The Year Ahead

The Beginning of a Beautiful Friendship?: AI, markets, & the investment landscape in 2026

January 2026

NORDWAND CAPITAL

Another year in the books! We are not short-term investors and caution our clients against that temptation as well. Focusing on long-term trends, buying good companies at reasonable prices, and finding managers and strategies that deliver value across market cycles is still the best way to compound returns over time and grow client portfolios.

Equities have been on an epic run these last three years, with developed and emerging markets across large and small cap company sizes participating. This run has been fueled by a generational investment boom in Artificial Intelligence that when it's over is likely going to reshape the way companies do business and people organize their lives. We think it changes everything from medicine to education to home maintenance. The discussion has been ubiquitous, and it's just getting started.

Cash and fixed income have been good places to seek lower-risk current returns over the last few years, but that run is ending with lower interest rates and a glut of new bond supply coming to the market to support the aforementioned AI boom. Finding more creative ways within credit to provide yield seems inevitable – hiding out in cash is unlikely to be productive over the next few years.

In short, a new year always leads to the turning of the page, and this year feels similar. Late-cycle equity rallies generally feel more fraught with risk, and finding diversification is paramount to provide protection and enhance returns. We have long been adherents of using private markets as a way to supplement public markets, and that remains the case – perhaps even moreso after the strong equities run and the lackluster private markets environment of late. We'll keep our nose to the grindstone and keep you all apprised of what we see along the way this year.

A Look Inside:

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1. Long-Term Themes:

Four forces shaping Investments over the next 1-3 years

Artificial Intelligence: AI has driven equity markets since ChatGPT was released by OpenAI in 4Q 2022. In fact, its release coincided within a few weeks of the market bottom. It may be instructive to break AI into smaller sub-groups, like the actual intelligence/processing, or logistics, or physical embodiment (i.e. robotics), or control functions. While the chips were the initial winners (e.g. Nvidia), the next phase will likely focus more on the application layers, be they software or hardware.

AI turning both the workplace and home into more automated versions of themselves while improving quality of life and productivity is the phase that will make it tangible for most people – and provide the next stage of winners for investors. Taking an AI model and improving its inference abilities is where AI can appear to reason autonomously and add real value in terms of problem-solving and analysis. This is the layer where things like full self-driving vehicles and the automation in the home and electrification of transportation could begin to become realities as well.

This has already required large amounts of capital investment, with expectations that the top five players in the space (Amazon, Microsoft, Alphabet, Meta, and Oracle) will spend more than $500 billion in 2026 alone. If we include power and infrastructure spending, alongside smaller companies investing in the space, overall capex in 2026 alone could top $700-800 billion. Over the next 3-5 years, it's entirely possible that total global capex in support of AI-related growth could top $2-3 trillion.

Trade and Industrial Policy: Tariffs, re-shoring of industrial capacity, national security needs, re-orienting 21st century global relationships – what does it mean for portfolios? Global trade is re-aligning, as long-held notions of comparative advantage are being challenged in a way that most of us who grew up on Adam Smith or even Milton Friedman might struggle with.

Offshoring of jobs has come with offshoring supply chains to places that sometimes are misaligned with each other. The consequent potential for shortage in a time of crisis – whether of semiconductors, pharmaceutical components, steel, etc. – has been revealed over the last handful of years and has forced a reckoning with the postwar trade order that both political parties in the US are seeking to undo.

Couple this realignment with the dawning reality that AI is going to change the nature of employment over time, and reshoring certain industries and processes feels like a policy that has legs. Industrials, pharmaceutical APIs, value-add equipment makers in both industrials and technology could all see tailwinds over the next several years. Power generation and utility infrastructure relates to both industrial policy and AI growth themes – the "picks and shovels" aspect of these themes – and represents an obvious possible winner as well.

Credit Markets: De-banking continues, in spite of a pushback from traditional banking in 2025 and concerns over private credit and its discipline. A good 3-year run for investment grade and high yield credit underscores that both liquid and illiquid credit can be used effectively in portfolio construction.

A lot of corporate bond supply in support of AI-driven capex, along with re-financing existing short-term Treasuries and funding ongoing US budget deficits means credit markets should be extremely busy over the next 2-3 years.

Private Markets: Private equity and venture capital have had a tough ride over the last 3-4 years. Coming through the other side of that experience, with interest rates stabilizing, exit activity beginning to grow, and AI-led investments continuing to expand, means we are hopeful for better pricing and more activity over the next 1-3 years.

