Macro Outlook

PEACEFUL SUNSET

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US growth remains resilient, but Q3 strength overstates underlying momentum as private consumption growth moderates and AI investment is expected to provide less incremental support. Inflationary pressures remain concentrated rather than becoming increasingly broad-based. Although the latest two supercore inflation prints warrant some caution, with private consumption likely past its peak, we do not expect consumer spending or wage dynamics to trigger a sustained broadening of supercore pressures. We forecast 2.3% GDP growth in 2027, with core PCE inflation easing to 2.3% in H2, consistent with an expansion broadly in line with potential.

Incoming data suggest that the EA may continue to weather the energy shock better than expected. However, Ireland's outsized contribution masks softer underlying growth, casting a long shadow over the sustainability of the recovery. Higher energy bills, tighter financial conditions and fading fiscal support point to a more challenging winter. Delayed pass-through of higher energy prices should keep core inflation sticky in the near term, while moderating wage growth limits second-round risks. We continue to expect core HICP inflation at 2.3% in 2027.

China's lower-end growth target is within reach, but rebalancing remains elusive as resilient production and exports contrast with persistently weak domestic demand. Structural constraints on consumption and investment persist, while reduced policy urgency limits the likelihood of additional stimulus. Inflationary pressures remain uneven, with recent strength concentrated in upstream prices and largely driven by external factors. We forecast GDP growth of 4.6% in 2026 and 4.5% in 2027, with headline inflation remaining subdued at 1.0% and 1.2%, respectively.

The Fed appears determined to achieve its inflation target while, at the same time, showing no urgency to accelerate monetary tightening, amid signs that the measures implemented so far (including the September rate hike) are having the intended effect and that the economy is not overheating. Accordingly, we expect one or two additional rate hikes by March 2027. Our view remains subject to an unusually high degree of uncertainty, reflecting: 1) potential changes in the Fed's reaction function amid upcoming reviews of its monetary policy framework; 2) the introduction of a dual approach to inflation; and 3) several inherently unpredictable factors, such as geopolitical developments in the Middle East. In 2027, assuming that inflation returns to target, the Fed could adopt an easing bias. However, there is a significant risk that the Fed will keep rates above 4% for longer given the strength of the economy, a later start to raising rates and greater uncertainty about the evolution of its reaction function.

We believe that another ECB rate hike in December remains on the table, especially if energy prices stay elevated, growth proves resilient and core inflation stays around current levels. Beyond December, however, we expect the ECB to remain on hold in H1 2027 before moving towards an easing bias in H2 2027, as tighter financing conditions, a less supportive fiscal stance and the prolonged energy shock weigh on growth and allow disinflation to resume.

PBoC's policymakers may see a more moderate pace of yuan appreciation as supportive of growth, reducing the immediate need for policy rate cuts. Nevertheless, the scope for monetary easing remains as long as the currency maintains its underlying strength, limiting capital outflow and depreciation risks for the PBoC. On balance, we believe that a 10bp cut in the overnight reverse repo rate — the new key policy rate — is likely by the year-end.

GROWTH & INFLATION

US – Firm growth, limited heat

US growth remains resilient, but Q3 strength overstates underlying momentum as private consumption growth moderates and AI investment is expected to provide less incremental support. Inflationary pressures remain concentrated rather than becoming increasingly broad-based. Although the latest two supercore inflation prints warrant some caution, with private consumption likely past its peak, we do not expect consumer spending or wage dynamics to trigger a sustained broadening of supercore pressures.

We forecast 2.3% GDP growth in 2027, with core PCE inflation easing to 2.3% in H2, consistent with an expansion broadly in line with potential.

Resilience, not a higher gear. The US economy continues to absorb the energy shock with remarkable resilience. But the stronger Q3 growth print overstates, in our view, the improvement in underlying momentum. Real GDP expanded by 3.4% q/q SAAR, up from 2.2% in Q2, while private domestic final purchases rose sharply (4.9% q/q SAAR). Taken at face value, these readings suggest an economy shifting into a higher gear.

We see a different picture: domestic demand remains firm, but several of the forces behind the third-quarter pickup are already losing traction.

Our baseline therefore remains one of growth broadly consistent with potential, rather than an emerging overheating cycle.

