

Research @ Citi Podcast Episode 59: The U.S. Economy's Future — Soft Landing ... or Hard Reality?

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Transcript:

Scott Chronert (00:03)

Hi, I'm Scott Chronert, Chief U.S. Equity Strategist here at Citigroup, and with me today I have our Global Chief Economist, Nathan Sheets, and we're going to address a very big topic, the global economic outlook, with a bit of a focus on the U.S. Obviously, this is all mission-critical to the way we're thinking about the U.S. equity outlook, but I think for purposes of this particular podcast, let's keep it focused on the task at hand.

The title of your outlook note, Nathan, has to do with a Goldilocks global economy. That's an important term and a tricky term through a traditional economic lens. Tell us a little bit about how you're thinking about this, what you're referring to with this setup going into 2026.

Nathan Sheets (00:48)

Well, first, let me say it's great to be here. And I agree with you that as I was picking the title for the outlook, the word "Goldilocks" was one that I spent a fair amount of time thinking about as to whether that's really the word that I wanted to use. But I think it's the word that describes what we're expecting for the coming year for the global economy.

And that is our forecast envisions another year of global real GDP growth that's close to — but just slightly below — our estimate of trend, which is around 3%. And while inflation in the United States is somewhat above target, in most other countries around the world, inflation has come down. Global headline inflation is in the neighborhood of 2%. And in that environment, we expect central banks to be cutting rates.

And so, when we put all that together, it feels like an economy, candidly, that's not too hot and not too cold. And if it's not "just right," it's definitely somewhere in between "not too hot" and "not too cold."

Scott Chronert (01:58)

So if it's not too hot, not too cold, that's a great starting point. And quite honestly, our U.S. equity views for next year are predicated on a similar set of assumptions: soft-landing environment, a bit more-accommodative central-bank tendency.

But we do have to deal with the upsides and downsides to this down-the-middle Goldilocks approach. So what can go right from here to get us back through that 3% longer-term trend line? And what are some of the risks that you're highlighting?

Nathan Sheets (02:29)

Well, you're right to press me on the risks. And candidly, over the last few years we've been consistently too pessimistic about the outlook and have been significantly surprised on the upside. So I'm attuned to those upside risks based on my experience over the last few years, and attuned to the downside risk by the very fact that I'm an economist — and we're trained to look for everything that might go wrong.

So on the upside, the U.S. consumer, particularly the upper-income U.S. consumer, remains in a very good place, by our reckoning. Secondly, the U.S. corporate sector, as you know well, Scott, is tuned up, efficient, competitive, benefiting from the early effects of AI, highly profitable. U.S. corporates are in a strong place.

Say a third upside for the outlook relative to what we penciled in, is there should be some stimulus associated with President Trump's Big Beautiful Bill that comes through during the first half of the year. And we see that as being supportive, but not a game changer for growth. And maybe the implications for investment at the corporate level or for households as they get tax refunds will be somewhat more pronounced than we're expecting. So, there are some important upside risks.

On the downside, first and foremost, our friends at the Federal Reserve are very focused on the softening of the labor market. Our expectation is that that's not going to seriously derail growth, and growth this coming year in the U.S. will be solid. But there's risks that when the labor market starts to soften, it softens further.

We're also continuing to watch the effects of the tariffs. We had a surge in spending through the first half of 2025 in anticipation of the tariffs, and we haven't really seen the payback as a result of that. As you spend early, that means you're going to spend less later, and we haven't observed that. So maybe we get some more headwinds from tariffs.

And then you have a whole range of standard kinds of issues associated with geopolitics, with high U.S. debt levels, which is an issue that we have written about. Systemic uncertainty associated with the political gridlock that we have.

So there are a lot of things that can go right and a lot of things that can go wrong. So there's a fair amount of uncertainty around Goldilocks.

Scott Chronert (05:11)

So let's tackle this inflation issue up front before we get to some of the other glass-half-full elements of this. You and I have talked about this *ad nauseum* over the past couple of years: We thought going into the tariff regime to last spring that we would see a net positive influence on inflation in terms of higher inflation levels.

How has it played out vs. what you might have thought would have happened, let's say, back in the last April, May timeframe?

Nathan Sheets (05:44)

This, for me, has been a significant surprise. The effects of the tariffs on inflation have come through much slower than I would have expected. And to be really candid, I would have strongly thought in April that by this point we would have seen the vast preponderance of the effects of tariffs on prices.

And now, do I think we've seen half, maybe a whole lot more than that? But I think there's still some more price effects that are likely to be seen early next year. So, much slower. But in addition, I would also have to admit that the total effects on inflation have been more muted than I would have anticipated — again, maybe by a factor of a half that it's been absorbed in other places, including in the firm margins.