On top of those factors, the relative explosion of evergreen vehicles as a means to increase retail investor exposure to the asset class has led to less restrictive ways of gaining access that on balance we find to be very positive when used in the appropriate manner. A final thought is that following the strong returns in public equities over the last few years, finding diversification in private markets may be particularly attractive, cyclically speaking.

2. Looking Back at 2025:
The merits of diversification – a story in four charts

The last three years have been a wild ride following the steep sell-off many investors experienced in 2022. The S&P 500 has provided a 23% annualized total return over the last 3 years (2023-2025), outpaced by the Nasdaq which returned 31% annualized over the same period. Growth stocks have returned 31% annually, more than doubling value stocks' returns over this period. The quite famous – and indeed "Magnificent" 7 – tech stocks that have led much of this equity rally have returned 63% annualized over this same three-year period. And lest we forget, gold has been up 33% and Bitcoin up 74% annually over this period as well. In credit, investment grade and high yield bonds have returned 4.7% and 10.1% annualized, respectively. A wild ride indeed.

2025 represented an interesting inflection point in this 3-year mini-cycle. Large-cap US equities continued their run but were eclipsed last year by emerging market equities (MSCI Emerging Markets in Figure 2) whose total return last year was almost double the S&P 500 (34.3% vs. 17.9%). 2025 was also another solid year for small cap US stocks, which returned almost 13%, which was close to their 3-year run-rate. Value stocks were stronger last year as well at almost 16%. Bitcoin was down 6-7% over the full year, and more notably for those who own some in portfolios, Bitcoin ended the year down 30% from its early October highs of $125,000.

Figure 1: Asset Class Returns (2025 & 3-Year)

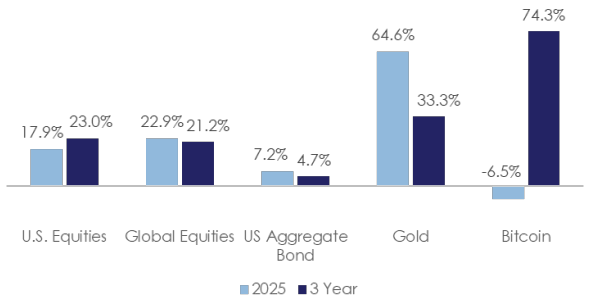


Figure 2: Equity Market Total Returns (2025 & 3-Year)

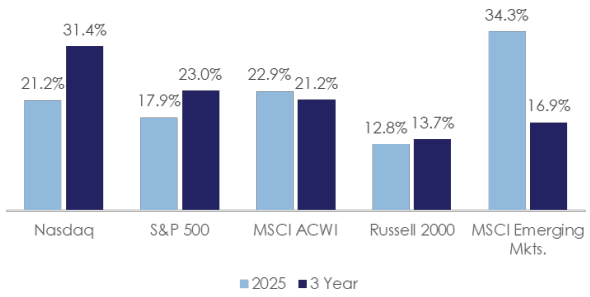


Figure 3: Magnificent 7 vs. S&P 500 (2025 & 3-Year)

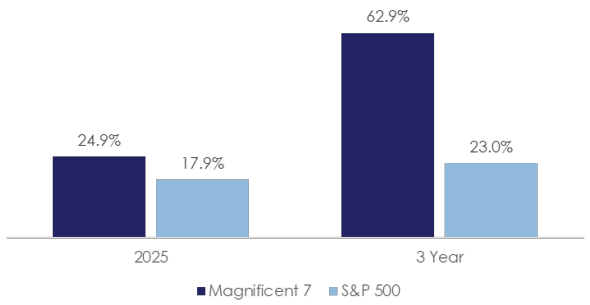
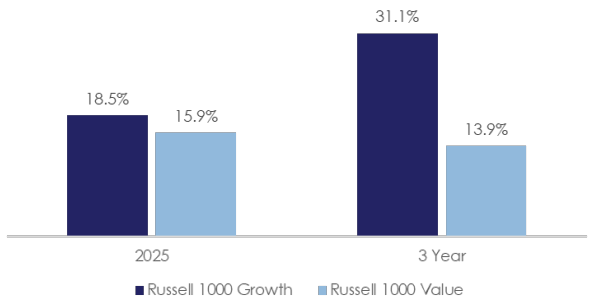


Figure 4: Large Cap Growth vs Value (2025 & 3-Year)



Source: Bloomberg, Nordwand Capital, as of December 31, 2025

Note: In Figure 1, US Equities = S&P 500, Global Equities = MSCI ACWI; In Figure 2, Russell 2000 is the proxy for small cap stock performance; In Figure 3, the Magnificent 7 is the colloquial name given to Meta Platforms Inc., Amazon.com Inc., Alphabet Inc., Tesla Inc., NVIDIA Corp., Apple Inc., and Microsoft Corp.; In Figure 4, the Russell 1000 is a commonly used universe of 1,000 large cap stocks.

