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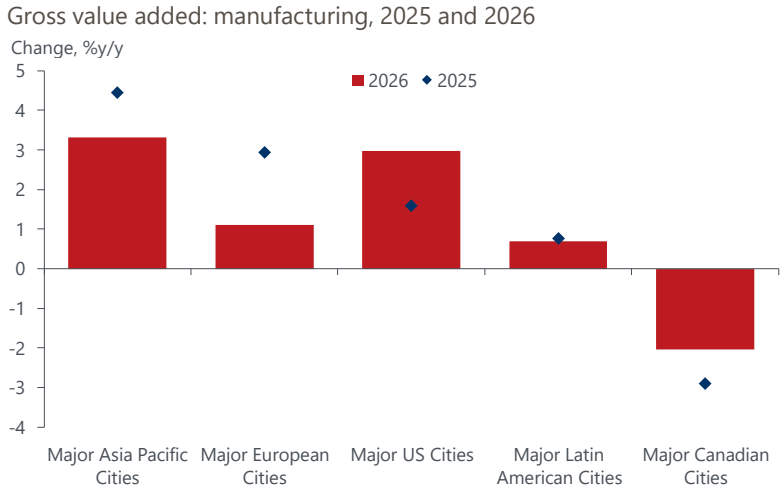
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Research Briefing | Global

Key themes for cities in 2026—growing divergence

- **The divergence in economic performance between service-oriented and industrial cities is set to continue in 2026, as trade restrictions, increasing competition in higher value-added industries, and elevated AI investment push cities onto different growth paths. Across our global services, service-oriented cities are outperforming their industrial counterparts, both within and across countries. As such, we have identified four key themes for the year ahead.**
- ***Tariff-induced downturn will drag into 2026.*** **Industrial hubs have held up better than expected. Front-loading and trade diversion softened the initial shock of tariffs, but mainly by spreading the impact over time. The result is a gradual deceleration rather than a sudden hit. This was evident in US industrial cities, as firms ran down pre-tariff inventories and adapted to higher costs, as well as in exporting regions such as China's eastern seaboard and Germany's industrial heartland, where elevated exports in the first half of the year boosted output.**
- ***China's move up the value-added chain is reorganising global trade.*** **Export-led cities in developed economies are increasingly confronting China's rise in advanced manufacturing. This is both closing off the Chinese market—previously an avenue of substantial revenue—and raising competition in their domestic markets. Alongside tariffs and higher energy costs, at least in Europe, industrial cities enter 2026 with weak fundamentals and a worrying outlook.**
- ***AI progress will not lead to widespread growth, yet.*** **Tech-heavy cities in China and the US are growing rapidly as developers race to enhance AI capabilities. Manufacturing hubs equipped to produce specialised chips and hardware—such as Hsinchu and Penang in Asia, and Eindhoven in Europe—will also post strong growth and buck wider industrial trends. For now, however, broader benefits will remain muted.**
- ***Housing will be at the centre of economic discourse.*** **In China, downward corrections in house prices look likely to continue throughout the year, having a negative impact on sentiment at a time when consumer confidence is already under strain. In Europe and North America, meanwhile, rising property prices, particularly in major cities, are exacerbating the region's affordability problem and depressing consumer spend.**

Chart 1: Industrial activity is expected to weaken as the world economy enters 2026