And we're not hearing that. This is something I know you track closely, Scott. We're not hearing it so much on the earnings calls of many of the large corporates. But we do see some at least fragmentary evidence that the SMEs — the small and medium-sized enterprises, firms of a few hundred workers — may be getting hit harder by this. But in any event, the total effects of the tariffs on prices have been more muted than I would have expected.

Scott Chronert (07:04)

So then let's take this to the next dynamic that relates, and that's Fed rate policy. And we have a house view that looks for some labor consternation and a quicker next Fed rate cut or two, vs. the market that's pricing in a couple of rate cuts for all of next year. So how do you see the Fed navigating the inflation landscape that you just identified, relative to this nagging labor issue that seems to be out there murking around in the periphery?

Nathan Sheets (07:39)

I think the unifying thought that brings together our house view, which sees these Fed cuts a little more rapidly, vs. what's being priced in the market, where the cuts are a little more gradual over the course of next year, is that there is a very high likelihood that over the course of next year — maybe it's faster, maybe it's slower — that the Fed is bringing rates back to around 3%. And that is very close to their estimate of the neutral rate. So he stamps a policy that's neither stimulative nor contractionary.

And I think the Fed desires that kind of a neutral stance because they feel like they're caught in the middle. There are really only two things in the world that Jay Powell cares about. One of those is low inflation that's close to its 2% target, and the other is a strong labor market that's generating jobs and delivers a low unemployment rate.

And what he's seeing right now — and part of this is the result of the tariffs — is inflation has persistently run above his 2% target. Indeed, the Fed has missed its inflation target now for five years in a row as of the end of 2025. So he sees inflation higher than his 2% objective. And at the same time, he sees the softening labor market. So should he cut to help the labor market, or hike to fight inflation? And he's cutting at the moment, to get back to that neutral stance where I think that he's likely to watch and wait for a while.

Scott Chronert (09:21)

So basically, what you're describing is, we've got a line of sight on the inflation condition that the Fed's going to be responding to. We're not sure we have a line of sight yet over where the labor condition takes us.

Nathan Sheets (09:33)

Very fair. Very fair.

More uncertainty on the labor market. And at the moment, when you look at the numbers in the labor market, hiring is off, but that reflects less demand for labor. It also reflects less supply of labor. But I think the Fed's main worry is not where the labor market is at the moment, but when the labor market starts to soften, it tends to keep softening and you have a problem. And so the Fed's trying to prevent that further deterioration.

So I think the way you frame that is: Is inflation going to break out on the upside? Not really. There are risks that maybe inflation expectations rise, but we do have a good line of sight there. But where the labor market has a floor at the moment, there's more uncertainty. What that ultimate ending point for the unemployment rate looks like is an open issue.

Scott Chronert (10:21)

Got it. So, in terms of a Fed objective for the listeners in terms of how we're approaching 2026 — again, you and I have talked about this as well, so this is not new news — it sure seems like given the dual mandate that the Fed needs to be sensitive to, it makes sense that you're migrating toward something akin to policy-neutral, albeit a very undefined or ill-defined policy neutral. Does that make sense?

Nathan Sheets (10:50)

I think that is exactly the way the Fed is thinking about it. And given that our main job is to figure out how the Fed's thinking about it, that's also the way we're thinking about it. And Powell, in his press conference, as he was taking rates down a little below three and a half, said, we're now in a range of neutral, but probably toward the upper part of that range. And we think that they're likely to move to the lower part of this range.

Now, let me just throw one more wrench into this discussion, Scott. I think it's critical, when we start talking about rates next year, there's one more important moving part here. And that is that in mid-May we're going to get a new Fed chair. And the discussion that we've had so far, the answers I've given, have largely assumed that that new Fed chair is going to act a lot like Jay Powell has.

I think that's a reasonable expectation. And candidly, I think that's what's been priced into the markets at the moment, both the rates market and Fed funds, futures markets and the equity market. But again, obviously, that's another source of uncertainty. So when you think about those risks for 2026, the possibility that you might get a Fed chair that has a different — and let me use a technical term — a different reaction function than Jay Powell does, and maybe is a little more open to running some risks with inflation, or is looking at different set of variables, is something we've got to think about. And there may be risks there.

Scott Chronert (12:23)

OK, so TBD on that. But it's kind of interesting. So it's another form of Goldilocks, right, where a Fed not too hawkish, not too dovish, puts us smack dab in the middle.

Nathan Sheets (12:42)

It's neutral.

Scott Chronert (12:43)

Now this is good news, bad news for me from an equity lens, because we're out there with an outlook for 2026. It entails a fairly strong rate of earnings growth, particularly relative to consensus.

Two percent GDP in the U.S., I would say, historically, wouldn't quite support my strong earnings growth outlook. So I'm looking for the upside potential that comes with a lot of this potential fiscal stimulus. But also, I'm going to pivot, right? Another discussion point that we've had for some time.

So let's talk about the role of productivity and something that you've written extensively on here, in terms of how we think about that influence relative to economic trajectories and then the Fed over here, with its uncertain path still in play right now.

