Investing in 2026: prepare for inflationary growth

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Key points

- While markets are currently priced for a "Goldilocks" scenario, we think this is the least likely outcome for 2026.
- Markets may remain anchored to this benign narrative until we see clear signs of stabilisation in labour data.
- Ultimately, the combination of negative global real rates, easing lending standards and policy loosening at a time of already sticky inflation suggests that inflationary growth is the most probable outcome for 2026.
- Looking at the bigger picture, 2026 should offer investors significant opportunities, provided they are prepared to adapt to very different scenarios, including the limited risk of recession and even stagflation.

The backdrop: a return to more frequent and volatile cycles

From a macro perspective, what matters for asset prices is, first, the interaction between activity and inflation, and second, the associated policy response. That sounds simple in theory and for a long time, it was in practice, as globalisation fostered a low-inflation/low-rate environment with extended growth cycles. However, in today's new economic regime, this interaction has become more complex because of:

- Sticky inflation, which in many countries remains well above central bank targets.
- Conflicting economic shocks that are jolting the global economy, be it loose monetary and fiscal policy versus tariffs, or the supply boost from AI versus the drag from protectionism and demographics.
- Increasingly politicised policy responses. Against a backdrop of rising wealth inequality and populism, central banks and governments are slower to tighten policy and quicker to stimulate.

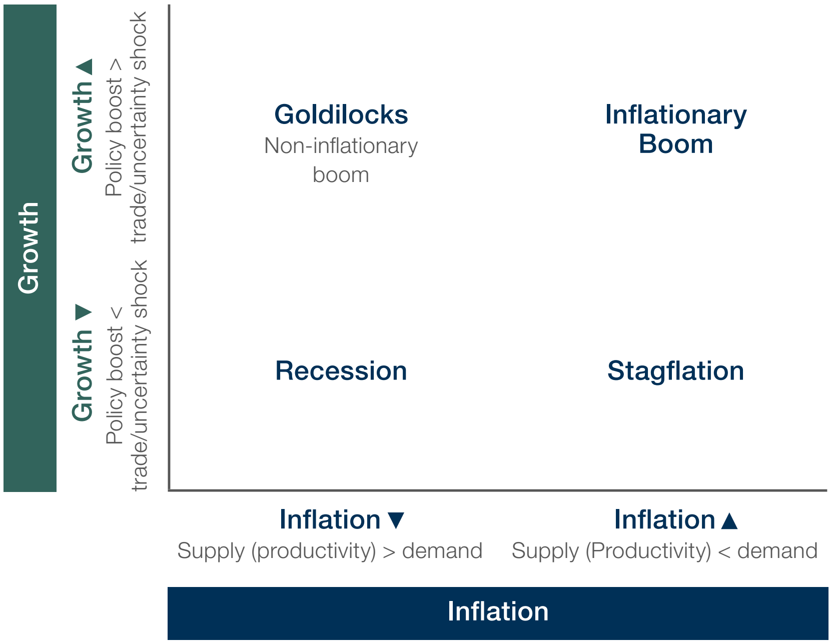
We have now returned to traditional cycles where growth drives future inflation, and the economy can move rapidly across the four quadrants outlined in Figure 1. This ongoing shift to a more cyclical world has major implications for investors, as different assets and investment strategies will perform differently at each stage of the cycle. Moreover, markets can rapidly and frequently revise the probabilities they assign to different outcomes as we've already seen throughout 2025.

Given this backdrop, we believe the outlook for 2026 will revolve around four scenarios:

1. **Goldilocks** — In the near term, markets are likely to remain priced for noninflationary growth.
2. **Inflationary growth** — Investors may be underestimating the likelihood of an inflationary boom. We think this could be the most probable outcome for 2026.
3. **Recession** — While we view recession as less likely, it cannot be entirely ruled out, with AI disappointment and higher private-sector savings in response to ongoing uncertainty the key potential triggers.
4. **Stagflation** — There is a tail risk that signs of stagflation could emerge next year, potentially exacerbated by inappropriate policy responses.

On the next page, we explore each scenario and outline the characteristics that can help investors determine which quadrant we are in, and what market reaction to expect.

Figure 1: The four quadrants of the economic cycle



Source: Wellington. For illustrative purposes only.

Four potential scenarios for 2026

1. Continued Goldilocks market narrative (for a while)

Looking across different asset classes, global markets still appear priced for a continuation of the noninflationary growth scenario that characterised the global economy prior to 2018. That is how you reconcile:

- Elevated equity valuations and strong EPS growth expectations, particularly in AI-related areas
- Tight credit spreads
- Long-term bond prices reflecting low inflation expectations (breakeven rates) despite pricing in further central bank rate cuts to neutral or slightly below neutral

This scenario largely depends on the success of AI. If productivity gains from AI outweigh the negative impact of tariffs and rising protectionism, demand in the economy could remain strong without fuelling inflation.

What would this mean for asset prices?
In this environment, equities should continue to rally, credit spreads remain tight and government bond yields rise modestly to reflect better trend growth. Yes, unemployment rates may temporarily rise due to AI-driven displacement, but policymakers could respond with looser policy as productivity keeps inflation subdued.

This market theme is likely to persist in the near term, given the likelihood of labour market weakening and lower (but still elevated) inflation. However, our analysis suggests it is unlikely to be the dominant outcome for 2026.

