Key Investment Themes to Watch in 2026

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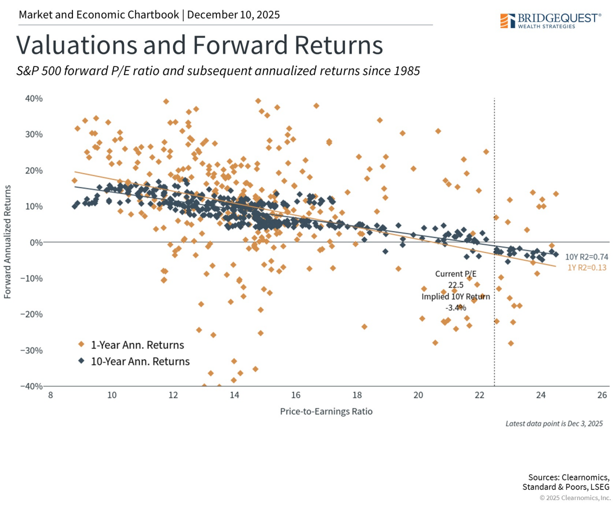
Markets are on track for another year of strong performance, with both equities and fixed income contributing meaningfully. Although these gains help advance financial objectives, record index levels and higher valuations have made many investors more wary, even as earnings remain broadly solid. Importantly, market leadership is beginning to broaden beyond the “Magnificent 7” and large U.S. growth stocks that have dominated returns in recent years. Reflecting this shift, we modestly increased exposure to small and mid-cap U.S. companies earlier this year and continue to view this positioning favorably.

Many long-standing concerns eased in 2025 as inflation stabilized a bit, growth stayed resilient, and widely feared market disruptions failed to occur, reinforcing the value of staying disciplined. As we look toward 2026, uncertainty is likely to remain, heightening the importance of thoughtful portfolio construction, strong balance sheets, and a focus on reasonable valuations.

Multiple asset classes are now supporting market returns as 2026 approaches, contrasting with much of the past decade when U.S. stocks dominated global markets. International equities are outpacing domestic markets in 2025, with developed markets (MSCI EAFE) and emerging markets (MSCI EM) each gaining approximately 30% in dollar terms, driven by improved growth expectations and dollar weakness.

Fixed income is also providing important portfolio stability. The Bloomberg U.S. Aggregate Bond Index has returned 7% as the Federal Reserve cuts rates and inflation stabilizes. Higher-quality bonds are fulfilling their role by generating income and offsetting equity volatility during uncertain periods. This reinforces the value of balance and diversification heading into the coming year.

Valuations are reaching historically elevated levels

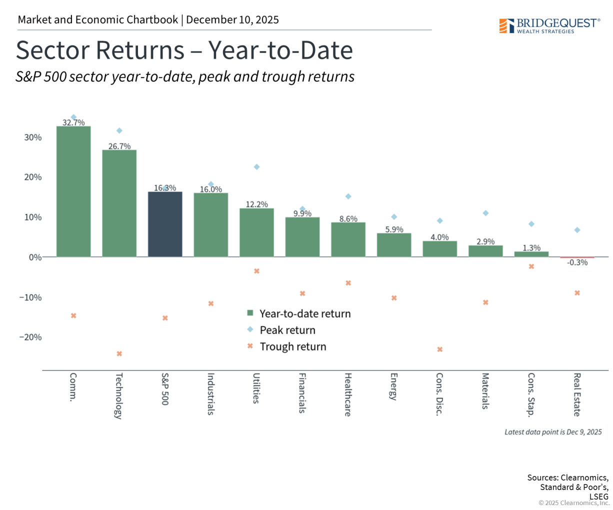


Strong multi-year returns have pushed stock market valuations higher. The S&P 500 currently trades at a price-to-earnings ratio of 22.5x, approaching the 24.5x peak from the dot-com bubble. This means investors are paying more for each dollar of future earnings than in recent years.

