alignment with Washington.

Risks remain broadly balanced. While geopolitical volatility has so far been supportive for the region, Latin America could be caught up in broader efforts to isolate China, the main destination for South American exports. Structural challenges also remain prominent, as the region continues to face demographic and security pressures that weigh on potential.

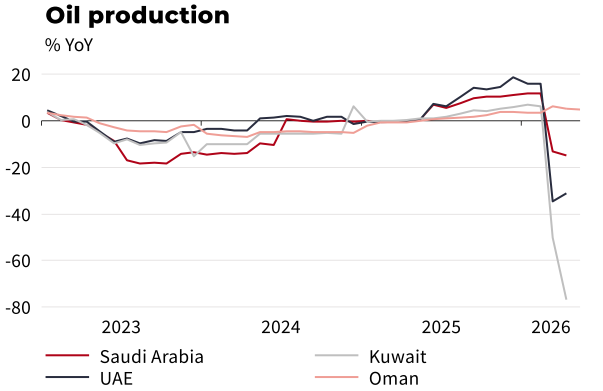
GULF STATES

- **Regional growth will fall sharply in 2026, at least due to contractions in hydrocarbon production.**
- **The regional conflict should have an asymmetric impact, with Qatar, Bahrain and Kuwait more severely affected on the one hand, and the UAE, Saudi Arabia and Oman on the other.**
- **Although the region's vast resources should enable it to weather the current crisis, new structural questions have emerged.**

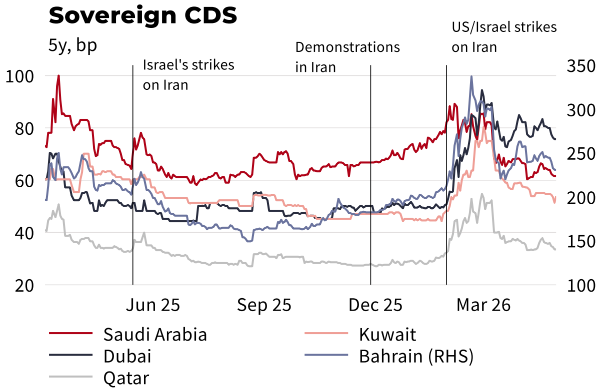
After reaching 4.4% in 2025, growth in the Gulf Cooperation Council (GCC) countries will slow markedly in 2026, due to the conflict in the Middle East. As things stand, the latter has already had an asymmetric impact on the countries of the region. Qatar is currently the most affected country and should record a GDP contraction of around 10% in 2026: Iranian attacks on the Ras Laffan complex (mid-March) have eliminated nearly 20% of the country's LNG production capacity (with the authorities indicating that three to five years would be needed to bring these capacities back online) and have significantly slowed downstream sectors (aluminium, fertilisers, etc.). Bahrain and Kuwait would experience more limited recessions, due to direct — albeit more moderate — attacks on downstream production sites (refining, aluminium), with the former also suffering from significant financial vulnerabilities predating the conflict, limiting its capacity to support the economy. More generally, these three countries all suffer from the quasi-total dependence of their export routes on the Strait of Hormuz. Conversely, the United Arab Emirates (UAE) and Saudi Arabia benefit from "alternative routes" (Fujairah on the Indian Ocean, Yanbu on the Red Sea, respectively), allowing them to export a non-negligible share of their oil production (~35% and ~60%, respectively, according to estimates that should be treated with caution). Oman, for its part, has direct access to the Indian Ocean and has therefore been able to continue increasing its production since the start of the conflict.

Several factors should help limit the scale of the shock. First, the market reaction remains contained for now: CDS and sovereign spreads have admittedly increased but still remain below their mid-2025 levels (the first Israeli strikes on Iran); regional stock markets have not sold off sharply; and Qatar and Kuwait have been able to issue eurobonds at relatively low cost. Second, before the conflict, GCC countries had vast financial resources (net external assets equivalent to 180% of regional GDP), while their fiscal positions should even strengthen in 2026 (except in Qatar and Bahrain).

