NAVIGATING 2026: POLICY TAILWINDS, AI INFLECTION AND QUALITY IN FOCUS

EXECUTIVE SUMMARY

- The investment landscape for 2026 will be complex, with Artificial Intelligence (AI) continuing as a dominant theme. Policy shifts in the US, Europe, and China are expected to support global growth.

- The US is moving towards a more supportive policy environment, with anticipated interest rate cuts and fiscal stimulus likely to underpin consumer and business confidence, despite ongoing economic vulnerability following a year of heightened uncertainty.

- European growth is showing early signs of a cyclical upswing, led by declining inflation, supportive fiscal measures (including defence spending), and an improved energy outlook, though structural challenges persist.

- China's growth resilience is under pressure from slowing domestic demand and persistent deflation, increasing the likelihood of further stimulus.

- The AI sector has reached an inflection point, with investors scrutinising the potential returns on infrastructure investment by technology giants. Market leadership is expected to shift from capital-intensive enablers to broad-based adopters of AI, making selectivity and an active management approach essential.

- Quality companies - those with robust profitability, consistent earnings, and prudent financial management - are attractive, especially as valuations are compelling relative to historic norms and the broader market.

- Recent geopolitical events, notably the US-led regime change in Venezuela, alongside ongoing credit market risks, highlight the necessity of maintaining diversified and defensively oriented portfolios to manage unexpected market disruptions.

- Asset class views for 2026 favour equities, particularly high-quality firms benefitting from AI-driven productivity, while fixed income markets are supported by declining yields amid monetary easing.

- Whilst the US dollar remains structurally dominant, global diversification—including exposure to Europe, Asia, Emerging Markets, and gold—is emphasised to manage risks and capture broader opportunities in a volatile environment.

INTRODUCTION

The early 2026 investment landscape is defined by complexity and disruption, with developments in Artificial Intelligence (AI) set to dominate market sentiment once again. Early cycle policies, such as interest rate cuts and fiscal stimulus, are combining with elevated investor sentiment and accelerating capital expenditure, features typical of a mature business cycle phase. Geopolitics is expected to remain a source of uncertainty, as US military operations in Venezuela set the stage for wider escalation and tension. Navigating this environment requires a disciplined, flexible, and forward-looking approach.

US policy is becoming more accommodative as fiscal stimulus and Federal Reserve easing filter through the economy, while Europe shows early signs of recovery after years of weak sentiment. Potential Chinese stimulus adds another tailwind, supporting a constructive global growth outlook. However, after three years of strong equity gains *(chart 1[1])*, selectivity is crucial. US markets remain highly concentrated around AI leadership, with lofty earnings expectations leaving little room for disappointment.

Chart 1: US Equities Have Led Markets Higher Over The Past Three Years

Our 2026 outlook retains a constructive stance, with supportive policy expected to sustain the market cycle. Following a period of impressive equity momentum since last April's tariff-led volatility, led primarily by high-growth AI stocks, our strategy reflects an expected resurgence of performance for quality companies this year. The next phase of AI development is poised to reward businesses that integrate new technology to drive competitive advantage and profitability, while capital-intensive 'enablers', such as semiconductor designers and model developers, face mounting competition and heightened investor scrutiny. As this shifting AI landscape collides with policy gyrations and heightened investor expectations, market volatility is likely to return, demanding an actively managed and flexible approach.

This year's Annual Investment Outlook examines these themes in depth, concluding with our core asset class views and potential market risks that reinforce the importance of a well-diversified multi-asset approach.

[1] *Source: Bloomberg, USD, December 2025*

Global Growth Supported: Policy Tailwinds Prolong Cycle

US: Politics in the Driving Seat

After three years of robust post-pandemic growth, the US economy softened last year, shaping policy priorities in this mid-term election year. Affluent households continue to benefit from the wealth effects of sustained equity gains, amplified by significant AI-driven capital investment. In contrast, lower and middle-income groups remain exposed to slower hiring and high borrowing costs. Recent labour market data for October and November, during the government shutdown, revealed that private sector employment growth is close to zero, lifting the unemployment rate (chart 2[2]). For investors, this 'K-shaped' dynamic is critical - if employment continues to weaken and financing conditions remain restrictive, the slowdown could tip into recession, weighing on corporate earnings and equity returns.

