arc_Projections

What Won't Happen

2026 Outlook

Dylan Smith
December 2025

Our Services

Research Publications

arc_Trajectories.
Weekly: Our regular review of macro/market news and data. Filtering signal from noise.

arc_Projections.
Quarterly: Periodic assessments of the economic outlook, with updates to our scenarios and in-depth analysis of topical issues.

arc_Dissections.
Ad-hoc: Deep dives on critical subjects ranging from geostrategy and macroeconomics to mega themes, regulation, and policy.

Consulting

- **Macro guidance:** Your independent chief economist is on call to advise. For anything macro-related, we provide bespoke research, modeling, reporting, and thought partnership.
- **Due diligence:** Enhance the diligence process with a dedicated macro lens. We combine our in-house expertise and models with industry-specific knowledge.
- **Fund strategy:** Get the macro angle right at inception. We help develop resilient fund strategies that capitalize on the macro cycle by optimizing thematic priorities, industry focus, and value creation strategy.
- **LP macro stress test:** We'll estimate the true macro betas at play. Work with us to understand underlying macro exposures in illiquid portfolios. Define custom scenarios to stress test portfolio performance and refine allocation strategies.

THE INDEPENDENT CHIEF ECONOMIST
FOR PRIVATE MARKETS.

Get in touch to learn more about our services and pricing.

Subscribe to founder and Chief Economist Dylan Smith's Tangents newsletter.

36 Toronto Street
Suite 850, Toronto
M5C 2C5

Email: info@arcmacro.com
www.arcmacro.com

arc • MACRO

Table of Contents

Executive Summary

For all the volatility, angst, and uncertainty that characterized 2025, very little was resolved one way or the other for the U.S. economy this past year.

Overall economic performance is holding up (if not spectacularly), and markets avoided the crash many expected. However, the same old fragilities and vulnerabilities linger. Wealthy consumers are sustaining growth while the majority struggle with affordability; business activity is weak outside the AI bubble; and a small group of high-flying assets is driving investment returns.

There are, of course, some differences. Inflation is trending up rather than down, the labor market is gradually cooling, and the Federal Reserve (Fed) has resumed an easing cycle.

So, we enter 2026 much as we entered 2025, under a cloud of extreme uncertainty. One of the many consequences of the clouded outlook is that annual prognostications on the macroeconomic outlook will almost certainly be wrong. Nonetheless, we in the research community are almost pathologically compelled to set our thoughts on the year to come.

To square that circle, we bring you an "anti-outlook." We can't say with confidence what will transpire in the year ahead, so here are five things we believe will not happen in 2026.

What Won't Happen

1. **Trump won't back down.**
   As pressure mounts and midterms approach, the President will trust his instincts and double down on signature policies.
   Avoid complacency regarding downside risk scenarios, and leverage the short-term benefits of favorable financial and regulatory conditions while they last.

2. **Inflation won't fall.**
   Emerging price pressures will prove more persistent than expected, and the Fed will find itself behind the curve.
   Investigate and prioritize inflation robustness when assessing investments, particularly mid-market equity business models. In credit and fixed income, position for a steepening yield curve as inflation premiums rise relative to low front-end rates. Stay long real assets (but be mindful of elevated entry valuations).

3. **The AI bubble (probably) won't pop.**
   But it's time to diversify. If tech stocks do crash, expect a shallow recession as AI investment slows.
   Diversify aggressively (geographical, asset class, factor) and underweight mega-cap AI stocks. Within the AI investment theme, move the focus downstream to businesses with truly disruptive potential (e.g., world models in game development) or a clear case for AI-driven value creation (e.g., drug discovery and defense tech).

4. **Private Equity optimism won't be misplaced**.
For a change. The early phase of a cyclical recovery in the PE industry will gain traction.
Focus on exits, distributions and regeneration to be on the right side of the deployment/distribution spectrum. Bias toward action; don't bank on better conditions in 2027/28.

5. **Private Credit won't blow up.**
There are performance headwinds and idiosyncratic risks, but "cockroaches" are not eating the foundations of the global economy.
Focus on risk appetite and understanding of underlying credit quality, overweight lower-risk segments, and stress factor exposure within the portfolio.

Top global calls

Looking beyond the U.S., we have identified three top global calls that will be prominent investment themes in 2026.

- **Europe: Another thing that won't happen**
The prospect of peace in Ukraine will not materially change Europe's geopolitical imperative to build its self-reliance. One manifestation of this theme, Europan Aerospace and Defense investments, is transitioning from a speculative macro bet to a stock-picker's market, favoring private equity and specialist investors.

- **Japan: Happening**
Economic normalization is on track despite demographic concerns, supported by rising labor force participation, strong productivity gains, and positive real interest rates that are unlocking corporate cash. We expect increased M&A activity and more foreign investment in 2026.

- **Canada: Could happen**
Structural underinvestment and trade headwinds have put Canada through the economic wringer, but accommodative BoC policy, ample fiscal space, and the Carney government's capital-focused budget position the country relatively well among G7 peers. Contingent on navigating USMCA talks this year, Canada is positioned to become the developed world's rising star.

Medium-Term Scenario Summary

Scenario 1: Stuck in the Muddle

Weight: 45%.

Sustained "Sluggish" regime over the 3-year horizon. AI investment and fiscal stimulus offset tariff and immigration headwinds, creating an unstable equilibrium in which growth remains below potential while inflation drifts above target.

Difficult fundraising environment for private funds, slow middle-market deal flow, and elevated valuations requiring operational improvements and selective deployment. Software, financials, specialty retail, and utilities outperform.

Scenario 2: Sudden Stop

Weight: 35%

The AI bubble bursts, triggering a short, shallow Crisis regime, followed by a Rebound. This phase proves inflationary, and after initially responding forcefully, the Fed must remain tight in a "Financially Constrained" regime.

Counter-cyclical investing opportunities emerge, shifting focus to undervalued assets with strong balance sheets and quality businesses that can capitalize on repricing.

Scenario 3: Slow Stagflation

Weight: 20%

Poorly timed Fed easing coinciding with tariff impacts, fiscal stimulus, and inflationary immigration curbs triggers an Overheating regime, which de-anchors prices and transitions into a Stagflation regime when growth eventually stalls.

For investors, this means a narrow exit window during the overheating for maturing funds. The Stagflation phase favors assets with pricing power and inflation protection—utilities, transport, healthcare, specialty retail, and private credit outperform.

Setting Out on Familiar Footing

Markets kicked off 2025 with a feeling of trepidation. U.S. trade policy was the great "known unknown"; immigration policy was not yet certain; geopolitical uncertainty was elevated; and no one knew whether stretched asset valuations could withstand a major policy shock.

A year on, we have a familiar feeling as we prepare for the year ahead. Against the backdrop of such extreme uncertainty, 2025 was surprisingly uneventful and has given us a similar starting point for 2026.

It took much of the year to get us here after a significant market rupture in April/May, and there are a few notable differences: interest rates are lower, and uncertainty has shifted slightly away from trade and toward monetary and fiscal policy. But just like last year, the macro path ahead is foggy, and a sense of danger lurks if we stray from the path.