A sharp drop in oil productions in countries most dependent to the Strait of Hormuz



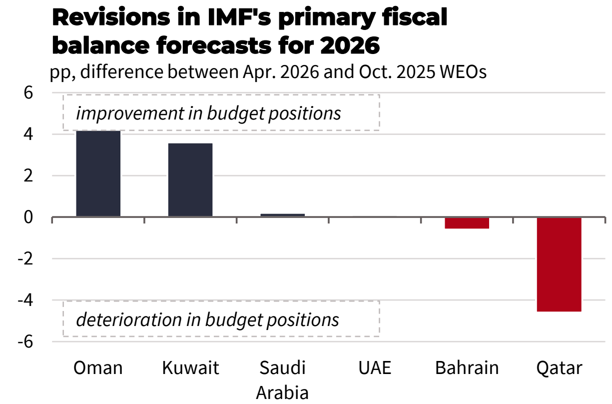
A limited increase in CDS levels



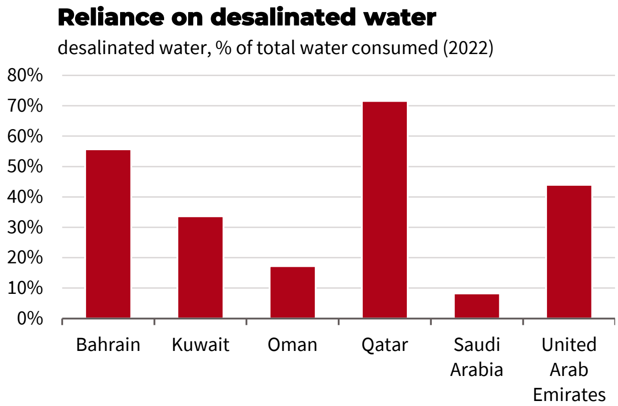
Source: LSEG, SG Economic and Sector Studies

Growth should reaccelerate in 2027, driven by the expected rebound in hydrocarbon production (generating particularly favourable base effects) and reconstruction efforts (financed by the financial resources mentioned above). Nevertheless, the current conflict has reinforced several structural questions affecting the region. First, the various diversification agendas — notably in Saudi Arabia and the UAE, and to a lesser extent in Qatar and Oman — which have been central to growth dynamics in recent years, could be partly called into question, particularly in the tourism and logistics sectors. Second, political "fragmentation" in the region has increased once again, as illustrated by the UAE's decision to leave OPEC from 1 May. Even weaker regional cooperation could lead to an increase in inefficient investment.

Most budget positions are set to strengthen in 2026



An important dependency on desalinated water



Source: LSEG, SG Economic and Sector Studies

Risks to the region have, unsurprisingly, increased sharply over the past quarter. For now, key civilian infrastructure has been relatively spared. A renewed escalation could have significant consequences for the region's economic and social structures, for example due to countries' dependence on water desalination.

CENTRAL AND EASTERN EUROPE

- **Regional growth outlook is deteriorating in 2026, amid renewed pressure on energy prices and weaker performance in the euro area, Central Europe's main trading partner.**
- **This new energy shock should nevertheless be less destabilising than in 2022, thanks to stronger security of supply, lower energy intensity and less tight labour markets, which should limit the risk of a wage-price spiral.**
- **Risks nevertheless remain tilted to the downside, against a backdrop of reduced fiscal space, rising defence spending and heightened political tensions in several countries in the region.**

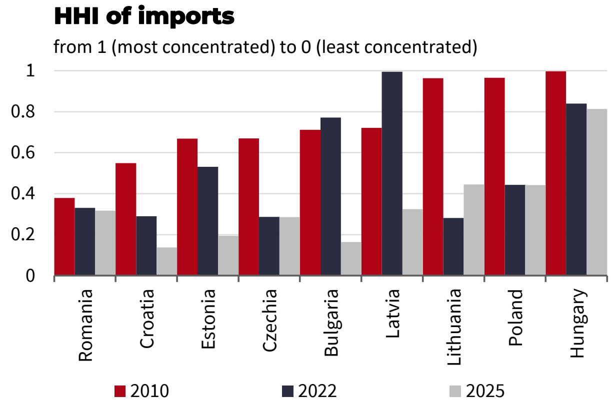
The spillovers from the conflict in the Middle East and the slowdown in the euro area are clouding the short-term outlook for Central and Eastern Europe. Energy price tensions are weighing on households' purchasing power across the region. In Romania, household consumption is expected to contract under the impact of a sizeable fiscal adjustment and weaker confidence amid political uncertainty following the fall of the pro-European government in May 2026. External demand is also likely to remain subdued: the region remains highly exposed to the persistent weakness of German manufacturing and to a still fragile European automotive cycle. This dependence is particularly significant for the economies most integrated into European industrial value chains, notably Czechia, Hungary and Slovakia.