Chart 2: Weakening US Jobs Market Supports Interest Rate Cuts
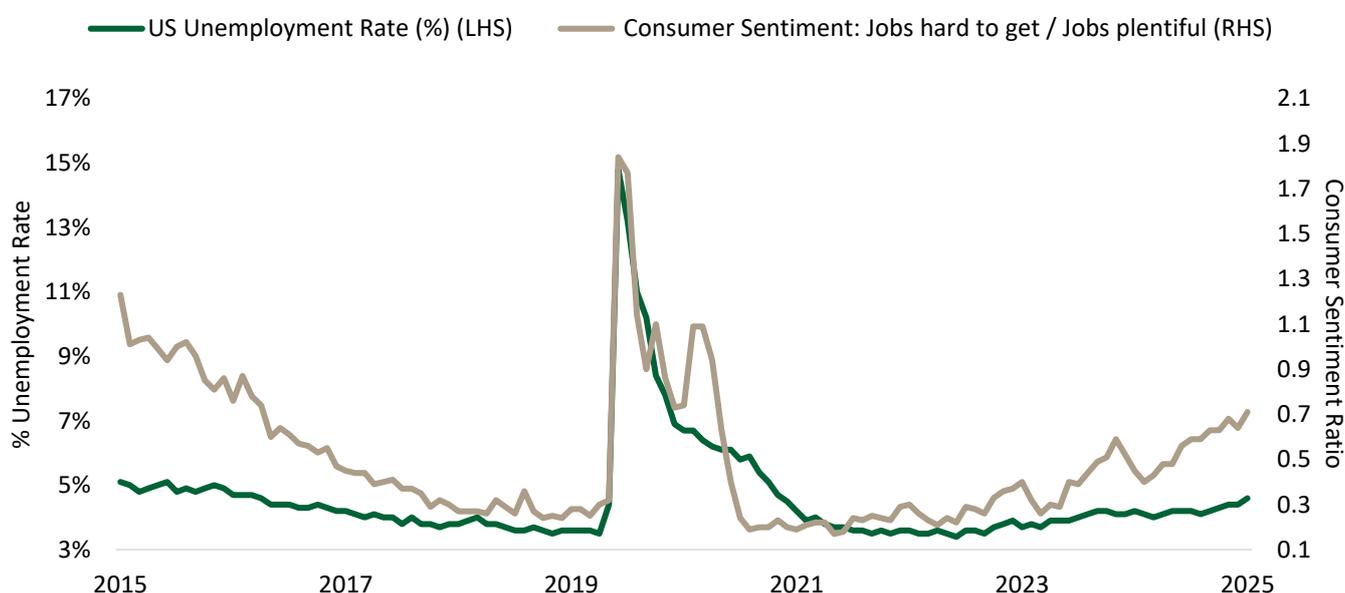
Growth and affordability will therefore dominate the political agenda as mid-term elections approach. After a year focused on protectionist measures, President Trump faces weak approval ratings on economic stewardship *(charts 3 & 4[3])*, prompting a pivot toward pro-growth policies and an attempt to restore confidence. The administration will be aware that pursuing a trade war is damaging their popularity with voters, making them more likely to strike deals and reduce tariffs in the coming months.

> Having faced policy headwinds from tariffs, elevated rates and a government shutdown, consumers face a more supportive environment in 2026.

In particular, the Federal Reserve is set to continue cutting interest rates, a move consistent with weakening labour markets and declining inflation. Earlier fears of a second inflation wave, fuelled by tariffs and rising wages, have proven unfounded. Inflation has slowed as consumer spending moderated, oil prices declined, and the housing market weakened under restrictive interest rates. These dynamics have driven rental inflation lower - a meaningful component of household spending. As Goldman Sachs Global Research argues, "*shelter inflation is set to sustainably undershoot its pre-pandemic pace… the official core PCE inflation rate inclusive of tariff effects is likely to reach 2.2% by the end of 2026.*" This reinforces our view that price pressures are easing rather than reaccelerating.

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[2] *Source: Bloomberg, November 2025*
[3] *Source: Bloomberg, Polymarket, Pew Research Centre, December 2025*

President Trump Will Focus on Pro-Growth Measures

Chart 3: 2026 Midterms: Probability of Republican House Control
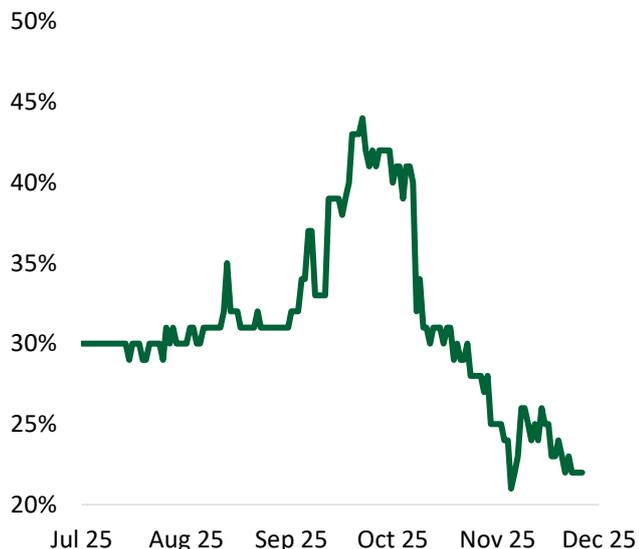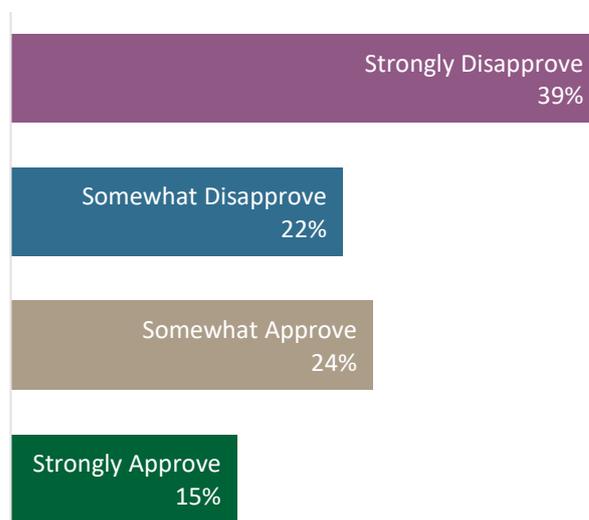
Chart 4: Survey Approval of Trump Tariffs

Beyond the economic case for rate cuts, the political dimension is also important. By mid-year, a change is due in Federal Reserve leadership, with the new chair likely more sympathetic to President Trump's calls for lower rates. This shift, combined with a backdrop of disinflation and subdued growth, points toward a continued period of monetary easing.