Here is the state of U.S. macro going into 2026:

- **Activity growth has slowed.** Our proprietary Real Factor points to persistent below-trend activity growth, 0.5-1.0 standard deviations beneath the long-run average rate. That's a little more pessimistic than the latest GDP data, which shows the U.S. economy growing by around 2% this year. Another official statistic, Gross Output (GDP plus intermediate activity), is more in line with our measure. The economic top line is growing, but aggregate activity is falling off as firms cut costs up and down the value chain, especially where tariffs are biting or where the end consumer is on the wrong end of the divergence between booming high-income consumers and low-income strugglers.
- **Inflation has picked up without reaching the 2% target.** The disinflation process stalled and then reversed in 2025. The low was in April, when the Consumer Price Index inflation rate reached 2.3%, before tariff pass-through and sticky super-core categories caused prices to accelerate again. Our broader proprietary is flashing a waning signal, showing price pressures picking up into year-end.
- **Financial conditions are easy**. Credit spreads are tight, banks have been easing lending standards, and leverage indicators are steady. The Fed also eased interest rates by 75 basis points in the final three meetings of the year. Our measure of financial conditions has been 0.5-1.0 standard deviations above the average all year, suggesting a financial sector in generally good health, with the only wrinkles being elevated long-term risk premia and rising default rates among the highest-risk consumers and businesses.
- **Sentiment has been volatile and is faltering into year-end**. Our measure, which incorporates direct surveys and financial ratios, has returned to natural levels. That's about where we started 2025.

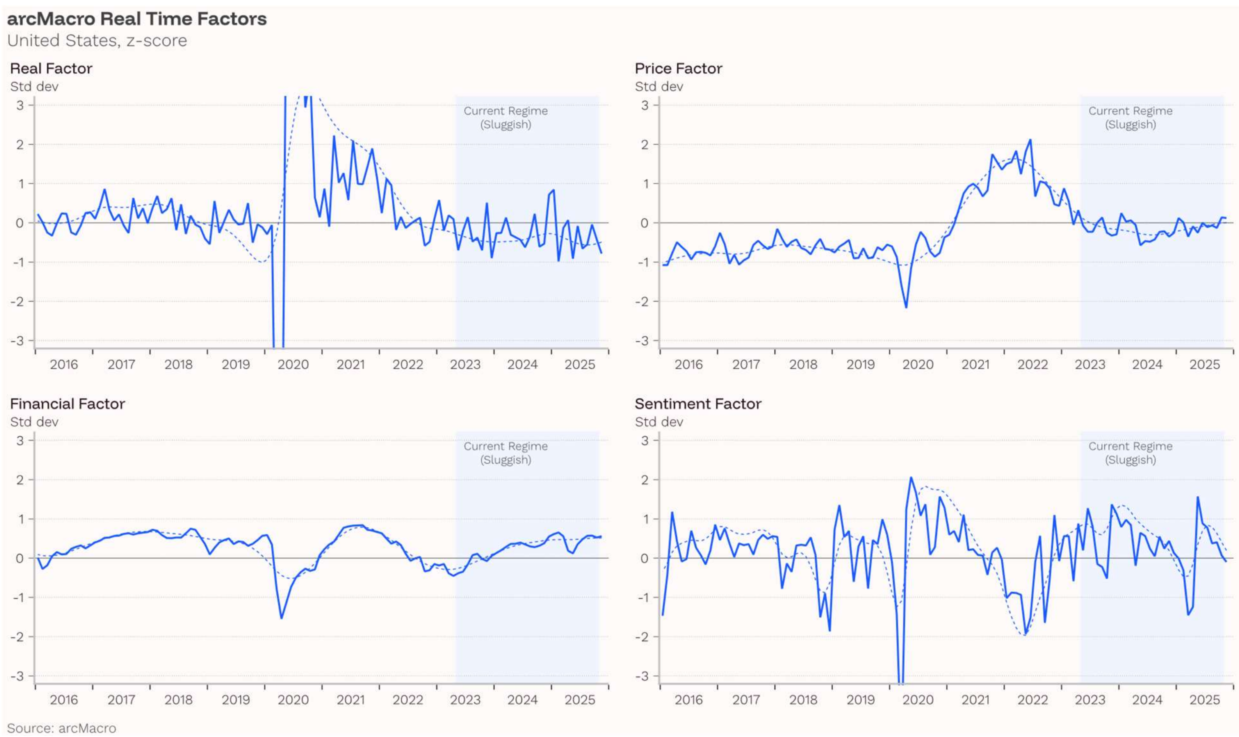
The most honest assessment of the 2026 outlook would emphasize the very high level of uncertainty that remains. That's also the most boring assessment.

To get around that problem, and to offer some reprieve from the deluge of vaguely similar year-end outlooks, we've taken a different approach.

We've identified five big calls that, on our read, are standard features of consensus outlooks that we don't think will happen in 2026.

Next, we offer some somewhat more conventional thoughts on three geographies where we have strong or out-of-consensus views.

In the second half of the Outlook, we refresh our **medium-term macro scenarios** for illiquid investors, making decisions over a cyclical horizon, building incrementally on our recent Quarterly Scenarios Update.



What Won't Happen

TRUMP WON'T BACK DOWN

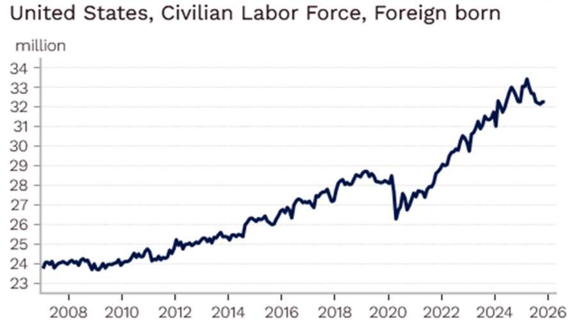
As pressure mounts and midterms approach, the President will trust his instincts and double down on signature policies.

Tariff uncertainty has eased, but there is plenty of room for surprises. While it's true that there is a sense that trade policy is now more predictable, that's only relative to the surreal "Liberation Day" formula. America's approach to the scheduled review of its USMCA agreement with Canada and Mexico is a "known unknown." There is also the lingering risk that Trump reneges on unratified agreements.

Immigration will be further restricted. As midterm elections approach, efforts to prevent or discourage both legal and illegal immigration will likely intensify. Combined with the aging population, this will bring breakeven employment into the low tens of thousands. If demand recovers sufficiently, skills shortages will emerge and the labor market will become stagflationary (with rising wages and cooling employment growth).

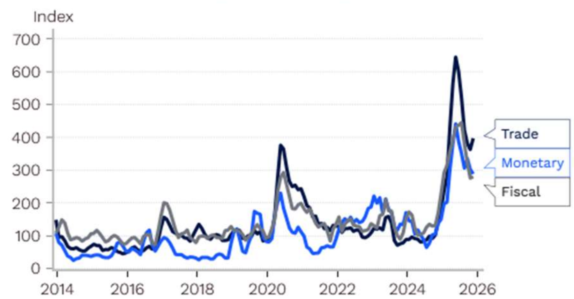
Deregulation will contribute to easy financial conditions. A range of ongoing measures to soften capital requirements and lending standards will improve credit risk appetite. Softer antitrust enforcement will support M&A activity. Upcoming implementation guidelines for allowing alternative investment funds in 401(k) retirement savings will unlock a wave of new financing for private markets.

The foreign-born workforce has stopped growing
United States, Civilian Labor Force, Foreign born



Source: U.S. Bureau of Labor Statistics (BLS), arcMacro

General policy uncertainty remains sky-high
U.S., Economic Policy Uncertainty Index, 3mma



Source: Economic Policy Uncertainty, arcMacro

The Fed will remain under intense pressure. Its credibility will continue to erode, with the most important events being the pending January Supreme Court decision on the President's powers to remove Governors, and the appointment of the next Chair before May. A Trump ally would signal a strong dovish bias, lowering short-term rates at the cost of higher term premia and a steeper yield curve. Other members of the FOMC would likely shift to a hawkish stance in response, raising general policy uncertainty.