Source: Oxford Economics

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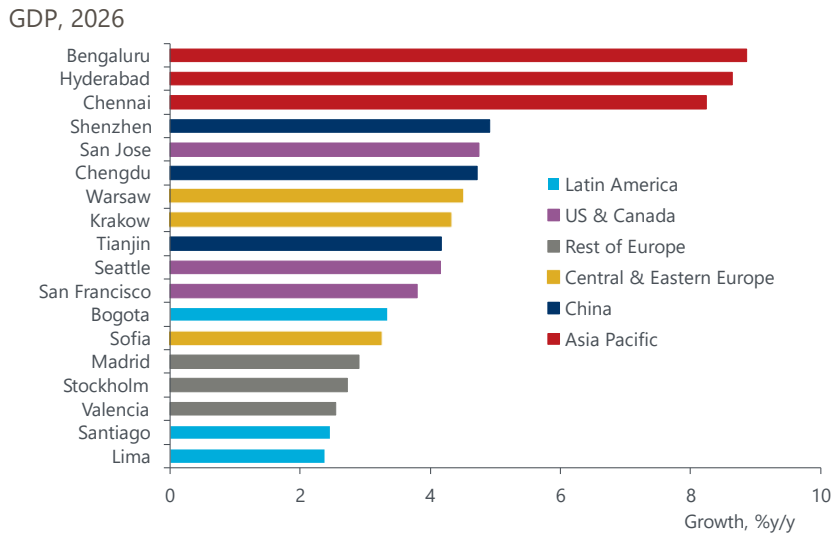
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Weaker growth prospects for industrial cities

Despite a volatile and uncertain 2025, global economic activity has held up remarkably well. However, significant downside risks persist and the factors stabilising growth—the AI boom, trade front-loading and diversion, and wide budget deficits—are unlikely to be sustainable in the long term. Our overriding outlook for 2026 is divergence, reflecting the significant pressure facing the world's industrial hubs (Chart 1) and the more limited exposure of their more service-oriented peers (Chart 2).

Our four key themes reflect this divergence and seek to explain the drivers behind the underperformance of industrial cities. And this divergence is not just confined to one part of the world, it is global. Chart 2 outlines this more clearly, highlighting the top three fastest-growing cities in a select number of countries and regions that account for the majority of global GDP. Here, it is clear that the more complex and service-dominated cities are set lead regional growth in 2026, while more industrial cities are forecast to lag.

Chart 2: Our forecasts for the top three fastest-growing major cities by region in 2026



Source: Oxford Economics

This divergence is not new, but the drivers and implications will be increasingly central to the political and economic discourse in 2026. The scale of divergence is also wider, reflecting a combination of global trends, national policy decisions, and technological change. And many of the challenges of 2025 are not going away. In fact, one of the key ones—tariffs—is set to drag into 2026.

Key theme 1: Tariff-induced downturn will drag into 2026

The spectre of tariffs continues to loom over manufacturing hubs around the world. In 2026, however, the concern moves from the uncertainty around tariff rates to uncertainty around impact. For many economies through 2025, exports appeared somewhat resilient—largely due to US import front-loading and Chinese transshipment—which helped to maintain relatively robust rates of output and employment growth. Consumer demand was also buoyant, despite the significant global uncertainty.

Europe's industrial cities are still set to bear the brunt of the tariff burden heading into 2026. The regions most dependent on US exports, such as the German industrial regions of Stuttgart, Bremen, Hamburg, and Dusseldorf, have some of the weakest growth projections among Europe's major cities. The story in Japan and South Korea is similar, where export-dependent auto and machinery hubs, such as in Nagoya and Ulsan, respectively, will see downward pressure on exports dragging down their growth potential this year.

In the US, the higher prices from tariffs will weigh on low-income households already reeling from a cooling jobs market and elevated living costs. While higher-income households are not immune from these challenges, they are much less exposed and are also far more likely to be benefitting from the stock market boom, high house prices, and the tax cuts in the One Big Beautiful Bill Act. As such, divergence will be the central dynamic, meaning metros with an elevated share of high-income households, such as the well-heeled metros on the West and East Coast, will continue to see stronger economic activity.