Fiscal policy is also expected to become more supportive this year. Last year's 'One Big Beautiful Bill Act' introduced consumer-focused measures, including federal tax refunds projected to rise by $150 billion in 2026 *(see chart 5[4])* - around 0.5% of GDP.

Chart 5: Federal Tax Refunds Will Support Consumer Sentiment

Federal Tax Refunds (USD billions)

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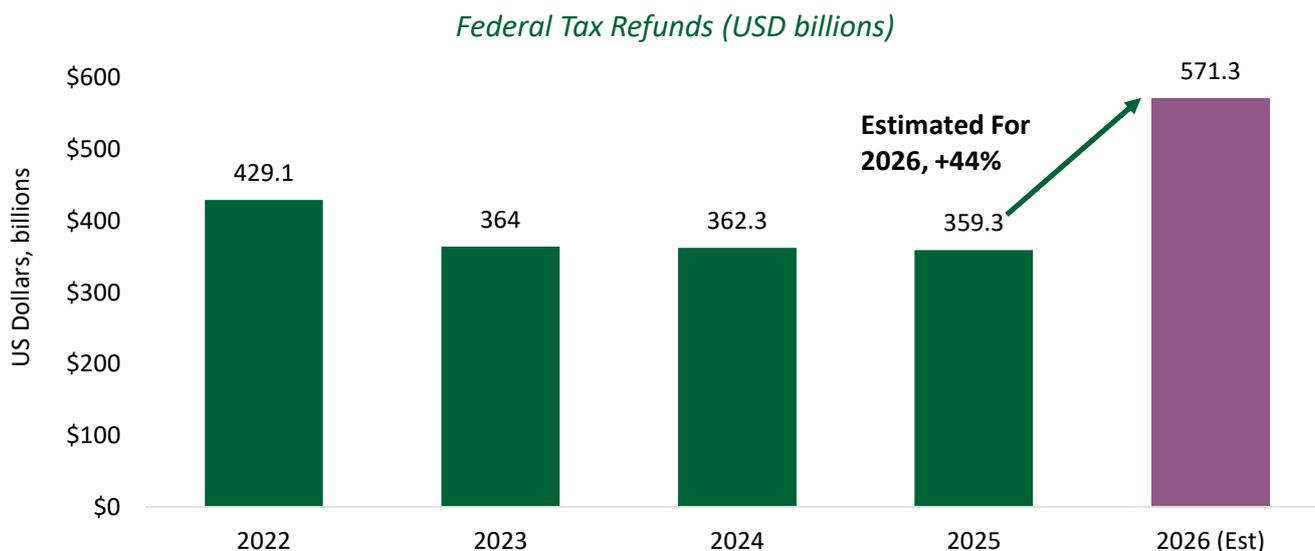
[4] *Source: Strategas Research Partners, November 2025*

The administration is also exploring ways to stimulate the housing market, with options such as portable mortgages and lower deposits for first-time buyers under consideration. According to Kevin Hassett, National Economic Council director and leading candidate for Federal Reserve chair, "*we have a big list of housing ideas that have been vetted very carefully by the cabinet secretaries to present to the president[5]."* Furthermore, revisions to business expensing and depreciation rules are expected to deliver over $230 billion in corporate tax relief, primarily through incentives for R&D, property investment, and capital expenditure.

Bottom line: US growth slowed as equities surged in 2025, leaving the economy in an imbalanced and vulnerable position. Yet the policy backdrop is turning notably more supportive after a year of tariffs, shutdown and restrictive rates. Consumers and businesses are set to benefit from a wave of tax reliefs and reduced borrowing costs, which stands to reinvigorate the business cycle in 2026 and support earnings growth. Whilst we will be watching these developments closely, the backdrop for US equities remains constructive for long term investors.

Europe: Cyclical Upswing Supports Growth

There are many reasons to doubt Europe's ability to deliver sustained growth leadership, following years of structural underperformance. Persistent headwinds, ranging from unfavourable demographics and political uncertainty to US tariffs and competition from Chinese imports, continue to weigh on growth potential. Many years of reform and economic rebalancing are required to drive European competitiveness higher once again.

Yet signs of a legitimate cyclical recovery are emerging. Inflation has returned to target and the economy appears to have achieved a soft landing *(chart 6[6])*. In the second half of last year, an encouraging acceleration in capital investment and domestic demand suggests continued growth momentum for early this year.