The chance of fiscal reforms to address debt sustainability is 0%. Tax deductions that take effect in Q1 will have the opposite effect. If Republican polling deteriorates further, some form of direct rebate cheque ("tariff dividends") is more likely than not. More broadly, a range of mechanisms tend to turn the fiscal impulse positive in election years. And to cap the problem, Democrats have yet to make debt sustainability a political priority, focusing instead on protecting social programs.

Investing implications

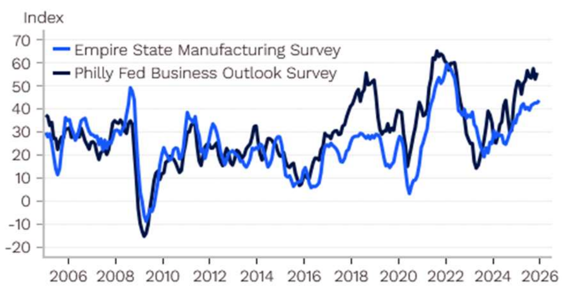
Avoid complacency regarding downside risk scenarios, and leverage the short-term benefits of favorable financial and regulatory conditions while they last.

INFLATION WON'T FALL

Emerging price pressures will prove more persistent than expected, and the Fed will find itself behind the curve.

Peak direct tariff pass-through to consumer prices will occur in the first half of 2026. Goods prices have shifted from falling slightly to contributing +0.5 percentage points to PCE inflation. Survey evidence consistently indicates that firms across supply chains have largely absorbed tariff costs in 2025 but plan to raise prices in the new year as margins compress and pre-tariff inventories are restocked. This alone will push annual inflation above 3.5% in 2026.

Manufacturers are planning to raise prices
Manufacturers, Plan to increase prices, Index, 3mma



Source: Federal Reserve Bank of Philadelphia, Federal Reserve Bank of New York, arcMacro

The trade war has indirect inflationary effects that are not being recognised. The trade war is acting like a tax on businesses, forcing costly adjustments to global supply chains, human capital management, and even working capital planning. These costs will be passed to consumers. More importantly, global disinflation transmission mechanisms have broken down, ending 30 years of globalization inflation dividends.

Immigration constraints amplify the inflationary effects of higher demand. A pickup in investment growth (both AI-related and traditional) alongside robust consumption growth will increase demand in 2026. Immigration has historically eased demand pressures and contained wage growth when demand rises. As in the early COVID-19 period, this mechanism is being disrupted. Wage growth can therefore coincide with a weaker labor market, in turn raising inflation.

Loose fiscal and monetary policy are inflationary. in the near term, the Fed's increasingly accommodative stance will do nothing to cool inflation. Its eroding credibility will contribute to higher inflation expectations. The same applies to fiscal policy, where ongoing stimulus is contributing to demand and stoking long-term inflation concerns.

The decoupling has arrived
US/China, price indices, Jan 1995 = 100

Source: China National Bureau of Statistics (NBS), U.S. Bureau of Labor Statistics (BLS), arcMacro

Investing implications:

Investigate and prioritize inflation robustness when assessing investments, particularly mid-market equity business models.

In credit and fixed income, position for a steepening yield curve as inflation premiums rise relative to low front-end rates.

Stay long real assets (but be mindful of elevated entry valuations).

THE AI BUBBLE (PROBABLY) WON'T POP

But it's time to diversify. If tech stocks do crash, expect a shallow recession as AI investment slows.

AI and big tech firms have driven aggregate valuations to near-bubble levels. Backward- and forward-looking metrics alike are raising overvaluation red flags in equities, with the forward price-to-earnings (PE) ratio of 21- 23x approaching Dotcom-era peaks. But this is a "big tech" story. Exclude the handful of top AI-heavy tech companies, and the forward P/E falls to a historically standard 18- 20x. A similar story applies to market capitalization, revenues, capex, and returns. Whatever way you slice it, U.S. equities are a story of "AI hyperscalers" and "the rest."

Stocks look expensive...
U.S., S&P 500, 12-Month Forward P/E

Source: S&P Global, arcMacro

The AI hyperscaler narrative has cracks, and a tech-stock crash is a risk (though not a base case). Capital expenditures have risen to the point that these companies now have a similar profile to energy firms. Sky-high multiples are easier to justify for cash-rich, capital-light businesses. Open-source AI models are a separate threat. For now, a critical mass of "greater fools" buys into the bullish narrative, but nobody can say for sure whether they're right, or for how long they'll remain invested.

Concentration is a blessing in disguise. If the market can rise in an extremely unbalanced way, driven by a small handful of stocks, it can fall similarly. We've already seen highly divergent macro/AI moves in U.S. markets, such as the simultaneous Fed-driven Russell 2000 small-cap index pop (+2.5%) and Oracle scare (down -10%) on Dec 10th. 2026 may bring a more sustained version of this type of divergence.

AI investment is contributing >1pp to GDP growth and is a net positive for employment. An AI stock crash would freeze a large share of this contribution while slowing consumption growth (reversing strong sentiment among wealthy consumers), triggering a shallow recession.

... but concentration obscures underlying value
U.S., Market Cap, Index, Dec 2022 = 100

Source: S&P Global, arcMacro

There are no major macro "imbalances" that make us fear a significant recession. Leverage is low, the housing market is in a cyclical trough, and the long tail of potentially flawed businesses is insulated in VC and PE funds, not listed publicly (and therefore not a systemic crash risk).

Investing implications:
Diversify aggressively (geographical, asset class, factor) and underweight mega-cap AI stocks. Within the AI investment theme, move the focus downstream to businesses with truly disruptive potential (e.g., world models in game development) or a clear case for AI-driven value creation (e.g., drug discovery and defense tech).

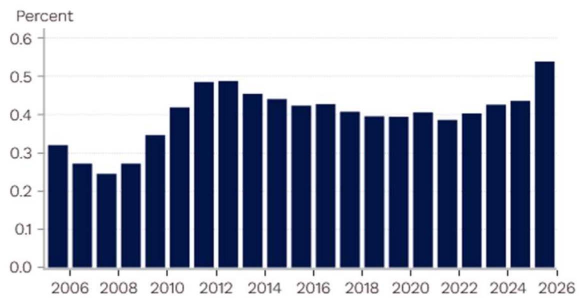
PRIVATE EQUITY OPTIMISM WON'T BE MISPLACED

For a change. The early phase of a cyclical recovery in the PE industry will gain traction.

There is a macroeconomic window for an acceleration in dealmaking. Interest rates are low and falling, financial conditions are easing, and public valuations are relatively high. Additionally, the regulatory environment is more supportive, momentum is building, and perceptions of economic uncertainty are improving. The rise in deal flow that took hold at the top of the market in 2025 can move to the middle market in 2026.

The tension between distributing cash and holding out for target valuations is shifting in favor of exits. Assets in the 2020-2022 vintages are maturing, but poor exit conditions have forced funds to hold investments and wait for valuations to hit their marks. The IRR math is starting to punish longer holds. As LPs become increasingly hungry for distributions and macro headwinds turn into tailwinds, the bar to exit is getting lower. This is sorely needed as the stock of exit-ready investment piles up.