As notable as the Bitcoin reversal was for some, the Mag 7 stocks (Figure 3) returned a much more "reasonable" 25% after stunning returns in '23 and '24. We believe we are witnessing an inflection point of the early AI equity cycle.

In other words, whether in emerging markets, small caps, or less-trafficked large cap stocks in the US, many of these were competitive with the big standard-bearers in 2025 as investors sought a way to extend their rally and reduce risk and concentration in the same over-owned names. Nordwand's clients will appreciate that this approach mirrors our exposures in client portfolios. Whether this has been reflected in higher EM and small cap exposures into their lagging performance over the last 2-3 years, diversified equity exposures through internally-managed portfolios, or higher exposures to private markets and alternatives, we have felt the risk of a pricey US equities market was becoming more acute and we have been comfortable leaving some potential upside on the table if it meant managing client risk more effectively.

In 2025, many of those positioning and diversifying decisions paid off for clients, we are happy to report.

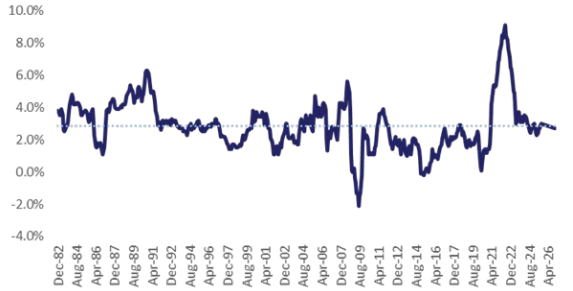
3. 2026 Macro Outlook

In the US, the first year of the second Trump administration brought with it an expected amount of turnover and policy changes at the Federal level. Looking ahead to 2026, the base case is that: 1) tariff rates remain in place but are not raised, 2) that the One Big Beautiful Bill Act of 2025 puts upwards of $100 billion in consumer hands in 1H26 and leads to an increase in capex owing partly to full expensing of plant and equipment expenditures, 3) that the Fed continues to cut rates, and 4) the current trend in deregulation continues and/or picks up speed. Going into a midterm election cycle and with the ability to place a new Fed Chair in the middle of the year, there is little reason not to expect easy financial conditions for economic as well as electoral reasons.

As of 3Q 2025, the most recent period for data, real GDP grew at an annualized rate of 4.3% following an expansion rate of 3.8% (real) in 2Q'25. 3.5% GDP growth is forecast through much of 1H 2026, driven by continued capital deployment in technology and bolstered by consumer spending likely to receive a boost from tax cuts and refunds showing up in 1Q and 2Q next year.

Unemployment is ticking higher and has been doing so since bottoming in 2023 in the mid-3% range. It currently sits at 4.6%, which remains well inside of the long-term average of 5.5-6.0% and at levels that have historically indicated full employment. It should also be noted that, with government employment on the wane, jobs growth will need to be carried by the private sector; this reverses the post-Covid trend of government job growth that added close to 2 million jobs before beginning to recede in 2025. Furthermore, when one backs out government workers from unemployment claims, 2025's figures look almost exactly like those of 2023 and 2024. This is one of the tension points for the Federal Reserve's monetary policy as employment is half of the Fed's policy mandate.

Figure 5: Headline Inflation (CPI, 1983-Present)



Source: Bloomberg, Nordwand Capital, as of December 31, 2025.

Inflation, of course, is the other half of the Fed's remit. Headline inflation has been coming down slowly into 2025, continuing the trend that has been evolving since inflation peaked in 2022 (Figure 5). It is important to note that the components of inflation have shifted since 2021-2024 from services-based (i.e. employment) to goods-based. This shift is evident in the rising unemployment statistics we've already discussed, along with the drop in average hourly wage growth, which peaked at close to 6% in 2022 and has now dropped to 3.5%. This is notable because goods-based inflation is quicker to change direction while services-based inflation tends to be stickier and more problematic.