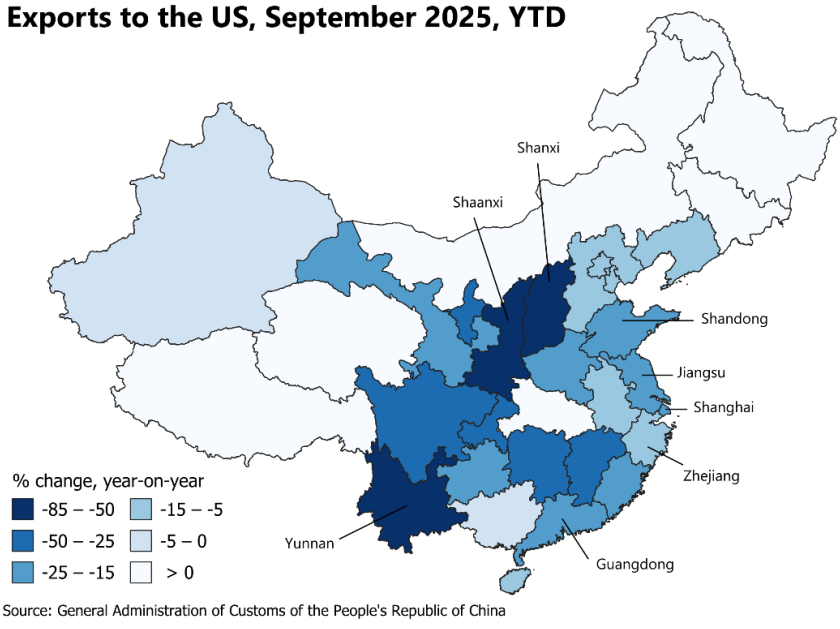
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Manufacturing-heavy metros will be hit by the double whammy of import tariffs increasing the costs of their inputs, and retaliatory efforts hampering the competitiveness of their exports. However, recent trade deals with major trading partners have lowered the US's effective tariff rate which, along with lower interest rates and positive investment incentives in the One Big Beautiful Bill Act, has gradually brightened a previously grim outlook for the country's industrial metros. There also remains a possibility that Supreme Court rulings could lower the effective tariff rate further. However, the Trump administration would likely use other sections of the trade code to levy tariffs. Therefore, it remains that we anticipate relatively weaker short-term growth for manufacturing-intensive metros than the tech-heavy metros, particularly those with significant shares of industrial activity within global and particularly Canadian supply chains, such as St. Louis, Detroit, Buffalo, and Memphis.

And crossing the border, trade tensions with the US have been particularly painful for the Canadian regions of Ontario and Quebec, which are under pressure from steel tariffs. After the Canadian economy avoided a technical recession in 2025, we expect it will struggle to grow in 2026, with manufacturing across its major metros looking set to contract for the fourth year in a row. The USMCA renegotiation will be one of the most important trade events this year for both US and Canadian metros, plus Mexico's industrial border states.

The greatest uncertainty last year was in China. Yet, despite this and the extraordinary tariff tit-for-tat, the performance of China's east coast manufacturing centres has been remarkably resilient. This is certainly not thanks to US importers, as orders have declined considerably (Chart 3), but rather reflects trade diversion and export-led investment. While tariffs will continue to put downward pressure on activity in 2026, the narrowing of tariff rates between China and other Asian economies will offer significant respite.

Chart 3: As a result of tariffs, direct exports to the US have declined across most of China's provinces



Source: General Administration of Customs of the People's Republic of China

Key theme 2: China's move up the value-added chain is reorganising global trade

An additional aspect of China's resilience is its ongoing ascent up the value-added chain. Once the world's factory for lower-value consumer goods, China's manufacturing sector is increasingly resembling those of advanced nations in terms of its products and export composition. China's manufacturing growth push is evidenced by its latest Five-Year Plan, which highlights policymakers' ambitions for advanced manufacturing to be the backbone of the economy alongside "self-reliance in science and technology". Capacity in advanced manufactures such as capital goods, semiconductors, clean vehicles, and green