2. Higher growth with inflation — the most likely outcome

Why? Nominal global growth remains strong, but inflation continues to exceed the 2% target in most developed economies. Yet policymakers remain firmly accommodative as evidenced by:

- Global liquidity near all-time highs, which, if deployed, could further support nominal growth.
- Government initiatives to stimulate lending, including banking deregulation, even as private-sector credit conditions are already easing across many countries.
- Real global interest rates at zero and about to turn negative again.
- Forthcoming fiscal expansion, with developed market economies set to embark on the sharpest fiscal easing since 2010 (excluding the COVID years).

This policy stimulus is occurring at a time when the world economy is being hit by several inflationary supply shocks:

- The imposition of US tariffs and the growing protectionist response from the rest of the world represent a significant negative global supply shock. Just as globalisation reduced global goods inflation by allowing capital to flow to the lowest-cost producers, protectionism and a rising focus on security of supply will raise it.
- China's increasing attempts to remove capacity in many sectors rather than continuing to add to it also has the potential to be a material source of sticky inflation.

If AI-driven productivity growth fails to materialise, conditions are ripe for an inflationary boom in 2026, with policy stoking stronger demand amid weaker supply. While this theme may not yet dominate, signs of labour market stabilisation could prompt a market shift as it becomes clear there will not be enough slack in the economy to bring down inflation.

What would this mean for asset prices?

The policy response is key. An inflationary boom can still benefit risk assets: strong nominal growth should lift equities and contain credit spreads. It also increases the likelihood of structurally higher yields in developed markets. The rally in risk assets may persist until policymakers stop prioritising growth and start trying to rein in inflation through tighter policy or if the bond market penalises the "inappropriate" policy response and forces a tightening via higher term premia. Bond investors will, at a minimum, need to see data that exposes the inappropriateness of loose policy at this stage of the economic cycle, such as clear signs of labour market recovery, and that may still take some time. In our view, the near-term risks to the labour market globally are skewed to the downside, particularly in the US. But the longer it takes for signs of stabilisation to materialise, the more policymakers risk generating the conditions for a boom and subsequent bust.

3. A lower-probability risk of recession

We can't completely discount the risk of a recession in 2026. The trigger could take many forms, but some would be more disruptive for risk assets than others. For example, there is a chance that the hit from tariffs and inflation already working its way through the system is more severe than economic models imply. However, this scenario aligns more with a temporary slowdown, given loosening policy and low private-sector leverage.

For us, the bigger recession risks stem from:

1. The market downgrading its views on AI, from either a timing or future earnings perspective, which could trigger a sharp equity correction, hitting households' wealth perceptions.
2. Today's rolling uncertainty and lack of fiscal discipline prompting increased private-sector savings, as already seen in large parts of Europe. If sustained, such a response would be highly deflationary, reminiscent of Japan in the 1990s.

What would this mean for asset prices?

We view the risk of a noninflationary recession in 2026 as still relatively low, albeit rising. If realised, equities would likely sell off while bonds (at least initially) would rally and credit spreads would widen sharply. If the recession is triggered by an AI-driven correction, it would likely also mean a substantially weaker dollar.

4. Stagflation: also a tail risk to monitor

Though currently a tail risk, some economies, most notably the UK, have exhibited signs of stagflation, which could be aggravated by escalating protectionism. The telltale sign would be inflation rising despite weakening employment. This risk matters because:

1. It would be very negative for risk markets.
2. Policymakers may repeat past mistakes, accommodating rather than countering inflation, similar to what occurred in the early 1970s.

What would this mean for asset prices?

Stagflation, especially if prolonged, would be most damaging for equities and credit spreads, but would also imply higher bond yields driven by breakevens and term premia.

In essence

As summarised in Figure 2, we believe an inflationary upturn is the most likely scenario for 2026. For now, markets may cling to the Goldilocks scenario, before adjusting to the new reality of high nominal growth. While much less likely, we can't rule out the risk of a recession and even stagflation.

Figure 2: Where we're heading in the cycle, what to look for and the market implications

		Signs we are living it				How markets should trade			
	Probability	Productivity	Unempl. Leads	Inflation Leads	Inflation Expectations	Equities	Credit Spreads	Yields	Yield Curves
Goldilocks-Non-inflationary upturn	20%	↗	↘	→/↘	Anchored at 2%	↑	↓	↑ r*↑, Be→/↓ Term Premia↓	Not clear cut
Inflationary Upturn	50%	→/↘	↘	↗	↗	↑ initially	↓ initially	↑ r*↑, BE↑ Term Premia↓ initially	Steeper initially
Recession	15%	→/↗	↗	↘	↘/ Anchored at 2%	↓	↑	↓ r*↓, BE↓ Term Premia↑	Steeper
Stagflation	15%	→/↘	↗	↗	↗	↓↓	↑↑	↑ r*↓, BE↑ Term Premia↑	Steeper

Source: Wellington. For illustrative purposes only. | Arrows indicate both direction (unchanged, down, upwards or combination thereof) and level of intensity (from single to double arrows).

Each scenario comes with very different implications for asset prices and portfolios. The most likely outcome, inflationary growth, is generally supportive of risk assets albeit that at some point, policymakers may start tightening or, failing that, markets may require higher risk premia.

In this fast-changing environment, we think investors need to be vigilant: look for tell-tale signs of shifts in the cycle and actively adjust asset allocations to make the most of the significant opportunities that 2026 is likely to offer while mitigating the increased downside risks.

IMPORTANT DISCLOSURES:

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