The PE exit pileup
U.S., PE-backed companies held for > 4 years

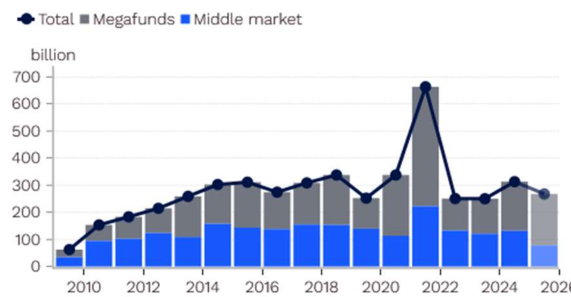


Source: Pitchbook, arcMacro

Liquidity bridge activity will remain highly active. A rise in exits will put pressure on funds that opt to extend fund life to return cash to LPs, keeping the continuation and secondaries markets active (but likely off their peaks).

Fundraising will lag exits. This is a structural feature of the market. A majority of funds nearing or beyond the halfway point in the lifecycle still need to prove their ability to return cash to investors. 2027 is the earliest year that a fundraising recovery among GPs outside the "mega" category could be a reality. Our baseline expectation is that this will align with a buyer's market, and we expect funds that prioritize exits now to prosper in the long run.

Middle market exits have slowed
U.S., PE exit deals



Source: Pitchbook, arcMacro

Investing implications:

Focus on exits, distributions, and regeneration to be on the right side of the deployment/distribution spectrum.

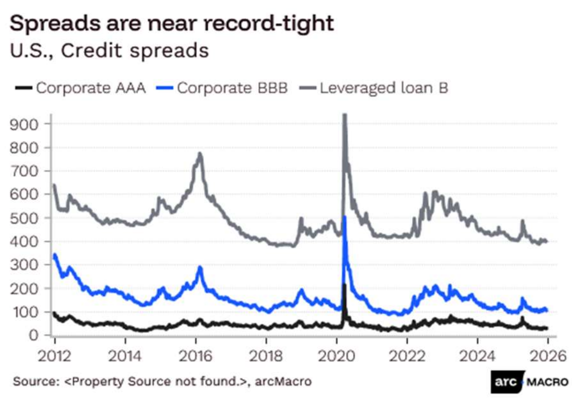
Bias toward action; don't bank on better conditions in 2027/28.

PRIVATE CREDIT WON'T BLOW UP

There are performance headwinds and idiosyncratic risks, but "cockroaches" are not eating the foundations of the global economy.

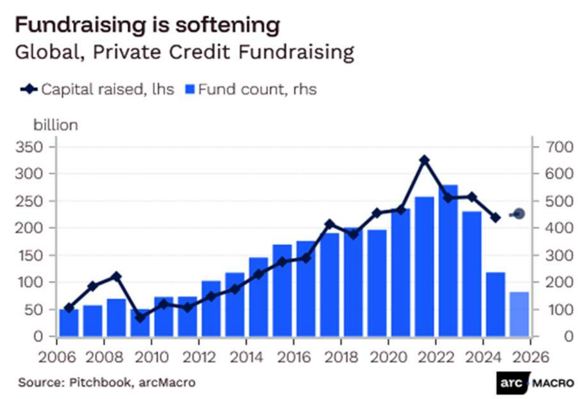
Risks are idiosyncratic, not systemic. Defaults are a regular feature of credit markets. After two very public failures in 2025, more are likely to occur in 2026, especially in weaker segments of the economy (e.g., housing construction, agriculture). The exuberance of the expansion in private credit over the past five years ensures that they will receive attention. Losses will be limited to investors (and creditors). Banks are well capitalized to absorb losses, and credit funds can take a hit without triggering contagion. Lower interest rates will alleviate some credit risk concerns.

Markets aren't pricing a catastrophe. Yields on traded instruments and leveraged loans do not signal broad creditworthiness concerns. They're a touch up from record-tight levels, and we don't see a case for sustained higher yields. Spreads on ultra-risky distressed debt have (appropriately) risen, but the rest of the market has stayed tight as the base rate has fallen.



Meanwhile, private credit diversification will continue. Core direct lending for PE buyouts and add-ons will pick up alongside higher private equity deal flow. However, the main story will be the increasingly "bank-like" profile of the largest operators backed by huge pools of patient insurance capital, who will continue to expand lending activity across strategies, asset classes, and deal types, while playing a central role in AI-related investment.

Fundraising will slow, and returns will moderate, especially for smaller, middle-market-focused credit funds. Part of the reason is the mechanical effect of a lower rate outlook on a floating-rate industry. Beyond that, the core buyout market has become saturated after years of multi-digit growth in global fundraising. Based on incomplete data, we're tracking around $450 billion globally in 2025, roughly equal to 2024, but far more concentrated in larger funds. In 2026, we expect both metrics to drop modestly.



Investing implications:

Focus on risk appetite and understanding of underlying credit quality, overweight lower-risk segments, and stress factor exposure within the portfolio.

Global Views

While our focus is primarily on the U.S. economy, we have three distinctive out-of-consensus calls on other developed markets.

Europe: Another Thing That Won't Happen:

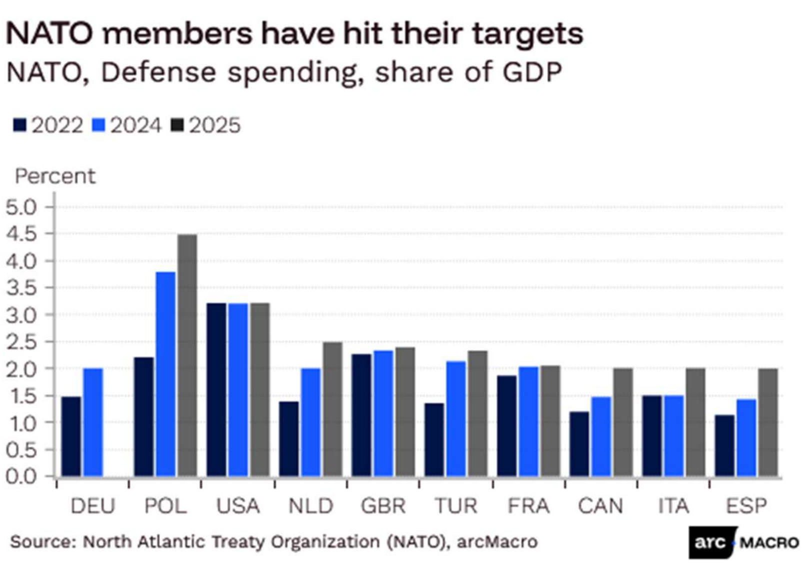
European Aerospace and Defense has been one of the strongest investment themes since Russia's invasion of Ukraine, with U.S. stocks more than doubling and European indices posting even larger gains—206% for STOXX Europe A&D, 380% for UK equivalents, and 635% for Sweden.

The rally has stalled since late September as the probability of a Ukraine peace deal, which would unwind defense contracts, has risen.

In our view, Russia has already guaranteed the durability of this theme, however peace negotiations turn out. All NATO members have now met their 2% of GDP military spending targets and committed to 3.5% by 2035. More importantly, the matter of European defense investment now goes beyond NATO and has become an existential issue for the continent. European leaders are convinced that Russia is a permanent threat to their eastern flank and are taking steps to guarantee their own security.

Another reason that the rally has stalled is harder to dismiss: having surged so powerfully over the past few years, stock prices of aerospace and defense companies (especially larger firms) now fully capture or perhaps even overestimate strong future earnings growth tied to the wave of public money heading their way.

But that doesn't mean the theme has fizzled out. Instead, we're entering a new phase of the Aerospace and Defense super-theme. The "speculative" phase – a macro bet on a persistent long-term rise in defense spending and (therefore) defense contractor earnings implemented through broad indices and large-caps – has paid off. Now the rubber is hitting the road, and industry expertise is required to pick winners and come out ahead.