EU funds and defence spending should nevertheless provide an important buffer. NextGenerationEU financing will continue to support investment until end-2026, subject to implementation deadlines being met - with targets and milestones to be fulfilled by 31 August 2026 and final payment requests to be submitted by 30 September 2026. EU structural and investment (ESI) funds and Security Action for Europe (SAFE) loans are then expected to gradually take over, particularly for investment related to infrastructure, energy security and defence. The SAFE instrument provides for up to EUR 150bn in long-term loans aimed at accelerating defence investment and strengthening Europe's industrial base.

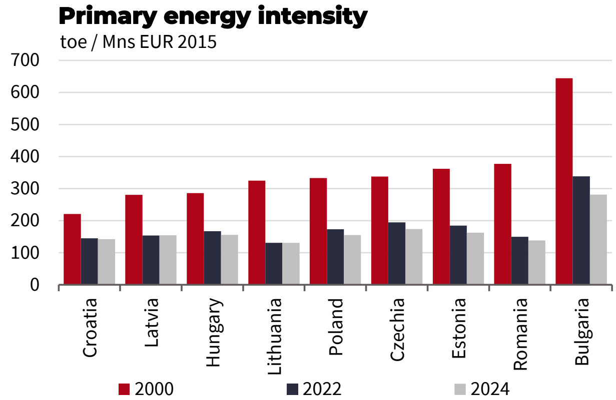
This new energy shock nevertheless differs markedly from the one observed at the start of the war in Ukraine in 2022. The region is no longer facing an acute risk of supply disruption linked to a single supplier. Increased access to LNG, the development of interconnections and the diversification of supply routes have improved the region's energy security. This is reflected in lower supplier concentration in terms of imports and reduced dependence on Russia. Conversely, this diversification leaves the region more directly exposed to global energy prices, particularly the LNG market.

The region has also made significant progress in terms of energy intensity. The decline in energy consumption per unit of GDP reduces the sensitivity of activity to energy price fluctuations, although industry remains more exposed in the most manufacturing-intensive economies. This structural improvement helps ease the impact of the shock on companies' production costs and margins compared with 2022. Imported energy intensive inputs nonetheless remain a source of vulnerability.

