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Weekly Investment Commentary

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The Macro Environment

2025 was faced with an onslaught of tariff announcements, new immigration policies, DOGE cuts, and the so-called One Big Beautiful Bill. The economic outlook shifted at many points, but the anticipation of these policies likely outweighed their actual impact. That said, some effects will still carry over into 2026.

There remain concerns about the U.S. economic outlook following the slowdown in payroll growth in recent months and anecdotal signs of stress in U.S. credit markets. Most economic indexes show growth holding at a steady pace, a trend matched by private sector retail sales data. The combination of healthy financial conditions among households and corporations, combined with supportive fiscal and monetary policies, should enable the U.S. economy to continue to expand at a healthy rate in the year ahead.

Key indicators are consistent with late-cycle economic conditions that argue for greater investment caution than the near-term economic and policy outlooks imply, especially since equities and credit are expensive by historical standards. The G7 unemployment rate, which typically declines steadily during an economic expansion, is already historically low, implying constrained labor supply for future economic growth. At the same time, corporate return on equity, which typically rises during an economic expansion, is already historically high, suggesting that the best of the profit cycle is in the past, while there is increasing downside risk were economic conditions to weaken.

The absence of U.S. government data has complicated the current global economic outlook, but recent data signal ongoing growth, albeit with a question mark over hiring. The global composite PMI is in moderate expansion mode, with services growing solidly and manufacturing having crawled into positive territory after three years of weakness. Global 12-month forward earnings are expanding at a solid pace. Global exports are also increasing, despite the drag from higher U.S. tariffs. Expanding global trade is especially noteworthy, as it typically coincides with broadening global growth, which, in turn, would add to economic resilience.

2026 will likely be supported by several decent tailwinds that should boost the economy: net stimulus from the OBBB, fading tariff uncertainty, easing financial conditions, foreign direct investment, and potential tariff refunds. It should be another interesting year for the Fed, with a new chair stepping in and the policy rate nearing the neutral estimate. As always, the consumer picture will be key. Similar to 2025, AI capex should be a continued support for growth. We anticipate real growth of 2-2.5% and inflation close to 3%. The global economy has proven to be more resilient in the past few years than many expected, buoyed by hyper-accommodative monetary and fiscal policies during the pandemic and still accommodative policies to date.

Several other key forces will shape global economic growth in the next decade:

1. A structural downshift in China.
2. The end of the drag from U.S. and euro area private-sector deleveraging.
3. Deglobalization
4. Elevated government debt
5. Artificial intelligence

We expect inflation in the next decade to be well above central bank targets, with risks to the upside. An expected weaker U.S. dollar will also contribute to higher U.S. inflation in the years ahead.

The AI theme is in full-blown extrapolation mode. Elevated equity valuations and tight credit spreads indicate that investors expect an optimistic future for the corporate sector. Gold, cryptocurrencies, and private credit have been floating on buoyant global liquidity. Even safe-haven bonds have produced solid returns this year, with investors confident that inflation will stay tame and the Fed will reduce interest rates substantially in the year ahead. Capital markets appear priced for permanent perfection. Such conditions cannot last indefinitely.

The Fed

Financial conditions remain easy, with projected nominal one-year-forward policy rates for the Fed and the ECB near zero in real terms, indicating that monetary policy in both regions is accommodative. There is little risk that the Fed will threaten the U.S. economic outlook, but the 80 basis points (bps) of rate cuts expected over the next year are inconsistent with underlying economic conditions and above target inflation.

Both bond and equity bulls are prone to disappointment if the Fed underdelivers, as we expect will be the case. Indeed, the re-rating of equities and credit that has occurred over the past three years has likely run its course, again implying lower total return potential over the next six to 12 months.

The challenges of valuation

Current investor exuberance discounts a very optimistic outlook that portends subpar investment returns in the coming decade. Global equities and corporate credit are expensive and already discount an optimistic outlook for economic growth and corporate profits. Meanwhile, high-flying gold and, until recently, cryptocurrencies, are riding a wave of easy money and skepticism about fiat currencies that are inconsistent with bond pricing. Investor expectations also partly rest on the extraordinary and unrepeatable capital market performances of the past four-plus decades. The strong returns of most assets since the early 1980s coincided with a huge and persistent decline in interest rates (despite the rise since the pandemic). The associated re-rating of equities, bonds, real estate, etc., is much more likely to at least partially reverse than continue in the next decade.

We expect U.S. equities to deliver low real returns over the next decade. Equities elsewhere will likely fare better. Bonds will generally contribute modest positive real returns, albeit far below the norms of the decade prior to the start of the Fed rate-hiking cycle in 2022. By extension, balanced portfolios will also deliver lower real returns than in the past few decades.

Fixed income

We expect G7 long-term bond yields to rise over the next six to 12 months, translating into poor or negative overall G7 bond total returns. G7 10-year government bond yields have edged lower over the past few months, primarily reflecting investor expectations of lower central bank policy rates, and a modest decline in long-term inflation compensation. We continue to recommend caution toward government bonds, expecting yields to creep higher over the next six to 12 months against a backdrop of sturdy global growth, lingering concerns about inflation, and rising term premia, given poor G7 fiscal fundamentals and uncertainty about the upcoming change in Fed leadership.

Equities

Global equities have tailwinds, but already rich valuations and elevated earnings should limit the upside in absolute terms and imply significant downside risks if earnings disappoint. The U.S. equity valuation premium relative to the rest of the world has narrowed recently, even as the U.S. earnings advantage has been sustained. That said, the valuation premium remains very large and likely to diminish further if the economic and earnings growth gaps between the U.S. and rest of the world narrow in the year ahead.

Most important near-term issues

1. Fed cuts/inflation
2. Job market/consumer spending
3. AI capital expenditure cycle (equity → debt financing)

Key risks

1. A significant rise in U.S. government bond yields.
2. AI order cancellations.
3. Renewed U.S. policy uncertainty.

Conclusions

- Asset prices reflect undue complacency about the outlook, despite a typically supportive economic growth and policy backdrop.
- The Fed is unlikely to deliver on investor expectations of meaningful interest rate cuts in the year ahead, which, combined with a likely rise in inflation expectations, will contribute to upward pressure on the U.S. and G7 government bond yields.
- Earnings are a tailwind for stocks, but returns are constrained by high valuations.