Investors can also look at the broader ecosystem. After years of underinvestment, there is an emerging focus on digital infrastructure, process modernization, AI integration, and asset regeneration. This will require consulting and investment that private equity professionals are well-positioned to support.

Japan: Happening

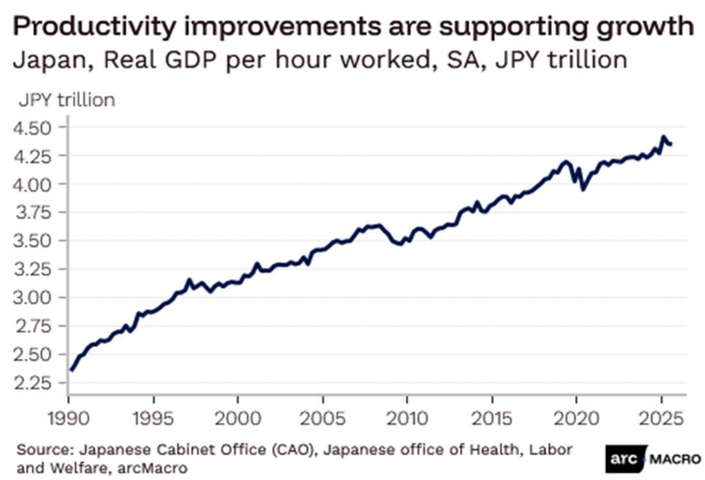
Japan's long process of economic normalization is a secular theme. With inflation above 3%, interest rates have turned positive and are gradually rising. We're structurally bullish on Japan, although we acknowledge that there will be inevitable bumps and frictions as the economy thaws from its 30-year freeze. Investors with a long investment horizon can look through these episodes.

We're also not too concerned about Japan's much-maligned demographic challenges. Despite slowing population growth, the labor force continues to expand due to higher participation among older men and women of all ages. On top of that, Japan is opening its borders to inward immigration to help plug skills gaps.

Those workers are productive. Unlike the rest of the G7, hourly productivity is rising rapidly in Japan.

Structural reforms, inflation, and positive interest rates are unlocking Japan's enormous corporate cash piles; a necessary condition for growth to accelerate.

In 2026 we expect the Yen to strengthen (helping to control inflation) and M&A activity to increase. We also anticipate reforms aimed at encouraging more foreign investment in Japan.



Canada: Could Happen

Canada has been in the economic doldrums, but it may be seeing the bottom.

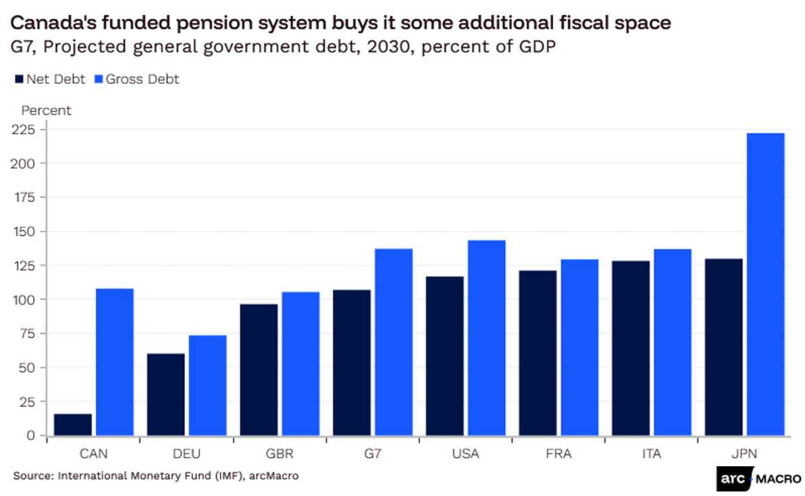
2025 was a tough year in the Great White North. Canada's exports to the U.S. in Q3 were -14.3% below the level a year ago in CAD terms. Despite having the lowest average tariff rate with the U.S. of any country in the world (85% of cross-border trade is tariff-free), Canada's economy is so intertwined with its larger neighbor that it has been hit hard by targeted tariffs in the metals, lumber, and automotive sectors.

Canada's current malaise goes much deeper than its trade woes. Around 2015, private investment plateaued in the wake of a collapse in the oil price, and hasn't recovered. The unemployment rate has climbed to 6.9%.

Policy settings are appropriately accommodative. The Bank of Canada has lowered its rate to 2.25% (where it has signaled it will pause), opening up a -1.6 percentage point gap to the effective Federal Funds Rate. This has enabled the Canadian Dollar to fall to 1.41 against the greenback — partly offsetting the terms-of-trade shock caused by the imposition of import tariffs in the U.S., while also highlighting the extent of Canada's economic weakness.

Underinvestment is not a unique problem. Aside from the U.S., the G7 and most advanced economies are suffering similar issues. Among its peers, Canada has perhaps the most fiscal space; a windfall from a disciplined fiscal regime that stretched from the mid-1990s to the COVID-19 pandemic. Canada's unique, fully funded public pension system helps too.

The Carney government has prioritized the investment problem with a budget that allocates more to public capex and offers tax and regulatory measures designed to spur private capital outlays. The local and international business community has responded warmly, despite a higher deficit.



In our view, the Carney government is making decisive use of its fiscal space, setting Canada on a firmer footing for future growth than its peers.

If the hurdle of USMCA negotiations can be successfully navigated, we're bullish on Canada relative to advanced economy peers.

Medium-term Scenario-based Outlook

While annual outlooks are interesting, any given year is only a thin slice of the broader economic cycle and structural forces that play out over decades. Investing decisions made in 2026 need to keep this deeper context in mind.

A core component of the arcMacro philosophy is to think on the same timelines as investors positioning for a full economic cycle, particularly in illiquid markets. We can convince ourselves of a certain level of certitude regarding what will (and more accurately, won't) happen in the next 6-12 months, but beyond that, potential outcomes diverge dramatically.

What matters over a longer horizon is understanding the range of paths the economy might take and having a plan for each.

This is why we structure our outlook around probability-weighted scenarios rather than a single narrative. Our approach to scenarios is sophisticated.

Our framework starts with four latent macroeconomic factors—real activity, prices, financial conditions, and sentiment—extracted from 227 underlying indicators using dynamic factor models. We then classify the economy into one of seven distinct regimes based on how these factors combine: Goldilocks, Overheating, Financially Constrained, Sluggish, Crisis, Rebound, or Stagflation. Transition probabilities between regimes, estimated via multinomial logistic regression and Monte Carlo simulation, provide the quantitative backbone for our scenarios.

This quarter, we maintain three scenarios. Stuck in the Muddle (45%) extends the current Sluggish regime through most of the outlook horizon, with offsetting forces preventing both crisis and recovery. One small change from last quarter is that the outer end of the scenario ends in a stable "Goldilocks" equilibrium supported by higher productivity growth.

Sudden Stop (35%) captures the risk of an AI-linked valuation reset triggering a mild recession followed by a strong rebound. Slow Stagflation (20%) reflects the significant tail risk of inflation becoming entrenched while growth stalls.