Chart 6: Low Inflation and Interest Rate Backdrop Supports European Recovery
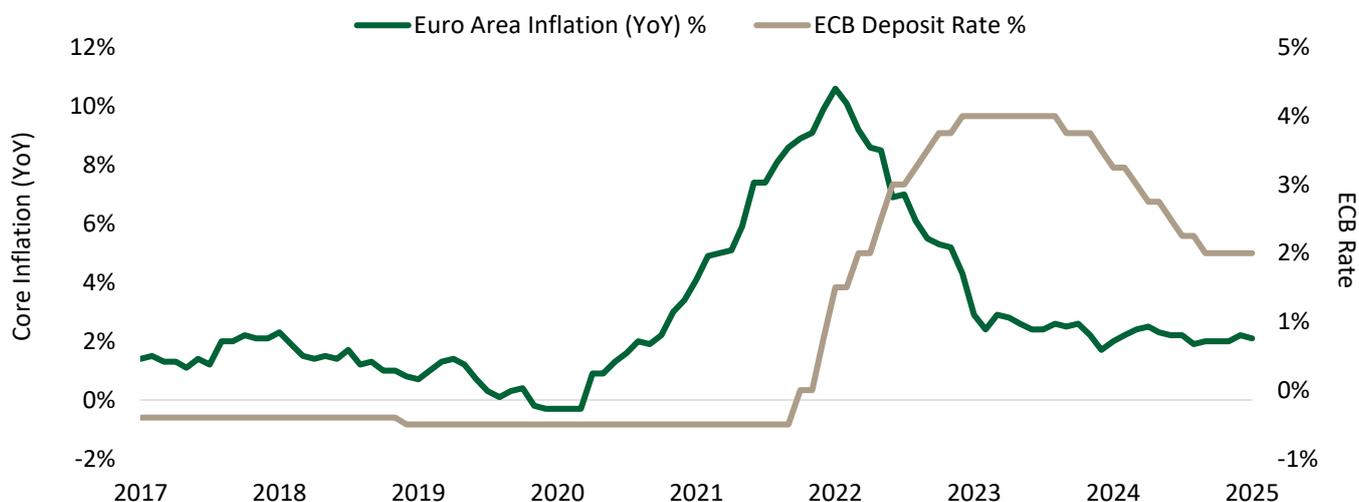
In addition, the prospect of a Russia-Ukraine ceasefire has gained traction, reducing risks to energy security and trade flows. Lower energy costs, supported by ample Liquefied Natural Gas supply from the US, should ease pressure on households and corporates, improving real income dynamics and competitiveness across the region.
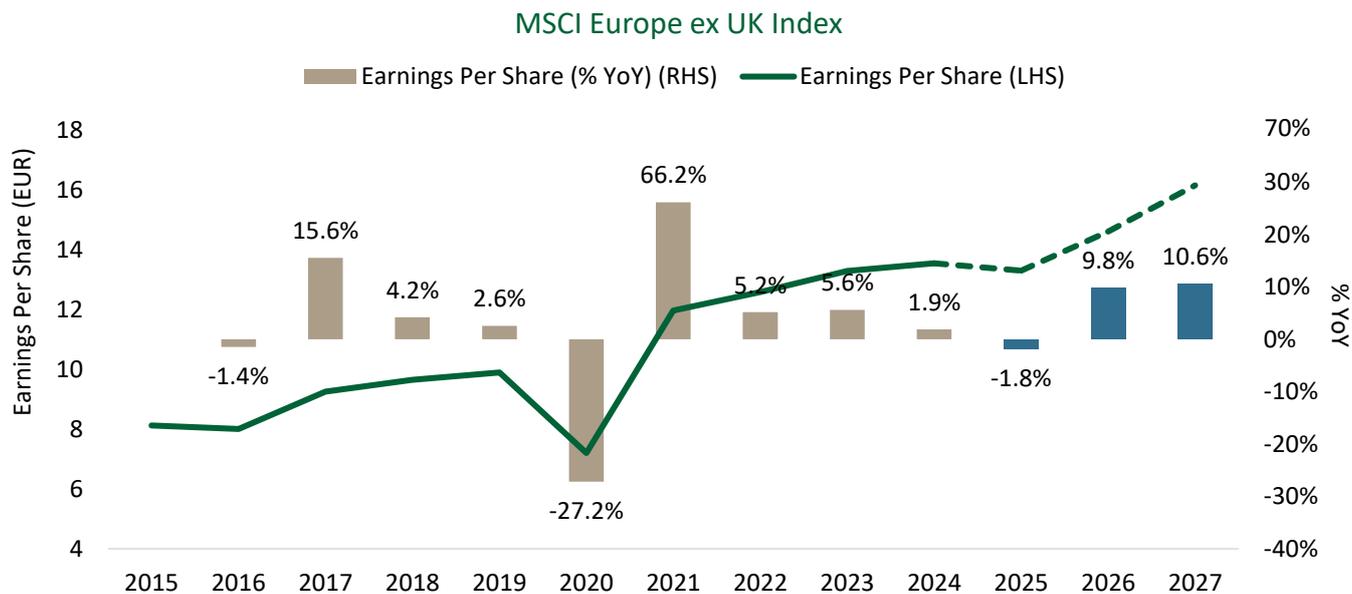
Fiscal policy is also beginning to play a more supportive role. Implementation of previously announced stimulus focused on infrastructure, defence, digitalisation, and industrial competitiveness is finally gaining momentum. This should help offset structural drags and reinforce domestic demand, particularly in economies like Germany and Italy where public investment has lagged in recent years.