Nathan Sheets (13:37)

Yeah, this is an issue we've talked about a lot. And one I think that we have, I don't think *inconsistent* views, but we have differing perspectives on.

And that is when I look at the macro economy, I don't see any strong signs of a meaningful acceleration in productivity growth. Powell mentioned that maybe there was some sign of that. I'd say that productivity is running stronger than it was before the pandemic, but that post-GFC, pre-pandemic period was the weakest productivity growth that had been recorded in 80 years.

And I think it was just a lot of ongoing headwinds in the aftermath of the Global Financial Crisis. I think you reconcile my view of “we're not seeing it” with your sense that maybe there is more there, and I shouldn't put words in your mouth, is that when I look at productivity growth for the IT sector, which is 6% of the macro economy, it's absolutely accelerating. But that IT sector, that 6% of the macro economy, is what, 35% or 40% of your indexes? And I think that that starts telling us something.

Before we get the productivity that I'm going to really see, I need to get that productivity out of the IT sector into the economy more broadly. And I just don't think that AI has really jumped those firewalls yet. I think it will over the next few years. But for the rest of the economy, I still think we're in an adoption phase.

Scott Chronert (15:19)

Got you. So that was the tech-bubble analogy that you wrote in the note, that it took two, three years of infrastructure buildup before you began to see the productivity benefits of that.

Nathan Sheets (15:31)

Yes. And that's referred to — there's a long academic literature on this — as the Productivity J-Curve. That when you get these new transformative technologies, like the internet, like the introduction of the steam engine, like electricity, you have to go through a period of building

out capital, of investment, of accumulating expertise, of developing applications, acquiring users. That all takes real time. And you need those networks in place before then finally you reach critical mass, and you get that economy-wide adoption.

Another way to put it — it's I think the way you framed it — is that AI needs to move out the value chain from just the producers, more broadly into the adopters. And that's where we're going to see the macro effects.

Scott Chronert (16:23)

Yeah, we're making a pretty big stand on that in terms of our earnings expectations. We're looking for AI to lead to, longer term, less earnings volatility, potentially more profitability metrics and so forth. But company by company, slowly but surely, as opposed to anything that you wake up one day and boom, it's happening. I think it's going to happen in a very measured pace.

But let's switch to one last topic in the remaining couple of minutes here. You mentioned J-Curve, and so we'll go back to the alphabet analogies. A lot of discussion about a K-shaped recovery. Can you speak for a moment on how you think about that issue and how it pulls together a lot of the other thoughts that you have regarding the U.S. and global circumstance?

Nathan Sheets (17:08)

I think this prism of a K-shaped economy is one that's very powerful. And I like it so much, I've actually been calling it the “K-squared” economy. Specifically, what I'm thinking of here is when I look at the household sector, I think I see a K shape, that the top 40% of the income distribution are in very good place, significant balance-sheet accumulation, enjoying the effects of rising wealth, wealth position in the labor market. They're doing well.

But the bottom 60% of the income distribution, which account for about a third of the consumption in the economy, it's more of a slog. And they are levered, and they've had problems with indebtedness. They're very dependent on the labor market — if the labor market were to crack, I think that you could have some significant problems. I think that the risks at the bottom part of the distribution are much greater.

And then, similarly, when I look at the firm sector, I think these large corporates — which are the ones that are listed, and maybe we'd call them small caps in the listed space, but I'd put them in the larger part of this case — they're strong, they're well-positioned, they're efficient, they're profitable, and they're going to benefit from AI. When I look at the small and medium-size enterprises — and I alluded to this, those 500 and less, and particularly if you go down to 50 or 75 or less — I think there's a fair amount of pain there.

An example of this is recently, as we discussed, we've seen some softening in the labor market. And when you break out where the reduction in hiring has been most pronounced, it's not amongst large firms — they're continuing to hire. It's amongst these smaller firms. And the smaller you get, the more they've been impaired.

So I think that this K concept applies to the household sector, to the consumer, it also applies to a production side of the economy and firms. And this is a great time for households and firms to be in the upper part of the distribution, but still a pretty challenging time to be in the bottom parts of the distribution.

Scott Chronert (19:22)

Nathan, thank you very much. It's been a pleasure having this conversation with you. We've run up against our allotted time. I've got to tell you, this was really insightful and informative for me.

And as a reminder for the listeners. I'm Scott Chronert, U.S. Equity Strategist at Citi. Grateful to have shared these 20 minutes with Nathan Sheets, our Global Chief Economist, and be on the lookout for this ensuing podcast and related publications going forward. Thank you very much for your time, Nathan. It's been awesome.

Nathan Sheets (19:49)

Thank you, Scott.

Scott Chronert (19:52)

This podcast was recorded on Dec. 16, 2025.

Disclaimer (19:56)

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