The combined picture is one of elevated uncertainty with asymmetric risks. Two of our three scenarios involve meaningful economic pain before any improvement materializes. For investors, this argues for disciplined deployment, attention to inflation exposure

Scenario 1: Stuck in the Muddle

Overview

Current		0-12 months		12-24 months		24-36 months
Sluggish	⇨	**Sluggish**	⇨	**Sluggish**	⇨	**Goldilocks**

Narrative

Not too hot, not too cold, but not quite right either. In our modal scenario, the economy remains suboptimal for the next 24-36 months. Growth is below trend, and inflation remains above target over this period. In the outer year of our outlook, productivity improvements will enable a transition into an equilibrium state.

Over most of the three-year outlook, a constellation of shocks keeps the economy in an unstable and unsatisfying position. Growth is below potential as tariffs bite and wage growth doesn't quite make up for prior inflation for most consumers. Inflation is stubbornly above target and drifting up. Stalled immigration caps labor supply and exacerbates both problems. Financial conditions are relatively easy, but valuations are so elevated that capital allocation is challenging.

Investment in AI and related industries, strong consumption at the upper end of the income distribution, broadly stimulative fiscal policy, and patchwork deregulation provide the economy with growth impetus. Rates are kept modestly accommodative.

These sets of forces are offsetting, preventing a distinct turn either for better or for worse. Eventually, the sluggishness trap is broken by productivity improvements stemming from the diffusion of AI technologies, the lagged effects of accommodative monetary policy, and a return to supply-side growth as immigration policy shifts and lost business regain efficiency after a long period of uncertainty and trade war adjustment.

Probability assessment

Weighting	Value	Comment
Model weight	**50%**	
Subjective adjustment	**-5 pp**	While this is the most likely scenario, in our view, it's not more likely than other outcomes.
Blended weight	**45%**	

Key macro indicator forecasts

Key Indicator	Unit	2025 (est.)	0-12 Months	12-24 Months	24-36 Months
Gross Domestic Product	Annual growth (%)	1.9	2.0	2.0	3.0
Consumer Price Index	Annual growth (%)	2.7	3.0	2.6	2.2
Effective Fed Funds Rate	End-of-period	3.6	3.4	3.4	3.6

Macroeconomic features

Assumptions: what you need to believe

- **Forces are in balance:** The relative magnitude of the tailwinds (AI, fiscal and deregulation, consumer) and headwinds (tariff and immigration policy) are roughly equal. Similarly, weak demand offsets inflationary pressures to prevent an inflation spiral.
- **If AI is a bubble, it’s a long way from popping:** It could be that elevated tech valuations are justified and do not crash, or a relatively orderly decline in tech stocks back in line with the rest of the market occurs over time. Either way, the current perceived “bubble” is resolved without macroeconomic spillover.

Consequences: what you need to prepare for

- **Activity:** Growth remains positive, but below potential. The economy is “K-shaped” for both consumers (spending driven by upper-income segments) and businesses (wide dispersion between tech and the rest, between mega, large, and small businesses).
- **Prices:** Inflation varies significantly across industries, but does not spiral out of control. Consumers become increasingly price-sensitive.
  Financial conditions: Relatively easy, but historically high valuations make capital allocation challenging.

Market Strategy

Public benchmarks

Equities

The market remains sensitive to news cycles and occasionally corrects, but the bull run extends at a reduced pace. Roughly normal annual returns by historical standards.

Fixed income and FX

The yield curve is steep but flattens somewhat over time as conditions gradually improve. Inflation and fiscal concerns keep the long-run term premium elevated.

The Trump administration successfully talks the dollar down, and investors continue to bet on long-term devaluation (but not full-blown loss of reserve status).

Commodities

Surpluses in key commodity markets (notably oil) and tepid demand keep the overall commodity complex subdued, but volatility in geopolitically sensitive markets is a constant risk. Real assets consistently outperform.

Private markets

Scenario summary

Element	Description
Fundraising	Challenged, with fluctuations
Deal flow	Moderate, supported by easy financial conditions
Valuations	Elevated
Returns	Mixed

Strategic considerations for illiquid investing

A protracted Sluggish regime demands disciplined capital preservation and selective deployment. LPs' denominator effects keep funding flowing, but a strong track record is essential, and bias toward larger funds remains entrenched.

Operational improvements and margin expansion remain the name of the game as the valuation gap remains a barrier to exits. Hold periods remain long, making continuation and secondary vehicles a highly active market.

Over time, exit activity and general deal flow pick up as the PE industry is forced by the distribution imperative to start recycling capital.

Corporate performance

If the macro environment is not set to change significantly, it makes sense to double down on what already works, but on a shorter investment horizon. Technology and defense, which are exposed to secular themes and have defensive characteristics, are particularly appealing.

Outperforming industries

Industry	Detail
Software, internet telecoms	Strongest performers in the current bull market alongside limited economic growth.
Funds and trusts, investments, and insurance, leasing	The financial sector consistently outperforms in Sluggish regimes, especially alongside easy financial conditions. The Fintech niche is especially attractive.
Specialist retail	Exposed to consumer tailwinds, but selection is key.
Utilities	Supported by AI tailwinds.
Industrials	Careful screening for tariff impact is required, but those with a strong inflation profile and the right sector exposure can benefit.

Scenario 2: Sudden Stop

Overview

Current		0-12 months		12-24 months		24-36 months
Sluggish	⇨	**Crisis**	⇨	**Rebound**	⇨	**Financially Constrained**

Narrative

This scenario captures the mounting risk of a loss of confidence in the AI buildout theme—the most potent force driving equity valuations and broader investment growth. This triggers a stock market bust, which ricochets into the real economy, first freezing investment (particularly on data centers and utilities), and then dampening consumer spending growth. Combined, this is enough to cause a mild recession.

Importantly, this is not a deep or sustained crisis because firms and households are not overleveraged. Instead, there is a "clearing out" effect. Unsustainable AI-linked business models fail, but overall, a valuation reset combined with highly accommodative monetary policy gets capital moving, and the economy enters a "Rebound" regime within 12-24 months.

Throughout this process, the specter of long-term inflation remains, but in the short term, the collapse in demand pulls inflation below target, allowing a robust Fed response. The Rebound regime re-establishes inflation dynamics, which are made worse by a lack of labor market flexibility due to immigration curbs. Eventually, the economy settles not into a "Goldilocks" regime, but a mildly "financially constrained" state that prevents a quick resumption of the asset price inflation cycle (while still enabling trend growth and moderately above-target inflation).

Probability assessment

Weighting	Value	Comment
Model weight	**45%**	
Subjective adjustment	**-10 pp**	Re-assigning some probability to Scenario 3 to capture risks of sustained downturn.
Blended weight	**35%**	

Key macro indicator forecasts

Key Indicator	Unit	2025 (est.)	0-12 Months	12-24 Months	24-36 Months
Gross Domestic Product	Annual growth (%)	1.9	-0.8	5.0	2.8
Consumer Price Index	Annual growth (%)	2.7	1.9	3.4	2.5
Effective Fed Funds Rate	End-of-period	3.6	1.4	1.9	2.6

Macroeconomic features

Assumptions: what you need to believe

- **AI is a bubble:** Most AI-linked assets are overvalued, and overcapacity is building.
- **There is a trigger event:** Disappointing earnings or other negative news can trigger a sudden general loss of confidence that breaks the bull market for all stocks.
- **Lower valuations will reallocate capital:** Capital is being sucked into AI-connected businesses at the cost of allocations to other sectors and themes; resetting valuations will allow capital to move to different industries, regenerating the investment cycle.