Consumption: a strong quarter, a softer exit. The 3.8% q/q SAAR increase in Q3 real consumption looks impressive, but it is not compelling evidence of a sustained upswing in household demand. The monthly profile is less buoyant than the quarterly average suggests, with upward revisions to July accounting for more of the strong outturn than sustained strength through September. Temporary factors also complicate the picture. An unusually early Amazon Prime Day brought forward online purchases that would otherwise have occurred in Q3, while World Cup-related spending provided an additional, short-lived boost. As those effects unwound, spending momentum moderated. Three-month annualised consumption growth eased from 4.1% in June to 3.0% in September, and the September reading fell short of expectations. Services spending increased by 0.2% m/m, but goods purchases declined by 0.3%, including a 2.0% fall in motor vehicle purchases. In real terms, personal spending was unchanged at 0.0% m/m in September. That softer exit leaves a less favourable starting point for Q4. The consumption carry-over has halved to 0.8pp from 1.6pp at the start of Q3, consistent with our forecast for spending growth to slow to 2.0% SAAR.

The income backdrop also argues against extrapolating the third-quarter strength. Three-month annualised nominal personal income growth slowed to 3.4% in September from 5.3% in July, while higher energy costs eroded purchasing power. Real disposable income growth slowed to -0.2% (three-month annualised rate) in September, from 3.6% in the earlier reference period, and the saving rate fell to 3.8%. Households are still spending at a healthy pace, but the underlying income dynamics offer limited support for another sustained acceleration.

AI investment: still an engine, but less incremental thrust. Fixed investment rebounded by 12.7% SAAR in Q3, led by a 20.9% increase in equipment spending and

an 8.4% rise in investment in intellectual property products (IPP). Investment in structures posted a more moderate 5.4% gain.

The composition was more striking than the headline. Spending on AI-sensitive assets, including computers and peripherals, data centres and software, accelerated by roughly 22pp to nearly 32% SAAR, accounting for almost two-thirds of business investment growth. The rest of business investment expanded at a comparatively modest 6.1% pace.

AI remains an important source of demand, but we would qualify its implications for aggregate growth in two respects.

- **First, gross investment spending is not equivalent to domestic value added**. The AI build-out relies heavily on imported equipment, particularly semiconductors, and imports of such equipment increased sharply again in Q3. The associated leakage through imports offsets part of the investment contribution to GDP, making the domestic growth dividend smaller than headline capex figures imply.
- **Second, the investment impulse is likely approaching an inflection point**. We suspect Q3 marked the peak contribution of business investment to GDP growth. Core capital goods orders increased by only 0.5% m/m in September, while three-month annualised growth in both core capital goods orders and durable goods orders excluding transport has slowed materially from its spring highs. More specifically, the three-month annualised growth rate of shipments of computers and electronic products, a category that includes electronic computers, storage devices, peripheral equipment and semiconductors, among other items, has been steadily decelerating from its June 2026 peak of 17.5%, reaching just 0.2% in September, its lowest reading since October 2025.

Looking further ahead, consensus expectations for slower hyperscaler capex growth in 2027 reinforce our view that the growth impulse from AI-related investment will roughly halve next year, to around 0.6pp. Spending can remain elevated and continue to rise, without delivering the same incremental boost to activity.

Politics: a potentially smaller overheating tail. The midterms delivered a considerably stronger Democratic result than markets had expected, which, in our view, could further reduce overheating risks through two channels.

The first is fiscal. Divided government would lower the probability of another substantial fiscal expansion, while introducing potential downside risks related to government funding and the debt ceiling.

The second concerns the AI build-out. To the extent that state-level outcomes translate into tighter constraints on data centre development, they could moderate the pace of investment expansion.

The implication would be a narrower upside tail for demand: less scope for a fresh fiscal boost and a lower probability of a further unchecked acceleration in AI capex. Neither channel would undermine the expansion on its own, but both would weaken the case for a sustained period of above-potential growth.

Against this backdrop, we remain constructive on the expansion without interpreting Q3 as the start of a materially faster growth regime. Consumers continue to support activity, but the spending trajectory looks solid rather than excessive, and the softer end-of-quarter profile points to moderation ahead. AI capex should remain a positive contributor over the coming quarters. However, we believe much of the initial growth impulse was delivered in H1-26, even as the broader

business investment contribution strengthened again in Q3. The distinction is between a high level of investment and an increasingly large contribution to growth. Our baseline assumes the former, not the latter.