Figure 6: Fed Funds Rate (1991-Present)

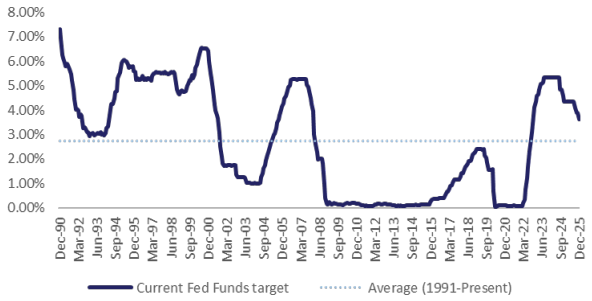
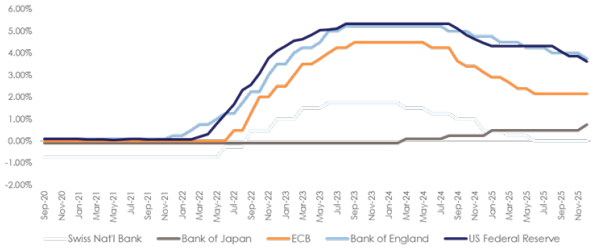


Figure 7: Global Central Bank Policy Rates (2020-Present)



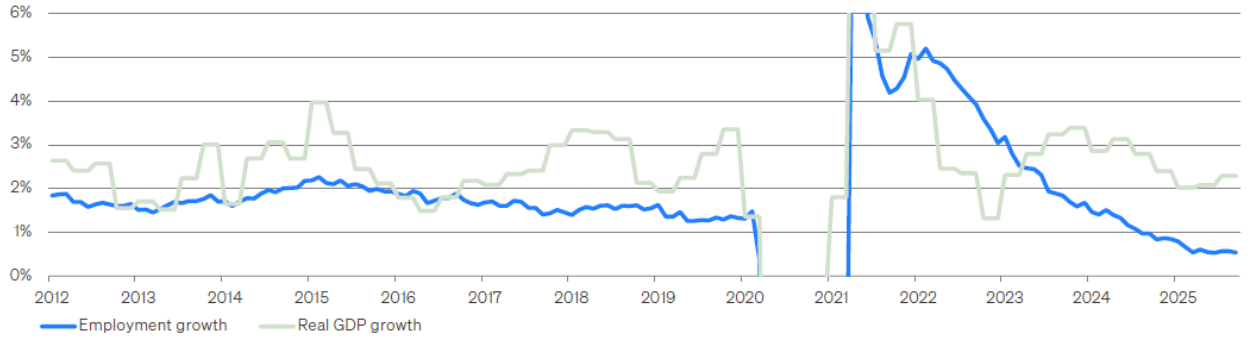
Source: Bloomberg, Nordwand Capital, as of December 31, 2025.

These two things taken together provide some support for the Fed's comfort in lower interest rates over the last 15-18 months (Figure 6). Rising unemployment and less pressure on hourly earnings arguably provides more room to cut rates and allow the economy to grow without spurring a big inflationary response, even while the headline and core inflation figures are above the Fed's long-term 2% target. In terms of ongoing headroom, it should also be noted that the longer-term interest rate target set by the Fed has averaged 0.50-1.00% lower than current levels.

A final note in this discussion is the relative interest rate in the US versus peer nations/regions. Figure 7 highlights that the rates in the US and UK remain higher than those at the European Central Bank, providing a bit of financing cost headwind to growth in the US versus Europe; this is a factor that could also point toward room to reduce rates by another 50-75 basis points over the coming months/quarters.

Overall, coupled with the political realities of a looming mid-term election in 2026, these factors combine to provide some support for the notion that the Fed is likely to keep monetary conditions supportive through 2026, generating a path for stronger short-term growth.

Figure 8: US Real GDP Growth vs. Employment Growth
(% change, y/y)



Source: FS Investments, as of September 30, 2025.

Figure 8 illustrates perhaps the most vital piece of the macro puzzle moving into 2026. Employment growth has been weak and below trend for much of the last two years. This is due largely to an economy sitting at full employment and with expensive labor costs coming out of the pandemic that made it costly to bring on new workers. But the gap between employment growth and GDP growth in this chart is all about productivity growth. In a country with lower net immigration over the next 2-3 years at least, growth in new jobs may well be more sedate; but GDP growth can be at or above trend over this period if AI-boosted productivity improves at a faster rate. Not only is this a critical point to recognize, but putting lower net migration into this context may provide for a more balanced labor market over the next few years as we move into this new environment.

