Our Investment Themes 2026

Creativity within Excellence

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Contents

AI – The Year of the Prisoner's Dilemma

Key Takeaways

- AI is entering a phase where economics and capital intensity matter as much as technical progress.
- The Prisoner's Dilemma explains the capex arms race: each player must invest, yet collectively this can compress returns.
- AI scaling is increasingly constrained by capital and power, pushing the theme into the realm of infrastructure cycles.
- Historical parallels (e.g., shale) suggest value may accrue more to users and integrators than to all builders indiscriminately.
- 2026 likely brings greater dispersion: focus shifts to monetisation pathways, pricing power, and capital discipline.

Artificial intelligence remains one of the most powerful and transformative forces reshaping the global economy. Over the past two years, advances in generative models, rapid enterprise adoption and unprecedented capital investment have reinforced the perception that AI represents a once-in-a-generation technological inflection point. Yet as we move into 2026, the investment narrative around AI is entering a more demanding phase — one where economics, capital intensity and return on investment increasingly matter alongside technological progress.

A particularly insightful framework to understand this transition has been articulated by Sparkline Capital, which frames the current AI build-out as a classic Prisoner's Dilemma. In this setting, each participant — hyperscalers, model developers and infrastructure providers — is individually incentivised to continue investing aggressively to avoid strategic irrelevance. Slowing investment risks falling behind in performance, scale or ecosystem control. Collectively, however, this rational individual behaviour raises the risk of overinvestment, excess capacity and declining returns on capital across the industry.

This Prisoner's Dilemma lies at the heart of the AI investment challenge for 2026 and provides a powerful lens through which to distinguish between technological success and investment success.

From digital promise to capital-intensive reality

AI is often framed as a software revolution, but its scaling requirements reveal a fundamentally different reality. The rapid expansion of AI capabilities has transformed the technology stack into a highly capital- and energy-intensive system, anchored in physical infrastructure: data centres, advanced semiconductors, cooling systems, grid connections and power generation.

Recent research highlights the magnitude of this transformation. Bain estimates that sustaining the current trajectory of AI deployment could require around USD 2 trillion in incremental annual revenue by the end of the decade simply to fund the necessary infrastructure investment. Even under optimistic assumptions — widespread cloud migration, accelerated productivity gains and rising AI monetisation — a substantial funding gap remains. In other words, AI demand is not the constraint; capital and power are.

This marks a structural break from the traditional technology model. Historically, the sector benefited from low marginal costs, rapid scalability and limited physical constraints. AI challenges this paradigm. Compute demand is growing faster than Moore's Law, while power availability, grid bottlenecks and construction timelines impose real-world limits. As a result, the AI build-out increasingly resembles a capital cycle, where returns are shaped as much by supply discipline and utilisation rates as by innovation itself.

The Prisoner's Dilemma in action

The Prisoner's Dilemma framework helps explain why this capital cycle is so difficult to escape. No individual actor can rationally choose restraint. Each incremental investment appears justified when viewed in isolation: more compute enables better models, stronger customer lock-in and strategic optionality. Yet when all players follow the same logic, the aggregate outcome may be capacity growth that runs ahead of monetisation, particularly if efficiency gains reduce compute intensity or if adoption progresses unevenly across sectors.

As Sparkline highlights, this dynamic creates a situation where even a successful technology can generate disappointing shareholder outcomes. The issue is not technological obsolescence, but economic saturation — a familiar pattern in industries where strategic importance overrides capital discipline.

Lessons from previous technological breakthroughs, particularly the shale gas revolution

The analogy with the gas and shale revolution is particularly instructive. The shale boom delivered abundant, cheaper energy and substantial productivity gains for the broader economy. Yet equity returns for producers were often poor. Competitive pressures, rapid capacity expansion and weak supply coordination compressed margins and destroyed capital. The primary beneficiaries were frequently downstream users, not the companies that built the infrastructure.