Assessing inflation through both top-down and bottom-up lenses. Core CPI inflation surprised to the upside in October, rising 0.3% m/m versus the 0.2% consensus expectation. At two decimal places, however, the increase came in at 0.29%, moderating from 0.33% in September.

Volatile components continue to drive fluctuations in core goods inflation. The past three releases have been characterized by seemingly idiosyncratic, short-lived upside surprises, with several components posting sharp increases that were subsequently reversed the following month. Household furnishings and medical care led the upside in October, with both categories now running close to their historical highs in terms of momentum and typically displaying a tendency to mean-revert. In September, toys and used cars had surprised to the upside before correcting in October, while new cars led the increase in August but declined over the subsequent two months. A similar pattern has emerged in sporting goods. Meanwhile, momentum in AI-related components fell sharply, to 0.4% from 0.9%.

Supercore inflation momentum appears somewhat more coherent. For the second consecutive month, price pressures were relatively broad-based. Shelter inflation, meanwhile, eased in October, reversing September's idiosyncratic increase, which had been largely driven by smaller cities, and returning closer to its pre-pandemic average.

Under our baseline, we expect core CPI inflation to remain at 0.3% m/m in November and December, averaging 0.25% in January and February, and 0.2% in March.

Against this backdrop, the past two CPI releases point to some upside risk on the supercore side, particularly if "other services" continue to print firmly, even if somewhat erratically. That said, consistent with our baseline view that private consumption has likely peaked, we do not expect consumer spending or wage growth to generate a sustained, broad-based acceleration in supercore inflation momentum. On core goods, by contrast, we remain agnostic and would prefer to see additional evidence before drawing firmer conclusions. The past three releases suggest that the core goods basket may still be adjusting unevenly to the earlier energy shock, rather than entering a self-sustaining inflationary upswing.

Narrowing breadth, lingering pressures. That said, the data over the past three months suggest that, beyond some erratic moves, there is no evidence of a renewed acceleration in underlying inflationary pressures. Within core CPI, our dispersion index, which measures how broadly price changes are distributed across the basket based on 12-month inflation across 177 detailed CPI categories weighted by their respective shares, stood at 7.9 in October, i.e. slightly below its long-run average. A similar message emerges from core PCE. Indeed, dispersion within core PCE inflation categories remains near historical norms and core skewness is close to zero, suggesting that headline/energy distortions have not spread widely across the underlying basket.

ANIMA baseline. We have incorporated the Q3 2026 GDP data into our forecast profile and made corresponding adjustments to our baseline for the remainder of the forecast horizon. We now expect GDP growth of 2.2% q/q SAAR in Q4 2026, followed by 2.1% in H1 2027 and 2.0% in H2 2027. Our full-year 2027 growth forecast stands at 2.3%.

On inflation, we mechanically adjust our baseline: we now expect core PCE inflation in Q4-26 at 3.1% (+0.1pp revision from prior baseline). Thereafter, in line with our prior expectations, favourable base effects should drive a sharp decline to 2.5% in H1 2027,

from 2.4% prior baseline, before inflation eases further to 2.3% in H2 2027 (vs 2.2% prior baseline).

EA – Winter is coming

Incoming data suggest that the EA may continue to weather the energy shock better than expected. However, Ireland's outsized contribution masks softer underlying growth, casting a long shadow over the sustainability of the recovery. Higher energy bills, tighter financial conditions and fading fiscal support point to a more challenging winter. Delayed pass-through of higher energy prices should keep core inflation sticky in the near term, while moderating wage growth limits second-round risks. We continue to expect core HICP inflation at 2.3% in 2027.

The EA weathered the initial shock better than expected. The advance estimate for EA GDP in Q3 2026 came in above expectations, with the economy expanding by 0.4% q/q, down from 0.6% in Q2. However, a large share of the upside surprise was driven by Ireland's notoriously volatile GDP, which surged by 5.5% q/q.

Excluding Ireland, the economy expanded by a more modest 0.2% q/q, compared with an average quarterly gain of 0.3% in H1. This is broadly consistent with our assessment: the energy shock has not derailed the expansion, but underlying momentum softened slightly over the summer. The expenditure breakdown for the EA aggregate is not yet available (scheduled for release on 7 December), although national releases provide some early indications of the drivers of growth. Taken together, they suggest a considerably less buoyant picture outside Ireland than the aggregate GDP reading would imply.