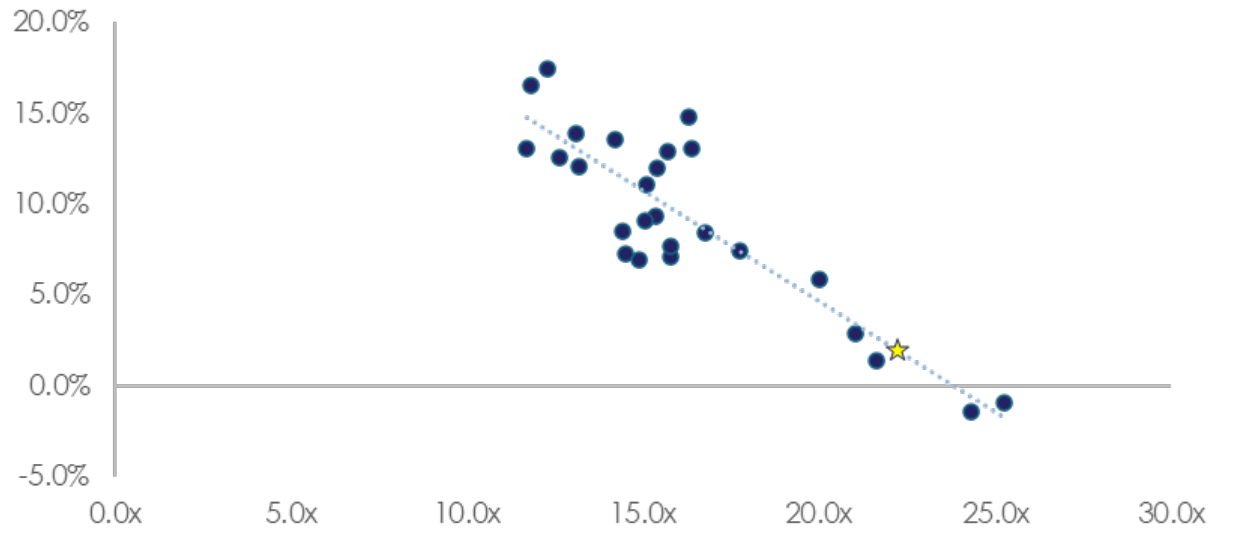
We are not sure how these factors will mingle and what outcome will be produced, but we thought it might provide context for clients looking at employment numbers and wondering how those translate into economic growth and activity. To state the obvious: we are living through the most interesting and transformative economic period since the heady early internet days 25-30 years ago.

4. Equities: Outlook & Opportunities

Looking back at Figure 1, using the S&P 500 as a proxy, US equities have posted an annualized 23% return over the last three years, versus 31% for the Nasdaq, almost 14% for small cap stocks, and 17% for emerging markets. By really any ordinary standard, those are impressive figures.

As we move into 2026, it's really critical to examine whether those extraordinary returns are achievable in the same markets for the next 3, 5, 7, or 10-year periods.

Figure 9: S&P 500 P/E Ratio vs. 10-Year Return (1990-Present)



Source: Bloomberg, Nordwand Capital, as of December 31, 2025.

History, as highlighted in Figure 9, tells us the answer is almost certainly "no." Going back to 1990 and looking at 10-year forward returns (y-axis) and plotting them against the forward earnings multiple (x-axis) of the market demonstrates that historically the more expensive the market, the lower the future returns investors can expect. In other words, current valuations imply 2-3% annualized returns over the next decade. We have been discussing this point with many of our clients over the last few years and have pivoted exposures into small cap, international, and emerging market stocks to protect against pricey US markets.

We believe this positioning is prudent for many reasons. First, we believe in diversification as a tool to optimize performance across market and economic cycles – the same market is unlikely to lead forever; so finding alternatives that have lagged or are less pricey is an obvious solution. Second, irrespective of the usual diversification discipline and rationale, the US market is *unusually* expensive at this point in time; this increases the reason for seeking safety by investing in other markets. Third, we are at a point in the AI revolution where it is unclear who the ultimate winners will be; the early-stage investor attention and capital has flowed into the chip makers and large language model (LLM) designers, but these may be the early, but not predominant, winners when we look back through time.