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[5] *Source: Barrons, Fox News Sunday, Strategas Research Partners, December 2025*
[6] *Source: Factset, November 2025*

Chart 7: European Earnings Growth Expected to Accelerate

MSCI Europe ex UK Index

Earnings Per Share (% YoY) (RHS) ▬▬ Earnings Per Share (LHS)

-1.4%
15.6%
4.2%
2.6%
-27.2%
66.2%
5.2%
5.6%
1.9%
-1.8%
9.8%
10.6%

Bottom line: Despite lingering structural challenges, Europe is poised to play a more meaningful role in global growth this year. Whilst earnings have been stagnant for two years, cyclical tailwinds, improving energy dynamics, and a calmer geopolitical backdrop underpin forecasts for 9.8% earnings growth in 2026 *(chart 7[7])*. We aim to capture these opportunities through our global equity managers.

China: Stimulus Pressure Builds

China's economy proved more resilient than expected in early 2025, buoyed by front-loaded US imports, expansion into non-US markets, and fiscal support. Bloomberg's December survey places full-year GDP growth at 4.9%, a respectable outcome given global headwinds. However, momentum faded sharply toward year-end as oversupply and anti-involution measures weighed on activity.

Chart 8: Contracting Chinese Investment Will Add Pressure for Stimulus Package

▬▬ Fixed Asset Investment (%, year to date, YoY)

-2.6%

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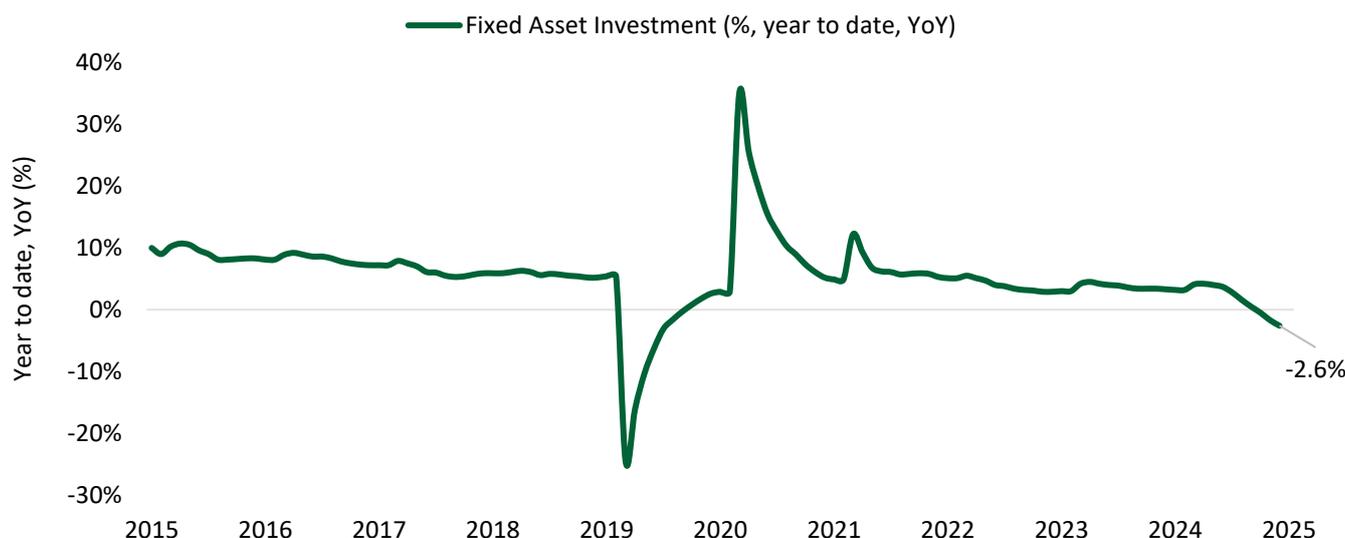
[7] *Source: Bloomberg, December 2025.*

Recent data underscore the slowdown: November and December saw steep declines in retail sales and fixed-asset investment *(chart 8[8])*, signalling persistent weakness in domestic demand. While industrial production remains supported by strong exports, particularly AI-related components, growth continues to be production-driven rather than consumption-led. This imbalance has sustained deflationary pressures.

Bottom line: Pressure is building for more decisive stimulus to revive consumption. Policymakers face persistent deflation and mounting challenges to the export-led growth model, compounded by US tariffs and signs of EU trade controls. After a strong year for Chinese and broader Emerging Market assets, we remain cautious on their continued resilience, favouring developed markets within our global equity portfolios. We continue to monitor for opportunities to increase exposure should a more forceful pivot towards consumer-led reflation materialise.

AI: An Inflection Point

Our *October Investment Outlook* examined the surge in AI-related capital expenditure, with US tech giants guiding toward roughly $500 billion in infrastructure and AI investment this year. Whilst signs of a systemic bubble remain limited, sharp corrections in valuation and growth expectations among leading AI players are possible, making a measured approach to this explosive growth trend essential.