AI exhibits similar characteristics. Intelligence, like energy, is a general-purpose input. As supply expands and costs decline, the economic surplus tends to migrate toward users who can apply it efficiently, rather than remaining with those who produce it. If compute and intelligence become increasingly abundant, the value created by AI may be captured disproportionately by enterprises that embed it into workflows, pricing models and productivity gains — not necessarily by the firms that financed the build-out.

This parallel reinforces the Prisoner's Dilemma framing: no single participant can afford to slow down, yet the collective outcome may favour application and integration over infrastructure ownership.

Why 2026 is a turning point

Several forces converge in 2026 that make this dynamic more visible to markets.

First, depreciation and capital intensity will become more prominent in reported earnings. As the AI CapEx wave matures, depreciation charges rise, while hardware cycles may shorten due to rapid innovation. This mechanically pressures margins, even if revenue growth remains robust.

Second, power and grid constraints are emerging as binding bottlenecks. Securing reliable, scalable energy supply is becoming a differentiating factor, favouring players with early access, long-term contracts or integrated infrastructure solutions. This introduces new sources of dispersion within the AI ecosystem.

Third, investor focus is likely to evolve. In earlier phases, markets rewarded ambition, scale and narrative dominance. As AI matures, attention should increasingly turn to unit economics, pricing power, customer willingness to pay and return on invested capital. The transition from "can it be built?" to "can it earn?" is a critical inflection point for any capital-intensive industry.

Dispersion replaces beta

This evolution does not undermine the structural importance of AI. Rather, it changes how the opportunity set should be approached. The AI theme is moving from a broad beta trade to a dispersion-driven environment, where outcomes vary widely across the value chain.

Some participants are structurally better positioned:

- Companies with long-term contractual visibility and pricing power in infrastructure and energy.
- Platforms that control data, workflows or orchestration layers, enabling monetisation beyond raw compute.
- End-users that deploy AI to enhance productivity, margins and capital efficiency rather than to showcase technological leadership.

Others face more challenging trade-offs:

- Firms whose competitive position depends on continuously escalating CapEx.
- Business models exposed to rapid commoditisation of compute or models.
- Balance sheets increasingly sensitive to funding costs and utilisation assumptions.

Investment implications

For investors, the central risk in 2026 is not missing AI exposure, but misallocating it. Owning AI indiscriminately assumes that value creation and value capture will align neatly — an assumption that history repeatedly challenges in capital-intensive revolutions.

A more robust approach recognises AI as a secular growth engine with cyclical and structural nuances. Maintaining exposure remains essential, but selectivity becomes paramount. The emphasis should shift toward monetisation pathways, capital discipline and resilience to changing funding conditions.

AI will transform the economy, but the Prisoner's Dilemma will shape investor outcomes.

Sparkline's Prisoner's Dilemma framework captures the defining tension of the next phase: individually rational investment decisions may collectively compress returns. As this reality becomes clearer in 2026, markets are likely to differentiate more sharply between those who enable AI profitably and those who must continually fund it.

In this environment, success will depend less on who spends the most, and more on who converts intelligence into sustainable economic value.

Electricity Renewal – the Capex Super-Cycle

Key Takeaways

- Electricity is shifting from a quiet input to a strategic constraint for competitiveness, AI infrastructure and industrial policy.
- The key bottleneck is often delivery, not generation: grids, transformers, permitting and "speed-to-power" are decisive.
- Data centres are a major incremental demand driver in the US, while globally electrification remains the broader engine.
- Value creation concentrates in the enablers: grid modernisation, electrical equipment, data-centre power infrastructure and flexible generation.
- The cycle is long, capital-intensive and political: discipline is required as execution risk, crowding and valuation dispersion rise.

The global economy is entering a new energy era. Electricity — long treated as a stable, abundant and relatively low-cost input — is becoming a strategic resource and, increasingly, a binding constraint on industrial competitiveness, digital infrastructure and geopolitical influence. Several forces are converging: the rapid rise of artificial intelligence (AI) and data centres, accelerated reindustrialisation in advanced economies, and the progressive electrification of mobility, heating and key industrial processes. The International Energy Agency (IEA) has described this shift as the arrival of a new "Age of Electricity", reflecting a regime change in which power demand grows structurally faster than overall energy consumption.