The winter slowdown is taking shape. We continue to expect economic activity to lose further momentum over the winter as renewed energy price pressures and tighter financial conditions increasingly weigh on domestic demand. The first signs are already visible in incoming hard data and forward-looking indicators. Consumer activity weakened in September, and higher household energy bills are set to squeeze purchasing power and undermine confidence in the months ahead. Meanwhile, higher interest rates and uncertainty surrounding key national elections are beginning to restrain credit demand and business expectations, as evidenced by the latest Bank Lending Survey (BLS).

The Q3 upside surprise therefore does not materially alter our assessment of the outlook, although we flag downside risks at this stage. Following two exceptionally strong quarters (10.2% q/q in Q2 2026 and 5.5% q/q in Q3 2026), we expect Irish output to contract in Q4 2026. Accordingly, we now forecast EA GDP growth to slow to 0.1% q/q in Q4 2026. Excluding Ireland, we expect GDP growth to ease to 0.15% from 0.21% in Q3 2026. For H1 2027, we continue to expect EA GDP growth to average 0.3% q/q, followed by 0.4% in Q4 2026.

Fiscal policy will remain expansionary in Germany, but slow growth elsewhere. Fiscal policy has helped cushion the economy this year. Germany's expansion and spending associated with the final year of the Recovery Fund have provided an important offset to the energy shock, helping explain the resilience of regional activity. In 2027, the fiscal action will continue to support growth in Germany, and we remain constructive on the German fiscal rollout driven by higher defence spending and improved execution of infrastructure investment. That said, fiscal policy looks set to turn contractionary in France and Spain as national consolidation pressures build and the Recovery Fund expires. As a result, we see a neutral area-wide fiscal stance in 2027 after a small net boost this year.

Against this backdrop, we expect economic momentum to moderate over the winter, as higher energy prices and tighter financial conditions weigh on activity, compounded by a French economy that is likely to remain broadly stagnant until after the elections. In the second half of the year, we expect the pace of expansion to improve moderately, supported primarily by a gradual recovery in the global manufacturing cycle alongside positive spillovers from AI-related investment.

Inflation: the energy pipeline has yet to clear. Core inflation remained relatively sticky over the first three quarters of 2026, averaging 2.4% y/y.

- NEIG inflation has picked up even before a meaningful proportion of the indirect effects of higher energy prices has been reflected in the data. Part of that acceleration reflects firmer prices for information-processing equipment, including computers, related hardware and memory cards, as AI-driven demand exerts upward pressure on prices in memory and other electronics markets.
- Services inflation has remained broadly steady, averaging 3.2% y/y over in the first three quarters of 2026. Price movements across the more volatile categories have been mixed, with little evidence so far of a generalised acceleration linked to the pass-through of higher energy costs. We would not interpret that relative stability as evidence that the adjustment is complete. In our view, a substantial share of the indirect effects of the energy shock has yet to feed through, particularly in highly exposed categories such as airfares. Those delayed effects should keep core HICP inflation close to current levels through the end of Q1 2027, consistent with the analysis in our note *"MACRO FOCUS - Lessons from the past, views from the future" - October 2026*.

Airfares: delayed rather than avoided. Industry commentary points to a marked increase in European airfare inflation in 2027, following relatively subdued pricing this year, in contrast to developments in the US. We discussed this dynamic extensively in our October 2026 note, *"MACRO FOCUS – Lessons from the Past, Views from the Future"*, and it is already incorporated into our baseline forecast. Several factors appear to have delayed the adjustment: fuel hedging, Europe's large low-cost carrier segment, pre-war plans for a substantial expansion of flight capacity, and shifts in demand. These factors help explain why higher energy costs have not yet been fully passed through to ticket prices. However, this does not necessarily imply that the eventual pass-through will be limited.

Moderating wage growth should help contain second-round effects. Importantly, the wage outlook is becoming more favourable. Forward-looking indicators continue to point to moderating wage growth, offering little evidence that the energy shock is generating persistent second-round inflationary pressures. The ECB's headline wage tracker, which captures active collective bargaining agreements and spreads one-off payments over 12 months, points to negotiated wage growth of 2.8% in H1 2027, easing further to 2.4% in Q3.