A well-known venture investor recently remarked that the people who invented refrigeration made a decent amount of money on their invention, but it was ultimately the Coca-Colas of the world who found a way to commercialize and profit off the invention in the most meaningful way. Using that analogy, the

Coca-Cola has most likely not yet been invented.

What this means for Nordwand's clients is that they should expect us to continue harping on the benefits of finding outperformance in less well-trafficked markets and segments while remaining invested in the current winners and taking profits and trimming risk where possible to extend gains and manage risk. That's been our approach up until now and will continue to be going forward.

In practical terms, we think that as long as geopolitics doesn't flare up and China remains viable that EM provides interesting opportunities, as do value stocks and small caps. It also means that we will continue, where appropriate, to seek alternative market exposures in places like private equity and credit, as means to augment risk-adjusted returns in ways that are less correlated to the current day-to-day volatility we see in public equities.

5. Credit Markets: Liquid and Private Credit

In private credit, a lot of digital ink has been spilled regarding the risk and pending doom awaiting investors who stray from liquid credit and bank-issued bonds and loans. To a very large degree, we think this take is overwrought. That said, the discussion of risk-adjusted returns is always worthwhile.

Publicly-traded business development companies (BDCs) and closed-end funds (CEFs) came under pressure as the canary in the coalmine for the wider illiquid space. Investors also worried about headline-grabbing stories (e.g the First Brands default: Auto Supplier First Brands Files for Bankruptcy Amid Accounting Questions - WSJ) that might have broader economy-wide implications. In a similar vein, there was a lot made late in 2025 about whether OpenAI – an industry-leading AI company responsible for the ChatGPT large language model (LLM) – could reliably fund the $1.4 trillion of commitments it has made to suppliers of chips and equipment based on its reported $13 billion in revenues. This seller-financing model of growth can lead to a circular firing squad where a single point of failure could lead to a much broader issue in equity and debt markets.

With First Brands, the more distance between that event and the current time provides comfort that these issues were much more idiosyncratic problems associated with poor risk management and control at borrowers than systemic problems in the credit markets. With OpenAI, the lion's share of growth in the AI industry is supported by orders from trillion-dollar companies with massive cash flows, leading to a different risk profile than late-90s internet-bubble times, when smaller companies with limited revenues exposed themselves with large leverage that could not withstand a hiccup or slowdown.

More broadly, unrealized losses in private credit through 3Q 2025 – the most recent period for which we have reliable data – were remarkably stable. Cliffwater, a major firm in private credit consulting and asset management, reports that those unrealized losses were close to

zero, suggesting that the market was not expecting a rise in realized losses in subsequent periods that would impact investors.

Figure 10: Cliffwater CDLI 2026 Return Forecast

	2026 Forecast	Last 4 Quarters
30-Day SOFR	3.50%	4.28%
CDLI Credit Spread	6.00%	6.39%
CDLI Interest Income	**9.50%**	**10.67%**

Source: Cliffwater Nordwand Capital, as of September 30, 2025.
Note: CDLI = Cliffwater Direct Lending Index.

To underscore this point, Cliffwater's expectation (Figure 10) for interest income in its Cliffwater Direct Lending Index in 2026 stood at ~9.5% as of September 30 - lower than the last four quarters – as base rates are lowering following the Fed's interest rate cuts and a reduced credit spread demanded by lenders. Their expectations for realized losses remains modest.

Figure 11: IG Less 10-Yr. Treasury Yield Spread

Source: Bloomberg, Nordwand Capital, as of December 31, 2025.
Note: IG = Investment Grade corporate bonds.

Figure 12: HY Less 10-Yr. Treasury Yield Spread

Source: Bloomberg, Nordwand Capital, as of December 31, 2025.
Note: HY = High Yield corporate bonds.

In periods of stress, lenders typically require wider credit spreads to compensate them for the additional risk; that spreads are this low (Figures 11 & 12) and trending even lower than long-term averages suggests that the risk we've seen to-date is more isolated than market-wide. We've highlighted these spreads for investment grade (IG) and high yield (HY) bonds many times before and continue to see scant evidence that investors are being compensated fairly for credit risk in both IG and HY bond markets.

With base interest rates lower by 1.5-1.75% in the last 16 months we expect to see lower yields across the spectrum of liquid and illiquid credit as well as cash. The yield-to-worst (YTW) at the Bloomberg Aggregate Bond Index stands at 4.3% at year-end, while the US Leveraged Loan Index's YTW is 7.62% and cash is below 4% and likely to stay there barring some large risk event that we currently don't see in the immediate future.