The concentration of energy supplies has declined …



… and energy intensity has improved in the region compared with 2022

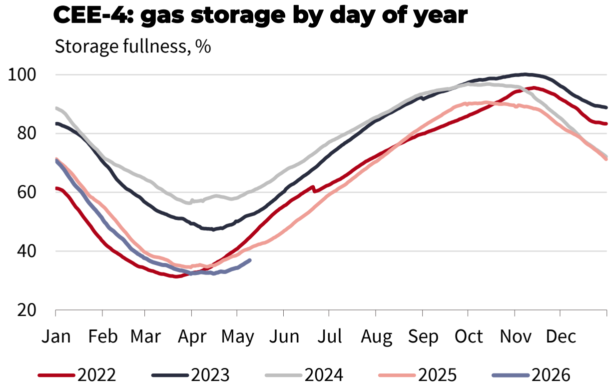


Source: European Commission, SG Economic and Sector Studies

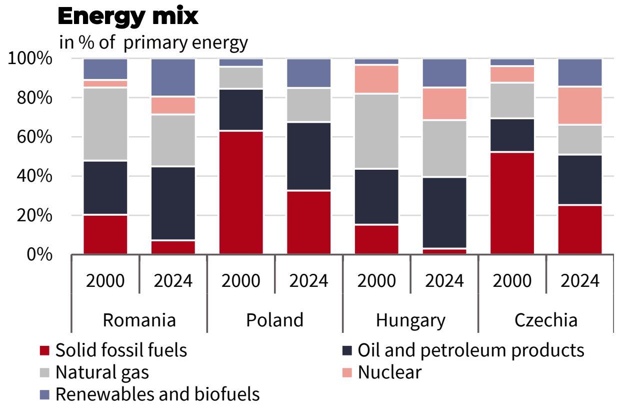
In addition, unlike in 2022, the energy shock is not occurring during a phase of vigorous economic reopening and should therefore not generate a wage-price spiral. German industry remains depressed, household confidence is deteriorating in several countries, and some economies - notably Romania and Slovakia – have implemented significant fiscal consolidation. Labour markets are also much less tight than in 2022, with lower job vacancy rates and higher unemployment rates. In this context, second-round effects should remain contained, and the risk of a wage-price spiral appears more limited than at the time of the 2022 energy shock.

However, gas storage levels remain a point of concern. Hungary, Czechia, Slovakia and the Baltic states have particularly low storage levels, below those observed in May 2022. In Poland and Romania, storage levels are higher than in 2022 but remain in the lower part of their 2016-2021 range. As a reminder, EU countries must now reach the target of 90% gas storage fullness at any point between 1 October and 1 December, whereas the initial rule imposed a strict deadline of 1 November.

Gas storage levels are at a low level in the region, as of May 2026…



… while energy mixes remain highly dependent on fossil fuels



Source: European Commission, Bruegel, SG Economic and Sector Studies

Moreover, fiscal space is now significantly more limited. Governments have less capacity to reintroduce broad-based energy price caps or subsidies, while defence spending is rising and the sovereign rating of several major countries in the region remain under negative outlook, notably Romania and Poland.

Risks remain tilted to the downside. The lack of progress towards a resolution of the conflict in Ukraine is maintaining lasting pressure on defence budgets, in a context of already more constrained public finances. In addition, political risks are rising in several countries in the region. In Romania, the fall of Ilie Bolojan's pro-European government in May 2026 is fuelling concerns over fiscal consolidation, access to EU funds and market confidence. In Poland, cohabitation between a pro-European government and a conservative president increases the risk of institutional gridlock, particularly on fiscal measures. In Slovakia, political polarisation could complicate European coordination, while in Hungary, political alternation opens the way for a possible gradual unfreezing of EU funds, although the institutional transition and compliance with EU rule-of-law requirements remain sources of uncertainty. In Czechia, the return of a government led by Andrej Babiš could ultimately lead to a recalibration of fiscal and European priorities.

CONTACTS

Michala MARCUSSEN
Group Chief Economist
+33 1 42 13 00 34
michala.marcussen@socgen.com

Foly ANANOU
Quantitative Economics, Geoeconomics
foly.ananou@socgen.com

Olivier de BOYSSON
Emerging Markets Chief Economist
+33 1 42 14 41 46
olivier.de-boysson@socgen.com

Evelyne BAHN
Asia
evelyne.bahn@socgen.com

Emmanuel MARTINEZ
Chief Environment Economist
+33 1 57 29 57 88
emmanuel.martinez@socgen.com

Constance BOUBLIL-GROH
Climate, Central & Eastern Europe, Russia
constance.boublil-groh@socgen.com

Ariel EMIRIAN
Head of macroeconomic analysis
+33 1 42 13 08 49
ariel.emirian@socgen.com

Natalia CARDENAS FRIAS
Germany, Latin America
natalia.cardenas-frias@socgen.com

Edgardo TORIJA ZANE
Head of macro-sectoral and macro-finance analysis
+33 1 42 14 92 87
edgardo.torija-zane@socgen.com

Clément GILLET
Africa, Middle East
clement.gillet@socgen.com

Dominic LOCK
North America
dominic.lock@socgen.com

Danielle SCHWEISGUTH
Western Europe
danielle.schweisguth@socgen.com

Yannik STRITTMATTER
France, Euro area
yannik.strittmatter@socgen.com

Stéphanie HUET
Assistant
+33 1 57 29 34 97
stephanie.huet@socgen.com

Antonio VISANI
Climate, United Kingdom
antonio.visani@socgen.com

Yolande NARJOU
Assistant
+33 1 42 14 40 07
yolande.narjou@socgen.com

Société Générale | Société Générale Economic and Sector Studies | 75886 PARIS CEDEX 18

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