High valuations become concerning when disconnected from fundamentals. While today's valuations reflect AI enthusiasm and economic growth, corporate fundamentals remain solid with healthy earnings growth expected to continue according to LSEG consensus estimates. Valuations don't necessarily predict immediate declines since markets can stay expensive for extended periods. Not all bubbles burst dramatically—some deflate gradually as fundamentals catch up, distinguishing the late 1990s dot-com crash from cloud computing's steady growth.

However, elevated valuations suggest more modest future returns and increased sensitivity to disappointments. Markets "priced for perfection" can experience volatility from minor earnings or economic data misses. This makes selectivity and balance across asset classes, sectors, sizes, and styles increasingly important.

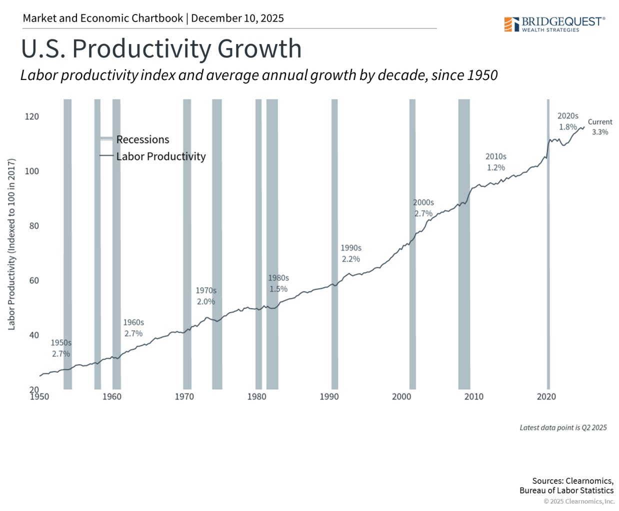
Artificial intelligence continues reshaping the economy



AI has captured extraordinary investor attention, with capital expenditures on AI infrastructure reaching trillions of dollars in 2025. This includes new data centers, equipment purchases like GPUs, and AI researcher hiring. Business adoption is growing—the Census Bureau's Business Trend and Outlook Survey shows AI usage more than doubled from 4% in September 2023 to 10% in September 2025, with anticipated usage rising from 6% to 14%.[1]

The Magnificent 7 technology companies now represent about one-third of the S&P 500, creating both opportunity and concentration risk. The question isn't whether AI will transform the economy—it will—but whether valuations reflect realistic timelines for investment returns. History shows transformative technologies follow similar patterns: skepticism, rapid adoption, market enthusiasm, and eventual economic integration. Markets often overestimate profit generation speed. Most investors have AI exposure through major indices, making awareness of this concentration and adherence to appropriate asset allocation essential.

Growth is moderating but remains resilient



Economic growth has slowed but remains stronger than feared. U.S. GDP dipped slightly in early 2025 but rebounded with 3.8% second-quarter growth—one of the strongest rates in years. The IMF projects global growth could ease from 3.2% in 2024 to 3.1% in 2026, with advanced economies growing around 1.5% and emerging markets maintaining above 4% growth.[2]

Growth has been uneven across income groups and sectors, creating a "K-shaped" economy where some thrive while others struggle. Technology positioning, particularly regarding AI benefits, drives much of this divergence. The crucial long-term question is whether productivity will rise from technological advances. Productivity growth averaged just 1.2% annually during the 2010s. Greater productivity could improve profit margins, supporting the broader economy and investor portfolios.

As 2026 begins, investors face a familiar challenge: balancing concerns with the reality that markets consistently reward patient, disciplined investors. History shows that for every crisis that disrupts markets, many feared events fail to materialize. Success comes not from predicting which concerns matter most, but from maintaining balance throughout all market phases.

The bottom line? Strong recent returns have elevated valuations, suggesting more modest expectations ahead. Rather than timing the market based on any single concern, we believe investors should continue to be diversified and growth oriented with long term assets (beyond 5 years) and conservatively positioned with all assets needed for short term purposes (less than 5 years).

References

1. https://www.census.gov/hfp/btos/data_downloads
2. https://www.imf.org/en/publications/weo/issues/2025/10/14/world-economic-outlook-october-2025

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