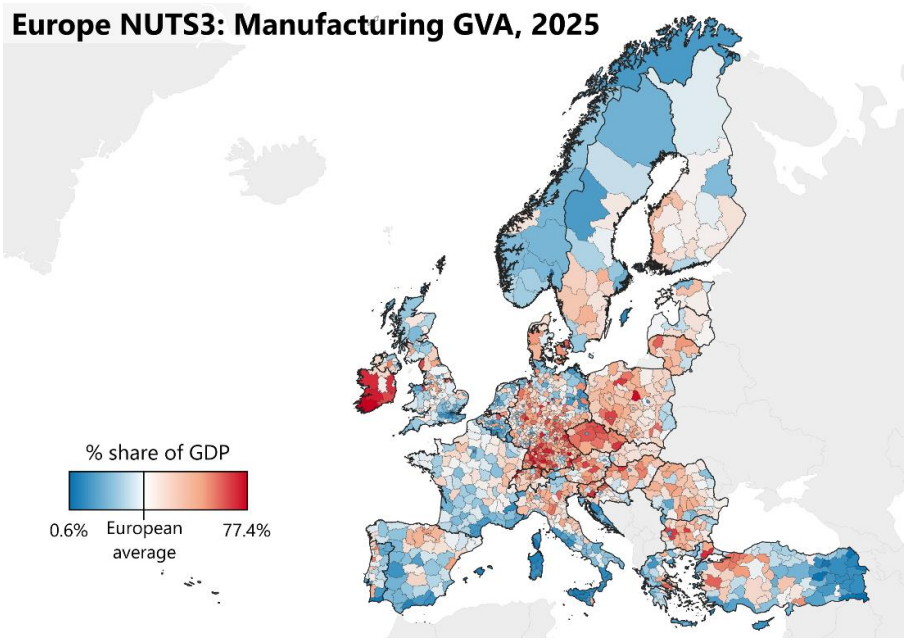
technology have exploded in recent years, and alongside tariff resilience has helped boost China's trade surplus in goods to a record $1trillion in the first 11 months of 2025.

And this growth has reached most areas of the country, with almost all provinces now recording output of semiconductors, when only a handful had the technical capability 10 years ago. It has created global leaders in electric vehicles, optics, robotics and automation, including Shenzhen, Wuhan, Hefei, and Hangzhou—each of which are forecast to lead Chinese city growth in 2026. Yet not all cities have managed to diversify; Guangzhou's auto industry, for example, remains largely geared towards conventional fuel vehicles and industrial growth has notably lagged more diversified cities in recent years.

China's manufacturing sector is now increasingly in competition with advanced nations, both in terms of exporting to the global marketplaces and meeting the needs of China's own domestic market. Rather than importing capital goods from advanced economies to drive its industrial expansion, and buying their cars with the spoils, China is increasingly producing both itself.

This reorganisation of the global trade hierarchy is creating a particular challenge for the auto and machinery hubs in Japan, as well as manufacturing-intensive regions in Europe (Chart 4), as China was previously a major revenue market. This is compounding the impact of US tariffs on these markets, and in Europe, adds yet another layer of downward pressure on growth to go alongside high energy prices.

Chart 4: Europe's manufacturing-intensive regions are largely concentrated in southern Germany, northern Italy, and eastern Europe



Source: Eurostat, Oxford Economics

For European cities, the combination of China's ascent up value chains, elevated tariff rates on exports to the US, and very high energy prices is seriously undermining competitiveness and output in industrial hubs. The chemicals industry is just one example of a sector that has declined significantly in recent years and seen firms move operations to China. Weak recent growth rates in Antwerp, with its large chemicals industry, is testament to the regional implications of this. But it is broader than one sector. Similar trends are noticeable in Europe's auto industry—once the bellwether of regional economic performance—with low growth across key auto regions reflecting a number of factors, including a gradual move in business activity to China to take advantage of lower costs and better EV technology. While higher defence spending will provide some upside, we do not expect this to be significant until 2027.