Consequences: what you need to prepare for

Phase 1: Crisis

- **Activity:** The stock market rout transmits first into a collapse in business investment, then a reduction in consumer spending (via a softer labor market and extinguished wealth effect).
- **Prices:** Price growth softens as a demand slowdown overpowers other inflationary forces.
- **Financial conditions:** Sharp tightening in financial conditions as credit spreads spike and collateral value falls with the broader market. The Fed lowers rates to partly offset this shock. Bank lending standards tighten, and deal flow slows.

Phase 2: Rebound

- **Activity:** ~12 months after the initial rout, a strong recovery sets in as sentiment recovers and unused capacity gets put back to work.
- **Prices:** As demand recovers, underlying price pressures reassert themselves, and inflation moves back above target. Supply chain pressure in the recovery (labor market) makes things worse.
- **Financial conditions:** Financial conditions gradually ease up, with the "shadow" banking system providing the initial impetus, where higher risk appetite combines with lower valuations to kick-start investment. The Fed embarks on a gradual tightening cycle as inflation upside risks become clear.

Phase 3: Financially constrained

- **Activity:** After the rebound has played out, growth settles down close to the long-run average.
- **Prices:** During this period, prices are gradually squeezed back down to target.
- **Financial conditions:** Tight-to-neutral financial conditions are required to prevent excess liquidity from translating into excessive inflation.

Market Strategy

Public benchmarks

Equities

The path of the stock market defines the scenario. First, a collapse deep and sudden enough to trigger a broader downturn, then a rapid but partial rebound to relative valuations more in keeping with historical averages.

Fixed income and FX

Risk premia rise sharply even as the Fed cuts rates, shifting the yield curve down while also steepening it. Credit spreads spike from a starting point of record lows, before drifting back down during the recovery phase.

Dollar performance and the degree of U.S. Treasury outperformance are indeterminate, as markets test the U.S. safe-haven status. However, we don’t see a sufficient supply of safe assets to provide an alternative, so the dollar likely appreciates and the belly of the yield curve compresses.

Commodities

The Gold bull market finds a new gear as its safe-haven status shines and lower rates decrease the relative cost of carry.

Energy and industrial commodity prices weaken as demand declines, and lag the recovery in other, more forward-looking asset classes.

Private markets

Scenario summary

	Crisis Phase	Rebound Phase	Financially Constrained
Fundraising	Severely constrained	Strong	Neutral
Deal flow	Weak	Accelerating	Average
Valuations	Falling sharply	Normalizing	Normal
Returns	Negative	Strong	Weak-to-average

Strategic considerations for illiquid investing

Shift to defensive positioning by reducing new investments, closing on fundraising, and preserving dry powder. Prepare to support existing portfolio companies through the downturn.

Aggressively deploy capital when the best opportunities emerge, 6-9 months into the crisis, when forced sellers capitulate. Maintain the deployment pace into the recovery phase while valuations remain attractive, but before competition returns.

The subsequent financially constrained period demands strategic exits of mature assets while valuations remain reasonable after the rebound. Maintain higher cash reserves throughout to capitalize on distressed opportunities and support portfolio companies as needed.

Corporate performance

In this scenario, investment decisions are heavily driven by macro factors and essentially industry-agnostic.

Once the Crisis hits, investors don't need to be too discerning about what industry a target sits in; underpriced assets can be found across the board, and patient capital can afford to wait out the lows.

That said, we can identify a few industries that typically outperform in Rebounds and subsequent stable periods. The most defensive assets that hold value during the Crisis (utilities, telecoms) will have the weakest long-term prospects.

Outperforming industries

Industry	Detail
Air transportation	Pent-up travel demand; low fuel costs.
Accommodation	Pent-up travel demand.
Durable goods retailing	Benefit from lower interest rates and recovering incomes.
Manufacturing	Tends to outperform during Financially Constrained regimes.
Clothing manufacturing and retailing	Outperforms in a rebound and demand returns.

Scenario 3: Slow Stagflation

Overview

Narrative

A set of inflationary factors combines to accelerate prices. This includes both direct tariffs and tariff-related cost increases (e.g., supply chain adjustment, domestic producer margins), easier monetary policy (Fed over-indexes on employment growth), deregulation (especially in the financial sector), fiscal stimulus (Q1/Q2 of 2025), and constrained immigration increasing the inflationary effect of the demand shock.

In the shorter term, the stimulative factors (easy financial and fiscal conditions) outweigh the growth-negative factors (tariffs and immigration restrictions). Activity accelerates alongside inflation, creating an impression of economic health but pushing the economy into an "overheating" regime.

During this period, financial conditions are easy, characterized by tight credit spreads, rising IPO and M&A activity, and elevated valuations.

However, the Fed is already behind the curve, and high inflation becomes entrenched. This (eventually) triggers a reversal in the path of interest rates, which, combined with the lagged impact of tariffs and immigration restrictions, stalls economic growth, even as inflation remains high. It takes several years to return inflation to target, during which financial conditions tighten, and valuations reset.

Probability assessment

Weighting	Value	Comment
Model weight	**5%**	
Subjective adjustment	**+15 pp**	The model underestimates the probability of a mild "stagflationary" period of low growth and high inflation because of the severity of prior stagflation episodes.
Blended weight	**20%**	**Significant tail risk; not a "black swan."**

Key macro indicator forecasts

Key Indicator	Unit	2025 (est.)	0-12 Months	12-24 Months	24-36 Months
Gross Domestic Product	Annual growth (%)	1.9	3.5	1.8	0.5
Consumer Price Index	Annual growth (%)	2.7	3.6	5.0	4.5
Effective Fed Funds Rate	End-of-period	3.6	2.9	3.6	5.1

Macroeconomic features

Assumptions: what you need to believe

- **Interest rates:** The Federal Reserve continues to ease interest rates aggressively in the next 12 months, downplaying inflation risk and indexing on employment creation. Rates drop as low as 3.0-3.5% over the next 12 months.
- **Tariffs:** The average U.S. tariff rate stays at current levels or rises somewhat without triggering a severe market correction.
- **Fiscal stimulus:** The Trump administration retains or extends proposed tax cuts and does not make economically meaningful cuts to program spending.
- **Labor market restrictiveness:** Strict immigration policy sharply curtails the inflow of economically active migrants (both legal and undocumented), causing some areas of the labor market to tighten despite tepid labor demand.
- **Risk appetite:** Investors retain an appetite for risk over the next 6-12 months, and can shrug off negative news, driven by a self-reinforcing loop of rising M&A activity, low rates, and solid activity.

Consequences: what you need to prepare for

Phase 1: Short Overheating Regime

- **Activity:** Key growth drivers, including consumption and AI-related investment, remain in place. Investment spending outside of AI picks up as lower interest rates pass through and M&A activity accelerates. Sectors such as manufacturing and real estate remain cyclically slow but do not deteriorate further.
- **Prices:** Prices accelerate gradually, but not fast enough to trigger alarm bells. Import prices and durable goods make larger contributions to inflation, eventually passing through into services inflation.
- **Financial conditions:** Credit availability goes from easy to easier. M&A activity picks up, supporting private valuations. Public markets retain elevated valuations relative to earnings.

Phase 2: Stagflation

- **Activity:** Growth stalls out. Depending on secular tailwinds, it may remain positive but well below potential.
- **Prices:** The Fed loses control of inflation, and price growth spikes to well above 5%. Even after the peak, inflation remains above 4% on a sustained basis.
- **Financial conditions:** A sharp tightening occurs as the reality of a sustained Fed hiking cycle sets in. The yield curve inverts. Credit spreads rise across the rates complex. Valuations adjust downwards to balance out supply and demand.