The resulting picture is one of near-term inflation persistence rather than a renewed, self-sustaining inflation cycle. Delayed pass-through of higher energy costs should slow the decline in core inflation, but weaker demand and moderating wage growth argue against a sustained reacceleration.

ANIMA baseline. We have incorporated the EA's Q3 2026 flash GDP estimate of 0.4% q/q into our forecast profile, exceeding our baseline estimate by 0.2pp, largely due to a sharp 5.5% q/q increase in Irish GDP. Following two exceptionally strong quarters, we expect a reversal in Irish output in Q4 2026. Accordingly, we now forecast EA GDP growth to slow to 0.1% q/q in Q4 2026. For H12027, we continue to expect EA GDP growth to average 0.3% q/q, followed by 0.4% in Q4 2026.

On inflation, we continue to expect core HICP inflation to remain stable at 2.5% y/y in Q4 2026, in line with our previous baseline. In H1 2027, core HICP inflation is projected to ease only marginally to 2.4% y/y, unchanged from our previous forecast, before moderating further to 2.3% in H2 2027 (vs 2.2% in prior baseline). On an annual average basis, we forecast core HICP inflation at 2.3% in 2027, unchanged from our previous baseline.

CHINA – Target in sight, rebalancing still elusive

China's lower-end growth target is within reach, but rebalancing remains elusive as resilient production and exports contrast with persistently weak domestic demand. Structural constraints on consumption and investment persist, while reduced policy urgency limits the likelihood of additional stimulus. Inflationary pressures remain uneven, with recent strength concentrated in upstream prices and largely driven by external factors.
We forecast GDP growth of 4.6% in 2026 and 4.5% in 2027, with headline inflation remaining subdued at 1.0% and 1.2%, respectively.

Target in sight, rebalancing still elusive. China's Q3 GDP report puts the lower end of the government's 2026 growth target comfortably within reach, but offers limited evidence of a more balanced expansion. Real GDP growth edged up to 4.5% y/y from 4.3% in Q2, in line with our forecast and above the consensus forecast of 4.3%.

With output up 4.6% over the first three quarters, growth of just 4.2% in Q4 would be sufficient to reach the lower end of the 4.5–5.0% annual target range. A more favourable base of comparison should make that hurdle manageable. The bigger question is not whether the target can be achieved, but whether the composition of growth is becoming more sustainable. On that front, the evidence remains unconvincing.

Production leads, domestic demand lags. September brought some improvement in domestic activity, although demand remains exceptionally weak by historical standards. Retail sales growth picked up to 1.1% y/y, while the year-to-date contraction in fixed-asset investment narrowed slightly to 7.2%, supported by investment in infrastructure and manufacturing.

The supply side continued to outperform. Industrial production increased by 5.5% y/y in September, following gains of 4.5% in July and 5.2% in August. AI-linked industries were an important source of strength, with integrated circuit output growing by around 20% y/y over the past seven months.

The contrast between robust production and subdued demand remains stark. Against Q3 GDP growth of 4.5%, average industrial production growth of 5.1% and export growth of 25%, our weighted composite of retail sales, fixed-asset investment and exports, deflated by core CPI, increased by just 0.6% y/y. The economy is generating output at a considerably faster pace than the broader demand environment would suggest.

Structural constraints limit the domestic recovery. We view the persistent weakness in domestic spending as more than a temporary loss of momentum. Household deleveraging, property-related wealth losses and a weak labour market continue to restrain consumption. We expect retail sales growth to slow to around 1% this year, from 3.7% in 2025.

Investment faces a similarly challenging set of constraints. The prolonged housing downturn continues to weigh on construction, while traditional industries are

scaling back capital expenditure. At the local-government level, strained public finances and weaker incentives to pursue aggressive infrastructure development further limit the scope for a meaningful investment rebound.

The result is an expansion that remains heavily reliant on production and external demand, with little indication that households or domestically oriented investment are ready to take over.

Policy: less urgency to provide additional support. With the annual growth objective largely secured, the case for a substantial additional stimulus package before year-end has weakened. We expect policymakers to prioritise implementation of existing measures, including the modest support package announced in late September, rather than introduce a fresh round of significant policy easing. Moreover, the fiscal impulse at the local level remains less supportive than central government guidance might imply. Local authorities continue to operate under debt consolidation mandates, resulting in a de facto fiscal contraction that offsets part of Beijing's expansionary efforts. This tension limits the extent to which announced support translates into stronger domestic demand.