On the flip side, China's move up the value chain and strong focus on advanced manufacturing provides opportunities for cities with activities in services and more basic manufacturing, particularly in South and Southeast Asia. This is adding impetus to the China Plus One supply chain diversification strategy, under which global corporate manufacturers mitigate China's higher geopolitical risks and rising cost base for low-margin products by increasing production capacities in emerging-market cities. Cities poised to benefit

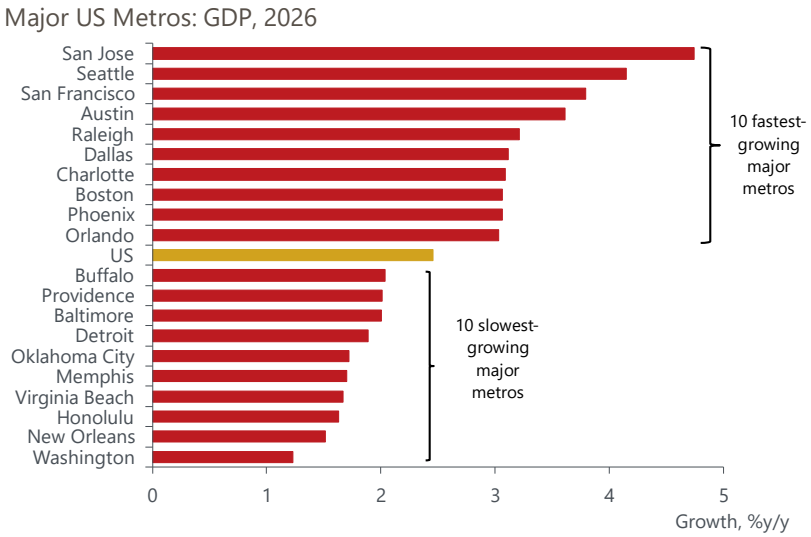
include Ha Noi and Ho Chi Minh in Vietnam, where workers and skills are abundant and typically available at lower cost. Although it is worth pointing out that tariffs generally remain a headwind here as much as anywhere else.

Key theme 3: AI progress will not lead to widespread growth, yet

Many leading Asian regions will increasingly benefit from the global boom in artificial intelligence (AI), particularly within the supply chain. A case in point is Taiwan, where the semiconductor industry, predominantly based at the Hsinchu Science Park south of Taipei, is one of the few capable of producing the cutting-edge chips required to meet AI's computing demands. Hence, extraordinary appetite for the most advanced chips has supercharged output growth of the island's advanced manufacturing hubs over the past year—with momentum set to carry through to 2026. A small handful of other Asian cities and regions in the semiconductor supply chain include Gyeonggi-do, south of Seoul in South Korea, and Penang in Malaysia.

Overall, global growth from AI this year will be highly concentrated in specific cities, particularly those at the centre of software development. The current momentum is concentrated in Silicon Valley in the United States, with competition emerging from China's tech cities of Hangzhou (the home of DeepSeek) and Shenzhen. Within these countries, the divergence in growth potential between the tech regions and the manufacturing-intensive hubs is stark. Particularly so in the US, where we expect the pace of GDP growth in the West Coast metros of San Jose, Seattle, and San Francisco, to vastly outpace those cities with more legacy manufacturing (Chart 5). The key risk, however, is that the current AI-driven jobless expansion in these metros transforms into a broader job recession, leaving the economy vulnerable to shocks.

Chart 5: Tech-heavy metros will lead US growth in 2026



Source: Oxford Economics

Unlike in the US and China, we expect the AI-investment boom this year to largely bypass Europe. This is primarily due to the concentration of investment activity among a small handful of US-based technology firms, but there are also risks around future expansion given high energy prices and the energy-intensive nature of developments. One specific industrial city bucking wider trends and riding the wave of AI development is the Dutch city of Eindhoven. As the base of ASML, a company producing the machines used to manufacture semiconductors, the city has strong near-term growth prospects.

Nevertheless, like in most other regions of the world, it remains the case that European cities with more activity in high-productivity sectors, such as IT, finance, and professional services, will lead the pace of urban growth. Central and Eastern European cities such as Warsaw, Prague, Budapest, and Bucharest, backed by their burgeoning ICT and business services, enter 2026 with the fastest growth potential alongside other large, service-oriented cities such as Stockholm and Madrid. These cities are also well-positioned to benefit from AI development, as they can harness advances in AI capabilities to boost productivity in key services.