Market Strategy

Public benchmarks

Equities

The bull market continues during the Overheating regime. However, the subsequent tightening cycle hits them hard because of the discount factor, and stocks go through a correction period before moving sideways. The result is significant downward revaluations relative to earnings

Fixed income and FX

US$ depreciation, initially because of lower U.S. interest rates, later because of sustained high inflation, accelerating dollar devaluation dynamics.

Long-end yield spike: Combined effect of rate increases and rising inflation term premium spike long-end rates.

Commodities

Gold and real assets face opposing pressures: higher rates make zero-yielding assets unappealing. But inflation fears stoke gold demand, and in the current global context of concern over dollar devaluation, this effect will dominate.

Industrial and energy commodities are a major wildcard. From the current starting point, this scenario is benign to deflationary, as demand will decline when growth slows. But any localized shock, especially to oil prices, will turbocharge the inflationary side of the equation. Commodities are an exogenous accelerator.

Private markets

Scenario summary

	Overheating	Stagflation
Fundraising	Improves from the current environment as cash flow improves and enables allocation turnover	Generally challenging, with large funds and a strong track record through the COVID crisis, prioritized.
Deal flow	Strong across the board.	Subdued, with leverage expensive and focus on operational quality. Extension vehicles (continuation, secondaries, etc.) return to prominence.
Valuations	High, roughly in line with current levels.	Normalizing, but with higher dispersion across assets.
Returns	Strong (depending on vintage)	Generally pressured, but with high divergence across industries and verticals, depending on inflation robustness.

Strategic considerations for illiquid investing

The “Overheating” phase presents a narrow exit window. Maturing funds should aggressively take advantage of the heightened optimism around M&A, even if that means shortening holding periods.

Now is a good time to initiate fundraising.

During this phase, discipline should be exercised for funds in the deployment phase, with careful attention paid to targets' exposure to inflation and higher interest rates.

In the subsequent “Stagflation” phase, top-quartile funds will consist of assets with strong pricing power, sticky customer bases, and proven competitive advantage. Diversification via real assets may offer further inflation protection.

Structurally, private credit is set for a strong comeback as floating rate structures and tight covenants again prove their worth in a challenging credit market.

Corporate performance

The key to success in this scenario is to look for inflation resilience alongside limited sensitivity to rising interest rates and tightening financial conditions.

As always, we can profile at the industry level, but individual assets within industries may differ significantly depending on their business structure, customer base, and marketing strategy.

Historically, commodities have outperformed significantly in stagflations. However, those were commodity-driven stagflation episodes. This case is a different type of high-price/low-growth episode.

Outperforming industries

Industry	Detail
Utilities	Stable, inflation-indexed revenue.
Telecoms	Utility-like.
Transport and warehousing	Very strong cost pass-through.
Specialty retailing	Sticky customer base and high margins (but be selective).
Leasing	Often inflation-indexed, sees higher demand when financing costs rise.
Healthcare services	Sticky demand, strong margin buffer.
Healthcare manufacturing	Sticky demand, strong margin buffer.
Education services	Usually similar to healthcare but may be exposed to immigration restrictions and funding challenges.
Insurance	The utility of the financial sector.

Final Word: Principles Beat Predictions

At the risk of sawing off the branch we're sitting on, we will conclude by pointing out that, for all the ado about **annual outlooks, they're almost always wrong.**

Too much of what drives economic fluctuations and market prices is unforeseeable.

Out of the vast array of low-probability events not worth flagging in annual prognostications, enough will come true to shape the year ahead in ways nobody would have predicted.

Avoid the temptation to throw your hands in the air and ignore the macro. The well-prepared investor can gain an edge with strong principles and a solid investment process.

Uncertainty remains the watchword going into 2026. It's shifting from uncertainty about President Trump's agenda (that is now clear; and we're convinced he'll double down) to broader monetary and fiscal policy concerns. And the overvalued tech industry hangs like the Sword of Damocles over the whole economy.

Scenarios are a critical tool for positioning in such uncertain times. They help us map the landscape and position against a balance of risks rather than a single all-or-nothing call – be that explicit or implicit.

Probability-weighting our three medium-term scenarios supports taking advantage of an emerging 6–12-month window to reposition ahead of a deterioration in conditions (either stagflationary or in a crisis-recovery pattern).

If the upside scenario emerges, all the better.

Discipline and diversification are always important, but all the more so in today's environment. Don't be all in on any particular narrative. Spread risk over geographies, industries and factors.

Finally, understand your exposures on a fundamental level. What might look on the surface like an investment in one theme may actually be a bet on underlying inflation and tariff policy. For instance, a bet on the habits and preferences of the U.S. consumer in an investment into a sports equipment manufacturer might actually be a gamble on the inflation outlook. It's important to understand this, especially if other seemingly unrelated investments share the same underlying exposure.

APPENDIX: arcMacro Regime Summary

arcMacro Regime Summary

Regime	Occurences	Historical share	Average duration	Average GDP growth		Average inflation	Average annual S&P 500 return	
	Count	Percent	Months	Percent	Std. dev	Percent	Percent	Std. dev
Goldilocks	5	27	32	3.2	0.4	2.5	14.5	10.8
Financially Constrained	8	21	16	3.4	0.4	2.9	14.7	15.8
Overheating	5	19	23	3.9	0.8	5.7	3.0	18.0
Crisis	5	10	11	0.0	0.6	2.0	8.5	17.8
Stagflation	4	10	15	-1.3	0.9	8.8	8.7	21.5
Rebound	3	7	13	5.5	1.5	4.0	10.6	23.2
Sluggish	4	7	11	1.8	0.4	3.0	18.5	14.9

Source: arcMacro

Goldilocks: This is the regime that policymakers are aiming for. The real economy is robust without being inflationary or creating financial imbalances. There is a general sense of equilibrium. Since 1970, the economy has spent more time in this Regime (27%) than any other, but we have not experienced a Goldilocks period since 2018.

Financially Constrained: In this regime, financial conditions are tight and are gradually cooling the economy. At times, this regime has reflected a “hangover” from a prior crisis, where growth has rebounded but credit remains tight. It can also result from a traditional central bank tightening cycle. In both cases, growth is coming down from an unsustainably high level (Rebound or Overheating Regimes), which explains why average GDP growth is relatively high. These regimes are common and highly variable in length.

Overheating: Easy credit conditions fuel unsustainable growth, pushing aggregate demand beyond supply and fueling inflation. The post-COVID-19 boom was a classic example. Creates the weakest return environment of all the Regimes as asset values become stretched.

Crisis: Total collapse in growth and credit, accompanied by stable or falling inflation. Very weak aggregate demand, with low-capacity utilization on the supply side. Extreme flight to safety behavior. Usually short-lived, but can stretch several years (e.g., dotcom recession) or double dip (GFC).

Stagflation: Simultaneous inflation spike and real economy collapse, usually accompanied by a credit crunch as monetary policy responds to inflation. Low (nominal) returns, but with very volatile markets. We have not experienced a Stagflation Regime since the First Gulf War, but we may be approaching one.

Rebound: Any period of super-strong real activity, which can only be achieved when idle economic capacity is rapidly reactivated. Always follows Crisis or Stagflation Regimes. Strong (but volatile) return environment, usually sparked off by a sudden surge in the Sentiment Factor (“animal spirits”).

Sluggish: Usually a transition Regime when entering or exiting a crisis. Real activity is below average, but not because of a lack of credit availability. Inflation is stable. The U.S. economy has been mired in a Sluggish Regime, without entering a recession or a recovery, since 2023. This is an unprecedented state of affairs over the past half-decade of economic history.

arc • MACRO