Market developments in recent months have underscored our outlook that AI is at an inflection point, as investor sentiment rotates from 'enablers' to 'adopters'.

The AI narrative to date has largely centred on companies producing AI-critical infrastructure and powering models and applications. Since the launch of ChatGPT in 2022 — OpenAI's Large Language Model (LLM) — major tech firms have experienced surging share prices on announcements of expanded capital spending. With hundreds of billions of Dollars flowing into data centre construction and maintenance, US technology firms such as Alphabet, Microsoft, Meta, and Amazon are racing to secure market share, while Nvidia has enjoyed extraordinary revenue and stock appreciation as the leading supplier of AI-critical semiconductors.

Recently, however, investor sentiment has grown more cautious. The financing backdrop is shifting, with greater reliance on debt and signs of speculative excess. Oracle, for instance, issued a record $18 billion in bonds in September to fund aggressive AI capex, making it the largest non-financial investment-grade issuer. CoreWeave, an emerging AI infrastructure player partly owned by Nvidia, has also taken on significant leverage, raising questions about long-term sustainability.

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[8] *Source: Bloomberg, November 2025*

Chart 9: Highly leveraged AI players have lately been punished by discerning investors
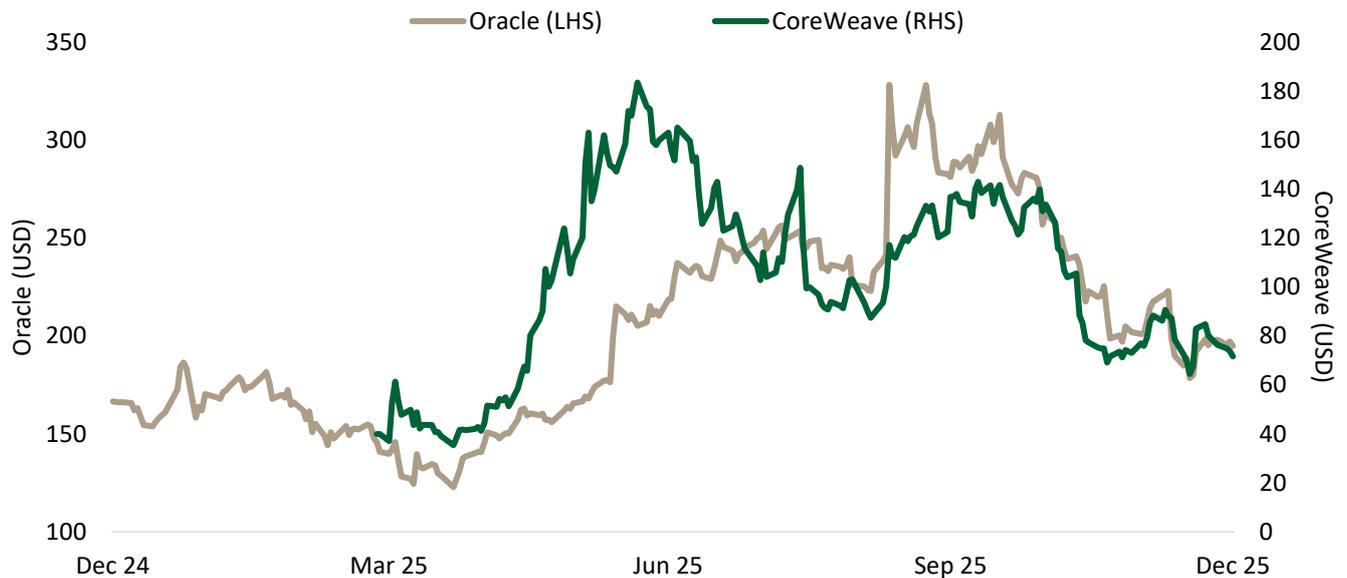
Both companies have faced sharp share price declines over the past year (chart 9[9]), underscoring a broader trend: as the AI investment cycle evolves, investors are becoming more discerning. Capital intensity and debt-driven growth are attracting scrutiny, signalling that selectivity and risk awareness are increasingly critical for investors navigating this evolving landscape. This supports an actively managed investment strategy to identify companies across the AI ecosystem that are well placed to capture the next phase of growth.

Bottom line: The AI investment landscape is shifting from capital-intensive enablers that dominate market indices toward broad-based adopters across industries, where integration of AI can drive sustained profitability. While we see little evidence of a systemic bubble, the market is becoming increasingly discerning, underscoring the need for selectivity and an actively managed investment approach.

Market Rotation: Quality Companies Lead

The AI inflection point signals a broadening of market participation, raising the critical question: which sectors and investment styles stand to benefit most?

A substantial body of research affirms that investing in high-quality companies delivers superior long-term returns (chart 10[10]). When paired with disciplined portfolio management, a focus on businesses with strong profitability, consistent earnings growth, and prudent financial leverage forms a compelling strategy — one that sits at the core of our equity approach.

