

No Soggy Bottoms

Trying to avoid a downturn in 2026, even a mushy one

By Chris Kuehl

IT MAY BE A BIT EARLY for the annual economist exercise of forecasting the year ahead, but nothing about this year has been normal. We are doing well if we can predict next Tuesday, much less next year. Nonetheless, there is demand to plan, and business leaders need some idea as to what is to come. It is time to trot out some scenarios.

The bad news

Let's start with the bad news option and work our way to something a bit more upbeat. There is a school of thought that holds that most of the negative developments expected in the first part of the year will arrive in the second half. There are signs of this already.

Inflation is rising despite some relief in sectors such as energy. The effects of tariffs are being felt as companies have worked through the extra inventory they loaded up on previously. The initial response to the tariff threats was expected, but they still altered a great many expectations as far as the economy was concerned.

Companies started loading up on inventory as they anticipated higher prices. That triggered a major surge in imports, which contributed to the severe slowdown in Q1 GDP. Once that buying surge ebbed, the GDP numbers returned to normal, but more important to note, the pad provided by the extra buying vanished.

Reorders will occur in the second half of the year, and these will be much more expensive, triggering inflation. Slowdowns are becoming common as businesses try to cope with all the uncertainty. That means reduced hiring and increased layoffs in addition to reductions in capital investment. After a pretty solid GDP number in Q2, the estimate for Q3 GDP growth is at 1.4%, with some asserting it will be even lower.

Two assumptions are driving this pessimistic outlook. The first is that tariff chaos will not decline and likely accelerate. The second is that consumers will react negatively to the inflation numbers and significantly reduce their holiday spending. This scenario is dominant now, with a 60% probability.

A more pleasant solution

Next up on our cavalcade of economic possibilities is the not-quite-so-bad scenario.



This one asserts that inflation due to tariffs will be mostly sectoral. There have already been many deals and changes that have reduced tariffs or at least limited them. China is actually getting the majority of these tariff breaks. High-tech and energy-related industries are getting a break, while construction gets the majority of the hits.

The nagging problem is still lack of certainty. Though consumer demand is always shifting, what makes this period different is the speed of change alongside radical variations in direction. Nobody can plan when the price of an input could surge by 50% one day and fall back the next. This is especially problematic in construction, since projects can extend for months and years.

The sectors hit by high tariffs will have little choice but to hike prices, and that is likely to cascade through the economy. In this scenario, there will be lots of caution but few immediate reactions. There will be fewer new hires, but layoffs will not accelerate. This scenario has a 25% probability, as there is an assumption that affected businesses will figure out a way to adapt (provided there is some stability eventually).

The best situation

This leaves the "unicorn scenario." This sees a stronger conclusion to the year, with GDP growth in the 2%-2.5% range. This is also based on assumptions. The first is that tariff policy settles down as most nations start to adjust to a new reality—one that will not be changing every other day. There will be

more reliance on non-tariff barriers (NTBs), as these are more stable and the United States has relied on their protection for years (73% of import restriction has been due to NTBs). The inflation threat starts to fade and rates remain around 3% rather than the predicted 4.5%. Hiring and investment returns to more normal rates as business starts to see more stability.

Lower inflation risks may also convince the Federal Reserve to start reducing rates. It is important to understand what the Fed can and can't do given all the attention focused on interest rates. Lowering rates will not automatically stimulate the economy; it is up to businesses to take advantage of the lower rates to borrow and invest. Doubt, uncertainty and concern regarding consumer mood will lead to less interest in borrowing—regardless of the rates.

Lowering rates is like pushing a string, while hiking rates is pulling that string. It's hard to get the string going in the right direction when one is pushing it. More stable trade policy may convince more companies to return production to the United States and would encourage foreign companies to build domestic facilities.

As appealing as this scenario is, the chances are considered very slim at 15%, which most think is generous. There has been no sign of tariff stability, and, without that, there is little opportunity for progress.

There you have it—an early set of prognostications. And just like in the Great British Baking Show, some luck is required to avoid a soggy bottom on our slice of the (economic) pie. ⚡

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