In other words, taking on private credit illiquidity risk is a trade-off many investors may be willing to make in exchange for yields that look to be meaningfully higher than their alternatives. Lending to the right asset, with the right coverage, and/or with the right manager, can be a very effective way to produce higher returns as long as investors recognize in advance the potential for higher losses if risk events materialize. Overall, we expect to continue allocating to pockets of private credit over the next 12-24 months.

In liquid credit the prices we noted above don't argue for the best opportunity set, but the liquidity and relative safety still argue strongly for portfolio inclusion. Furthermore, there is likely to be a lot of IG credit issuance in 2026 as companies finance M&A and capex – both of which should be expected to rise this year. M&A growth is supported by an overall late-cycle risk-taking attitude and quest for growth, while capex associated with AI and its ancillary industries (e.g. power, pipelines, utility infrastructure, automation, industrial/transportation infrastructure, etc.) is still in the early innings of a generational expansion.

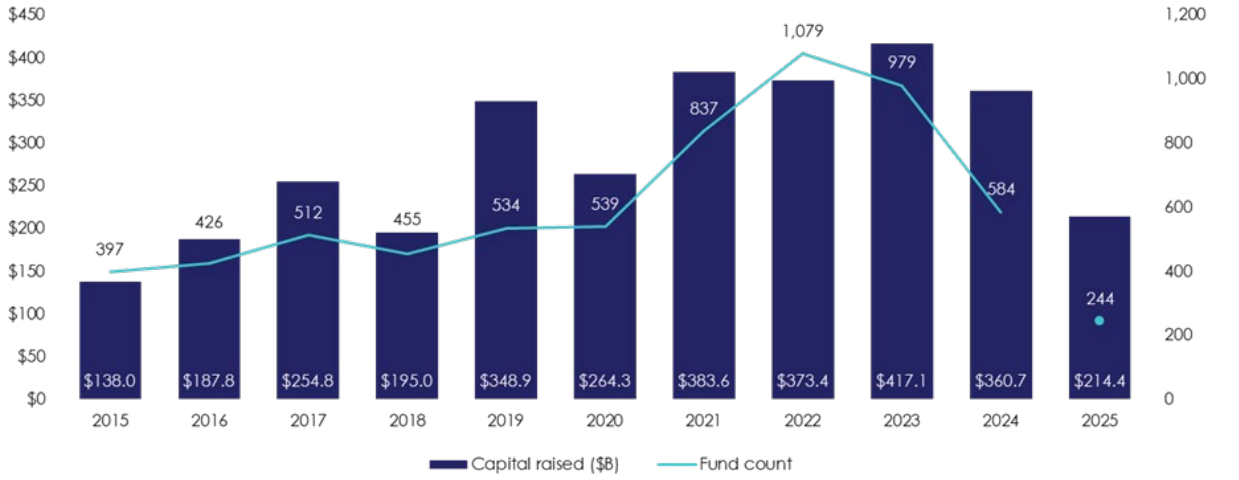
Overall, these conditions should lead to widening credit spreads, presenting an opportunity for Nordwand's clients, albeit at the risk of short-term underperformance for some credit managers. We have allocated to multi-sector bonds and agency debt during this tight spread environment, and would expect more of the same moving into 2026.

6. Private Equity & Venture Capital: Inflection Point Looming?

Private equity capital deployment and deal activity continued to grow in 2025. As we have highlighted endlessly over the last few years, fundraising (and therefore deployment) are concentrated amongst larger managers. The need to deploy these larger funds can put pressure on performance as managers may be forced to pay premium prices to win deals and deploy capital.

This is a considerable part of our thesis that finding attractive lower-middle-market private companies in which to invest is a much more productive exercise for investors – albeit one that comes with higher risk of betting on smaller companies that are still in early growth mode.