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[9] *Source: Bloomberg, December 2025*
[10] *Source: Bloomberg, USD, December 1999 to 2025*

Chart 10: Quality Companies Have a Track Record of Long-Term Outperformance
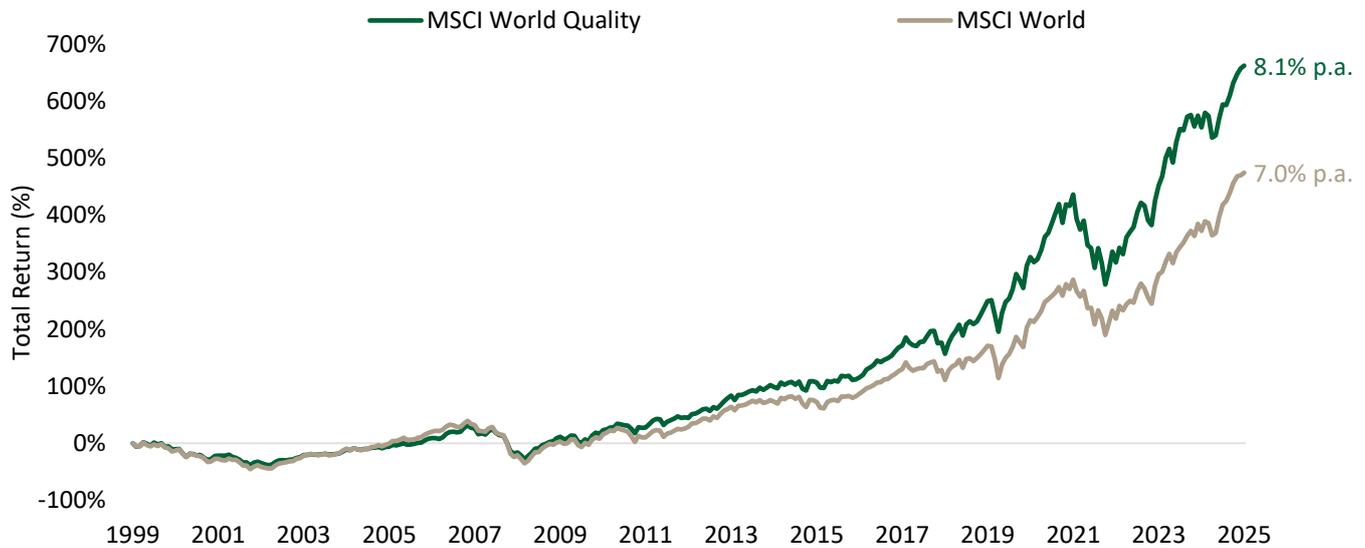
Whilst quality investing has demonstrated strong long-term returns, it is important to acknowledge that there will be periods when it underperforms, particularly when high growth momentum-driven stocks dominate.

The recent surge in enthusiasm for AI is a prime example: investor attention and capital have gravitated toward capital-intensive AI names with lofty growth expectations, leaving many high-quality businesses overlooked.

This dynamic has created a compelling backdrop for active investors. Quality stocks now trade at levels that are highly attractive relative to both their historical norms and the broader market, whilst also offering valuable defensive characteristics. Ruchir Sharma, writing in the Financial Times[11], captures the point succinctly: *"There is nonetheless a way to generate decent returns in this environment. That's by buying quality stocks."*

Capturing the excess returns associated with quality companies over the long term requires a disciplined and rigorous portfolio management approach. Last year, we made a key adjustment by broadening our quality allocation across high conviction global active managers. This allows us to reflect a more defensive bias within our equity strategy, recognising the market backdrop characterised by AI concentration and associated high valuations. But also, in many cases, these managers are finding quality companies who are integrating AI into their businesses and improving profitability and productivity.

Healthcare companies offer a compelling example, which typically offer defensive properties and are favoured by several quality managers in our portfolios. Yet at the current time, the sector is trading at an attractive valuation discount to the broader market after prolonged drug-pricing and tariff uncertainty. Meanwhile, leading pharmaceutical companies are demonstrating both the appetite and capability to industrialise AI across their operations, particularly in R&D, where notable productivity improvements are emerging. As Goldman Sachs Global Research observes, *"as AI development and adoption continue, healthcare should rank among the potential beneficiaries of AI productivity gains as well as a potential revenue beneficiary if AI assists with the discovery and development of novel therapeutics."*

Bottom line: The convergence of attractive valuations and AI adoption positions quality investing as a compelling long term investment opportunity, which sits at the core of our equity strategy.

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[11] Source: Financial Times, "The best time to buy quality stocks is now", by Ruchir Sharma, December 2025

Market Disruption: What Could Surprise Investors?

Whilst our core investment views provide the foundation for this year's strategy, we remain alert to currently unforeseen drivers of volatility that could emerge. Market disruptions often arise unexpectedly, and history reminds us that even well-anchored assumptions can be challenged by sudden geopolitical or macroeconomic shifts. Against this backdrop, we outline two potential developments that are 'top of mind' today and underscore the virtue of a broadly diversified portfolio.

Firstly, the removal of Nicolás Maduro as Venezuela's President by the US military on 3 January underscores the capacity for geopolitical events to surprise investors. In the absence of a significant shock to energy or commodity markets, such incursions typically exert only a short-lived impact on global markets. Nevertheless, regime change in Venezuela could foreshadow a broader willingness by the US administration to intervene elsewhere in Latin America or the Middle East. Whilst President Trump's domestic priorities suggest sustained engagement is unlikely, an increase in tensions between spheres of influence could challenge market sentiment. Events in Venezuela could embolden the actions of China in Taiwan, or Russia in Eastern Europe.