Prices: upstream reflation, limited downstream traction. The GDP deflator rose by 1.4% y/y in Q3, its second consecutive quarterly positive reading. However, the improvement appears to reflect upstream price developments rather than a broad-based recovery in domestic pricing power. Higher global energy and non-ferrous metals prices pushed producer price inflation (PPI) to 4.1% y/y in Q3, up from 3.6% in Q2. Consumer prices, however, show little evidence of pass-through so far. Headline CPI inflation averaged 0.7% y/y in Q3, slightly below the 1.0% average recorded in H1. This pattern was confirmed by the October release, with headline CPI inflation easing to 0.7% y/y from 0.9% in September. Underlying inflationary pressures also remained subdued at the start of Q4, with core CPI inflation slowing to 0.8% y/y from 1.0% in September. This suggests that inflationary pressures remain uneven, with recent strength concentrated in upstream prices and largely driven by external factors.

Continued price declines across several major CPI categories reinforce this picture: stronger producer prices have not translated into generalised consumer inflation. The return to a positive GDP deflator reading should therefore not be mistaken for a decisive turnaround in the domestic demand cycle.

China appears to be on track to meet its growth objective, but the underlying imbalance persists: resilient output, weak domestic spending and a price recovery driven more by global input costs than by stronger final demand.

ANIMA baseline. We maintain our real GDP growth forecast for 2026 at 4.6%. Given the persistent weakness in domestic demand indicators, we expect GDP growth to reach 4.5% in 2027, a downward revision of 0.1pp from our previous baseline.

Turning to inflation, our annual headline CPI inflation forecasts remain unchanged at 1.0% for 2026 and 1.2% for 2027.

MONETARY POLICY

Fed – Between a rock and a hard place

The Fed appears determined to achieve its inflation target while, at the same time, showing no urgency to accelerate monetary tightening, amid signs that the measures

implemented so far (including the September rate hike) are having the intended effect and that the economy is not overheating. Accordingly, we expect one or two additional rate hikes by March 2027. Our view remains subject to an unusually high degree of uncertainty, reflecting: 1) potential changes in the Fed's reaction function amid upcoming reviews of its monetary policy framework; 2) the introduction of a dual approach to inflation; and 3) several inherently unpredictable factors, such as geopolitical developments in the Middle East. In 2027, assuming that inflation returns to target, the Fed could adopt an easing bias. However, there is a significant risk that the Fed will keep rates above 4% for longer given the strength of the economy, a later start to raising rates and greater uncertainty about the evolution of its reaction function.

We believe that further monetary tightening remains a possibility for the following reasons:

1. According to Chair Warsh, FOMC discussions are currently focused primarily on inflation. The FOMC's assessment is that economic growth has strengthened and is broadening beyond the AI sector.
2. Chair Warsh has reiterated on several occasions since his appointment that the FOMC is firmly committed to achieving its inflation target and that there is no "soft" inflation target.

At the same time, Chair Warsh's rhetoric suggests that he is in no rush to accelerate the pace of tightening, for the following reasons:

1. **Inflation expectations remain anchored**. Both medium-term inflation compensation (as measured by breakeven inflation rates) and inflation expectations have remained well anchored, including among consumers.
2. **The correction in AI-related equities and, to a lesser extent, the September rate hike are contributing to tighter financial conditions.** While financial conditions in the US remain relatively accommodative, the easing trend observed over recent months is beginning to reverse.
3. **Neither we nor the Fed believe that the US economy is overheating.** We expect economic growth to moderate in 2027 and inflation to return to target towards the end of the year.

We maintain our baseline scenario. Against this backdrop, we expect one or two additional rate hikes by March 2027, bringing the federal funds target range to either 4.00–4.25% or 4.25–4.50%. Our view remains subject to an unusually high degree of uncertainty, reflecting: 1) potential changes in the Fed's reaction function amid upcoming reviews of its monetary policy framework; 2) the introduction of a dual approach to inflation; and 3) several inherently unpredictable factors, such as geopolitical developments in the Middle East.

ECB – Getting there

We believe that another ECB rate hike in December remains on the table, especially if energy prices stay elevated, growth proves resilient and core inflation stays around current levels. Beyond December, however, we expect the ECB to remain on hold in H1 2027 before moving towards an easing bias in H2 2027, as tighter financing conditions, a less supportive fiscal stance and the prolonged energy shock weigh on growth and allow disinflation to resume.