In this new regime, a simple but consequential reality emerges: AI rests on three critical inputs — semiconductors, data and electricity — and electricity is increasingly the bottleneck. Analysis from the Center for Strategic and International Studies (CSIS) argues that among these three inputs, electricity is becoming the most binding constraint on the expansion of AI computing capacity, particularly in the United States. The key question is no longer which AI model will dominate, but who can deliver reliable gigawatts of power, fast enough, to where computing capacity is built. This challenge is captured by the concept of speed-to-power: the time required to translate a potential site into effective access to electricity, often constrained less by generation capacity than by grids, equipment availability, permitting and skilled labour.

From Stagnation to Structural Growth in Electricity Demand

The clearest evidence of regime change comes from the United States. For nearly two decades, US electricity demand remained broadly flat, with compound annual growth close to zero. That era is ending. The International Energy Agency (IEA) and the Lawrence Berkeley National Laboratory (LBNL) both project a sharp re-acceleration, driven by AI data centres, electrification and industrial reshoring. LBNL estimates that US data centres consumed around 176 terawatt-hours (TWh) of electricity in 2023, equivalent to roughly 4.4% of total US demand, and that consumption could more than double within the next decade under central scenarios.

At the global level, the International Energy Agency (IEA) projects electricity consumption by data centres rising to approximately 945–1,000 TWh by 2030, more than doubling from today's levels. Importantly, this growth is highly concentrated geographically. The United States and China together are expected to account for close to 80% of incremental data-centre electricity demand through 2030, with increases of roughly 240 TWh in the United States and 175 TWh in China.

The role of data centres, however, differs markedly by region. Globally, the International Energy Agency (IEA) estimates that data centres account for less than 10% of total electricity demand growth to 2030, with the majority coming from electrification of industry, buildings (notably cooling) and transport. In the United States, by contrast, data centres are expected to represent nearly half of incremental electricity demand growth over the period, making AI infrastructure a central driver of the domestic power outlook. In emerging economies, where baseline electricity demand is already rising rapidly due to industrialisation and urbanisation, data centres remain a much smaller contributor to incremental demand.

Europe sits between these two extremes. Electricity demand is re-accelerating on the back of data centres, electrification and low-carbon industry, but the region faces tighter constraints. According to the International Energy Agency (IEA), more than half of Europe's electricity networks are over 20 years old, and regulatory fragmentation and lengthy permitting processes slow adaptation. While European utilities acknowledge the growth opportunity, the translation into near-term guidance remains gradual, reinforcing the importance of long-dated infrastructure investment.

China and Asia represent the other epicentre of the electricity renewal cycle. China alone accounts for roughly 40% of global electricity demand growth through the mid-2030s, supported by rapid electrification, manufacturing of energy-intensive products and the expansion of data-centre capacity under the "Eastern Data, Western Computing" strategy. The region is also investing aggressively in high-voltage and high-voltage direct current (HVDC) transmission, reinforcing the idea that the opportunity set in electricity renewal is not confined to Western markets.

The System Under Strain: Speed-to-Power as the Binding Constraint

Across regions, the binding constraint is increasingly not generation itself, but the ability of the electrical system to deliver power where and when it is needed. The Center for Strategic and International Studies (CSIS) highlights that in some US data-centre hubs, connection delays now extend to several years, driven by grid congestion, transformer shortages, permitting delays and workforce constraints. In this environment, the speed-to-power becomes a decisive competitive advantage.

This dynamic reshapes the capex landscape. McKinsey & Company estimates that around $6.7 trillion of investment will be required globally to scale data-centre capacity by 2030, of which more than $5 trillion is directly linked to AI-oriented infrastructure. A significant share of this spending flows not into computing hardware, but into what McKinsey terms "energizers": power generation, transmission, transformation, cooling and electrical equipment that make high-density computing physically possible.