A deterioration in the US credit cycle represents another potential headwind, particularly if bond yields rise sharply in response to an inflation surprise or a widening fiscal deficit. Corporate debt issuance surged during the pandemic when interest rates were at historic lows, leaving a cohort of highly leveraged smaller businesses exposed as refinancing costs climb and maturities approach. This vulnerability was highlighted last year when Jamie Dimon (longstanding CEO of JP Morgan) warned of "cockroaches" in the system, suggesting that isolated defaults may lead to broader stress[12]. Whilst we anticipate that a supportive economic backdrop and lower rates will underpin credit conditions, any adverse shock could reignite these concerns and trigger a market repricing.

Macroeconomic and geopolitical developments are notoriously difficult to predict; our multi-asset approach nevertheless accounts for uncertainty through thoughtful scenario analysis and asset diversification, aiming to ensure our portfolios remain robust in a variety of environments.

Summary: Core Asset Class Views

The outlook for 2026 presents a constructive yet challenging investment environment, marked by the dominance of Artificial Intelligence, evolving fiscal and monetary policies, and significant shifts in global economic leadership. While the US and Europe are both benefitting from more accommodative policies, and China faces mounting stimulus pressures, investors must adopt a selective and disciplined approach to navigate macro developments, heightened AI growth expectations and associated market concentration. Our asset class views, and sources of potential market volatility which dictate portfolio strategy at the start of 2026, are as follows:

Equities: An accommodative policy stance, particularly in the US, combined with resilient and broadening earnings growth should support equity returns this year. Increased scrutiny of capital-intensive technology giants is likely to drive market volatility higher, yet today's environment is far removed from the late 1990s, making fears of a systemic bubble overstated. We anticipate a broadening of market participation, favouring high-quality companies harnessing AI-driven productivity gains. Smaller firms are also likely to benefit as interest rates fall and consumer confidence improves. This backdrop bodes well for active management.

Fixed Income: With the Federal Reserve easing policy and inflation and growth expected to remain modest, bond yields are set to decline. After peaking for 2025 at 4.8% on 14th January, the US 10-year yield trended lower through last year, showing little concern over fiscal risks despite Congress passing the 'One Big Beautiful Bill' Act. In Europe, the European Central Bank paused its rate-cutting cycle in June at a 2% deposit rate, yet with recovery still fragile, further cuts remain possible, a potential surprise this year. In the UK, Gilts have carried a political premium since 2022, but the Bank of England resumed rate cuts late last year despite a divided committee. With labour market weakness and inflation continuing to ease, additional cuts are likely, pointing to further declines in Gilt yields.

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[12] Source: JP Morgan third-quarter earnings call, October 2025.

Currencies: After weakening by around 10% in the first half of 2025, the trade-weighted US Dollar stabilised and ended the year modestly stronger than mid-year levels. The Dollar's prospects this year remain finely balanced; structural economic advantages collide with volatile equity sentiment, particularly around US AI leadership which dominates market indices. Meanwhile, foreign governments continue to diversify their reserves and foreign investors seek appropriate hedging strategies. However, as we argued in our *July Investment Outlook*, the absence of credible alternatives to the Dollar's dominance in trade, settlement and liquidity makes a sustained decline unlikely. This reinforces our preference for US assets where growth opportunities are most compelling. Global diversification will be critical in the year ahead; our strategy maintains a prudent mix of European, Asian and Emerging Market investments alongside physical gold, which has proved highly valuable in recent years.

Alternatives: Having delivered strong real returns with low correlation to equities and conventional bonds last year, selective alternative assets remain an attractive component of our investment strategy in an environment of heightened uncertainty. Long/short hedge funds are particularly well placed to exploit valuation dispersion, where elevated multiples in certain sectors contrast with overlooked opportunities elsewhere. These strategies delivered c. 8-12% last year, whilst navigating volatility and concentration risks effectively. Equally valuable are sources of risk unconnected to the economic cycle, such as catastrophe bonds, which returned around 10% in 2025. With persistent market uncertainties and uneven valuations, the outlook for alternatives is strong, reinforcing their role in delivering resilience and differentiated return drivers.

Private Capital: Whilst optimism for an exit recovery in 2026 is strengthening, we expect the most compelling opportunities to emerge in the mid-market. AI-enabled assets will continue to draw early-stage venture interest, and leading, cash-generative buyout businesses should remain in demand. Yet ageing vintages reliant on financial engineering face structural challenges that will not fade quickly. With fundraising concentrated among mega-funds and competition intensifying for large, resilient assets, we believe mid-market strategies, anchored in operational excellence, are best positioned to deliver superior returns. A broader range of exit routes, combined with hands-on value creation across diverse sectors, offers a sustainable path forward. Our Private Capital strategy aims to capture this next phase of growth through a disciplined selection of managers with deep operational expertise.

Stonehage Fleming Investment Management
Chief Investment Officer Group
06 January 2026

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