At the October ECB meeting, President Lagarde went so far as to say that, although the ECB's mandate is to maintain price stability, this cannot be achieved without financial stability.

Against this backdrop, we expect the ECB to deliver a final rate hike in December, particularly if: 1) energy prices do not decline significantly from current levels; the longer energy prices stay high, the higher the probability of second-round effects; 2) economic growth does not slow significantly, signalling resilience despite tighter financing conditions; and 3) core inflation remains around current levels.

Beyond December, we expect the ECB to remain on hold for the following reasons:

1. **President Lagarde stated that the ECB sees no second-round effects beyond those already incorporated into its September projections.** Meanwhile, underlying inflation has not risen significantly.
2. **Financial conditions are becoming an increasingly important consideration in the ECB's reaction function.** Most ECB Governing Council members, including even the more hawkish ones, have acknowledged in recent weeks that financial conditions have tightened considerably in recent months, primarily as a result of rising long-term interest rates, which could pose downside risks to growth.
3. **Rising sovereign bond yields and spreads are adding to the pressure from tighter financing conditions.** We believe that the least controversial way for the ECB to counter an excessive widening of sovereign bond spreads would be to signal that it does not intend to implement all the rate hikes currently priced in by markets (a further 60 basis points by July 2027). Other policy instruments, such as slowing the pace of quantitative tightening (QT), activating the Transmission Protection Instrument (TPI) or even resorting to Outright Monetary Transactions (OMT), would, in our view, require more severe market fragmentation and could prove controversial, either because of the eligibility criteria for activation (in the case of the TPI) or because of the instrument's original purpose (in the case of slowing QT).
4. **Although the fiscal stance has supported economic growth this year, the fiscal impulse is expected to turn moderately negative in 2027.**

We expect the ECB to adopt an easing bias in H2 2027, as the prolonged energy shock, tighter financing conditions and the shift towards a contractionary fiscal impulse in 2027 suggest that economic growth will moderate from its current pace, allowing disinflation to resume. That said, the actual number of rate cuts will depend on the euro area's progress towards lower inflation and the resilience of economic growth.

PBoC – No urgency

Policymakers may see a more moderate pace of yuan appreciation as supportive of growth, reducing the immediate need for policy rate cuts. Nevertheless, the scope for monetary easing remains as long as the currency maintains its underlying strength, limiting capital outflow and depreciation risks for the PBoC. On balance, we believe that a 10bp cut in the overnight reverse repo rate — the new key policy rate — is likely by the year-end.

The first FX RRR adjustment in three years. The PBoC's 2pp increase in the foreign exchange reserve requirement ratio (FX RRR) to 6% on 3 November, effective from 15 November, is a clear tactical move to slow the yuan's recent appreciation. Viewed strictly from a foreign exchange market perspective, the intervention makes sense: a strong yuan is fundamentally at odds with both China's weak domestic economic conditions and the widening US–China interest rate differential.

In the broader macroeconomic context, however, the timing of the move is perplexing. Any boost to exports from a weaker currency is likely to be marginal, given that export growth is being driven more by the global AI boom than by exchange rate

movements. Meanwhile, slowing the yuan's appreciation risks further eroding investor appetite for yuan-denominated assets and exacerbating weakness in China's already underperforming equity market.

The implications for the PBoC's monetary policy outlook are mixed, in our view. Policymakers may see a more moderate pace of yuan appreciation as supportive of growth, reducing the immediate need for policy rate cuts. Nevertheless, the scope for monetary easing remains as long as the currency maintains its underlying strength, limiting capital outflow and depreciation risks for the PBoC. On balance, we believe that a 10-basis-point cut to the overnight reverse repo rate — the new key policy rate — is likely by year- end. Indeed, the PBOC announced changes to its open market operations (OMO) framework on 31 October, shifting its key policy rate from the seven-day to the overnight reverse repo rate, with effect from 2 November. It also announced that the overnight reverse repo rate currently stands at 1.25%, 15bp below the seven-day rate of 1.40%, confirming earlier media reports. This transition brings the PBoC's monetary policy framework more closely into line with international central banking practices, following Governor Pan Gongsheng's speech on 19 October, in which he signalled the move.

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