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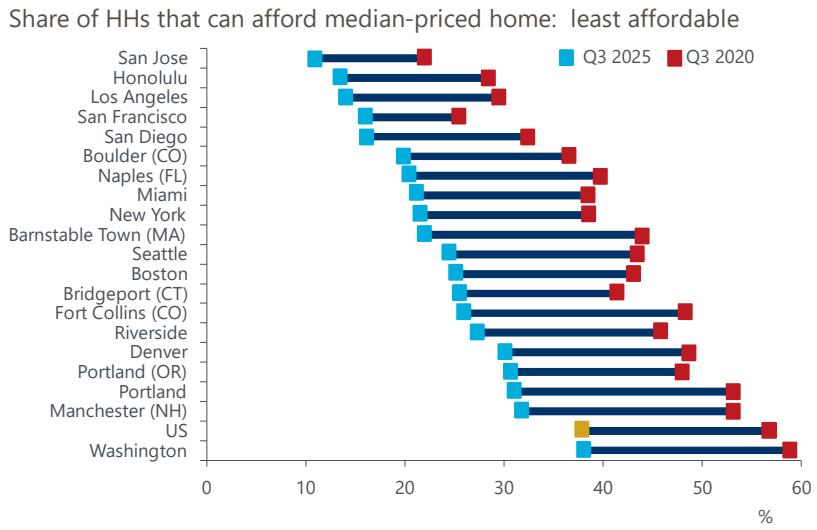
Key theme 4: Housing will be at the centre of economic discourse

However, the stronger performance of service-oriented cities does not mean they are not facing challenges. Housing is the key one, and in 2026, it will be at the centre of the narrative around affordability, economic growth, and fairness. Already, it has climbed to the top of the agenda in both North America and Europe and is becoming an increasingly relevant challenge in emerging global cities such as Dubai and Riyadh.

In the US, the high cost of living will remain a central economic and political challenge. Tariffs, stricter immigration policies, rising health insurance premiums, and resilient consumer demand will all continue to push prices upward. Elevated housing costs are a major part of this pressure. They were a key factor in the recent election of Zohran Mamdani in New York—an outcome that will place housing even more firmly at the centre of policy debate. The economic consequences are also significant. Expensive housing reduces labour mobility by preventing skilled workers from moving to where the most productive jobs are, raises operating costs for businesses, and weakens consumer spending.

The scale of the housing affordability challenge is borne out in our recent analysis, showing how only 38% of US households earn the necessary amount to afford a home, down from 57% five years ago. Rising house prices have been compounded by significant increases in mortgage rates, property taxes, and home insurance, pushing home ownership beyond the reach of many. And while housing affordability issues are now broad-based, with many previously affordable metros seeing significant housing affordability declines, there is a particularly acute challenge in the fastest-growing and most prosperous metros (Chart 6).

Chart 6: The dynamic West and East Coast metros have significant affordability constraints



Source: Oxford Economics/Nat. Assn. of Realtors/Census Bureau/Nat. Assn of Ins. Comm./FHLMC

The US is not alone in facing this challenge. Europe has seen a significant worsening in housing affordability, particularly within major cities and tourism hotspots, and a lack of affordable housing consistently comes out as top of the immediate challenges facing residents. The current policy response has been to implement or expand rent controls and affordable housing targets. Yet, this may prove counterproductive given that it raises costs to developers and could reduce housing supply, particularly in the rental market. Our view is that rising house and rental prices still have some distance to run, although the cities with the most challenging affordability rates—London, Paris, Zurich, Amsterdam—may be less exposed to these dynamics, given that they are already highly unaffordable.

China is also facing a major housing challenge, though the dynamics differ sharply from those in the US and Europe. Here, falling house prices are the problem. Official data for October show that prices for existing residential properties declined in all 70 surveyed cities—marking the 22nd consecutive month in which not a single city recorded year-on-year price growth. The steepest declines are concentrated in lower-income cities, where the pressures on local economies are most acute. The overall outlook remains weak. Trade uncertainty, adverse demographic trends, and persistently negative price expectations continue to erode market confidence, reinforcing a self-perpetuating downward cycle.

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