Figure 13: US Private Equity Fundraising Activity (2015-Present)

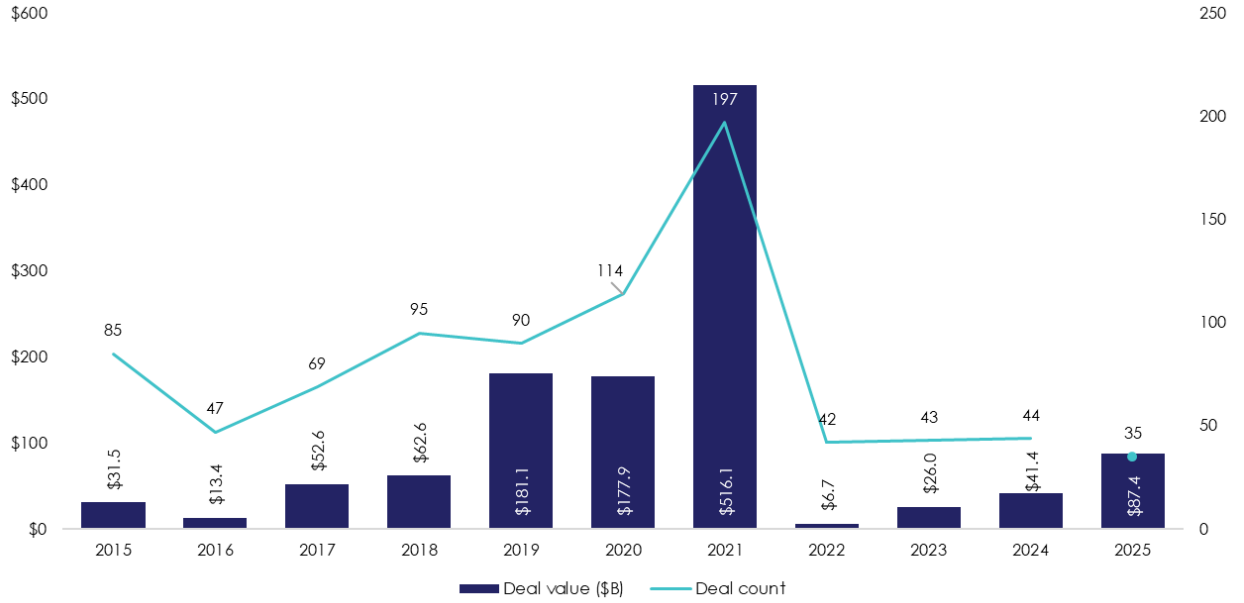


Source: Pitchbook, Nordwand Capital, as of September 30, 2025.

This growth in PE activity was modest, and clearly investors are feeling fatigue from being overextended and overallocated to private equity in portfolios as a result of sluggish exit activity over the last 3+ years. In fact, fundraising overall (Figure 13) is slowing with larger managers, as we noted above, accumulating more capital at the expense of smaller firms and strategies. It is also taking longer to raise new funds, which we view as a positive in that Nordwand's clients may benefit from improved economics to potential allocations.

Venture Capital has been a roller coaster in the last 3-4 years, with prolonged capital raising periods, stress on investment valuations, and reduced liquidity for investors owing to a dramatic drop-off in IPO listings.

Figure 14: US Venture Capital IPO Activity
(2015-Present)



Source: Pitchbook, Nordwand Capital, as of September 30, 2025.

As 2025 turns into 2026, some of the same pressures exist in the VC landscape. We would remind investors that 2025's level of IPO activity (Figure 14) was low relative to the 2019-2021 period, but consistent with longer trends and otherwise showed some encouraging signs. To be sure, one of the big issues remains that public listings are being sought by companies that have been around longer and are larger at exit. This is why we saw similar aggregate value in public listings, but far fewer deals. Breathing life into VC more fully in 2026 will involve seeing an uptick in smaller companies going public and trading hands.

Regulatory hurdles from the Federal Trade Commission (FTC) and Department of Justice (DOJ) have been reduced in the new administration, and this lower level of scrutiny should also increase M&A activity – again providing a more robust path for liquidity for companies and their investors. The combination of IPO listings and M&A is crucial to injecting liquidity into the VC space. According to Pitchbook, since 2022 net cash flows to LPs has been negative $169 billion – in other words, investors have made more capital contributions than they've seen in distributions by a wide margin. This understandably has put downward pressure on investor sentiment.

Against this dubious backdrop, optimism about AI and its potential to create exciting investment opportunities continues to grow. It is driving early-stage venture investing, which is an area that we believe will be extremely active over the next 1-2 years as investors look for the next unicorns. It is rational to

assume that as these investments continue to experience an uptick in deal volume, along with the ongoing growth in exits that we have been highlighting in these letters and which Figure 14 above illustrates as well, that VC sentiment could turn profoundly positive. As clients will know, we are supporters of this early-stage investing style for the right clients and expect to continue making investments here as appropriate in 2026.

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