Where the Capex Super-Cycle Creates Value

The electricity renewal theme is therefore best understood as a physical infrastructure investment cycle, rather than a narrow technology trade. Value creation concentrates in several distinct but interconnected segments:

- Grid Modernisation and Transmission

High-voltage lines, HVDC corridors, substations, transformers and grid digitalisation sit at the heart of the theme. These assets enable the connection of new generation, the integration of renewables and the delivery of power to data-centre and industrial hubs. They benefit from strong policy alignment, structural under-investment and long asset lives.

- Data-Centre Electrical Infrastructure

Within data centres themselves, electrical reliability becomes mission-critical. Uninterruptible power supply (UPS) systems, switchgear, power distribution units (PDUs), busways, medium-voltage transformers and advanced cooling solutions are all required to support rising power densities. These segments combine strong growth visibility with high technical barriers and pricing power.

- Flexible Power Generation and Natural Gas

Over the next five to ten years, flexible generation remains essential. Gas-fired plants — including simple-cycle and combined-cycle gas turbines — offer the speed, reliability and dispatchability required to support AI workloads. According to the International Energy Agency (IEA), natural gas is expected to provide the majority of incremental electricity generation linked to US data-centre demand through the early 2030s.

- Solar and Grid-Scale Storage

Utility-scale solar is among the fastest technologies to deploy, while battery storage plays a growing role in integrating renewables and providing grid flexibility. Although parts of this segment are already well owned, its anchoring in data-centre and electrification demand extends the depth and duration of the cycle.

- Materials and Upstream Inputs

Copper, aluminium, lithium and other critical materials form the physical backbone of electrification. Constraints in mining, refining and manufacturing capacity can amplify pricing power but also introduce volatility, making selectivity essential.

- Nuclear as a Strategic Option

Nuclear power is unlikely to resolve near-term speed-to-power constraints, given long construction timelines. However, it increasingly features in long-term strategies to stabilise grids and decarbonise baseload generation, particularly in the United States and China.

Risks and Discipline in a Crowded Theme

The strength of the electricity renewal narrative should not obscure its risks. Demand projections may prove optimistic if AI productivity gains disappoint or capital costs rise. Efficiency gains at the chip, software and infrastructure level could flatten electricity intensity over time. Regulatory and permitting constraints, particularly in Europe, may delay project execution. Finally, parts of the theme already reflect high expectations, raising the risk of crowding and valuation compression.

Portfolio Implications

We are moving from a world where electricity was an abundant and largely invisible input to one where electricity — its availability, reliability, price and speed of deployment — becomes a strategic determinant of economic and technological leadership. For investors, the opportunity lies less in betting on AI applications themselves than in owning the physical enablers that allow AI, reindustrialisation and electrification to materialise in the real economy.

Electricity renewal is a long-cycle theme. It will be uneven, capital-intensive and politically influenced. But as the Age of Electricity takes hold, the capex super-cycle is less a discretionary wave than a necessary response — positioning those who control grids, power infrastructure and critical equipment at the centre of the next phase of global growth.

Robotics – The Next Frontier of AI

Key Takeaways

- Robotics marks the physical realisation of AI, extending automation beyond factory floors into healthcare, logistics, services and unstructured environments.
- Demographics and labour scarcity are no longer cyclical issues but structural forces, making automation an economic necessity across developed economies.
- Growth within robotics is uneven but broad-based: service robots and collaborative robots are expanding fastest, while industrial robotics accelerates through AI integration.
- The competitive landscape is geopolitically fragmented: Japan leads in precision engineering, China scales rapidly through supply-chain control and domestic demand, and the US dominates frontier AI but lags in manufacturing.
- Robotics represents a long-duration structural megatrend, where value will accrue to players that successfully integrate hardware, software and application-specific expertise over time.

The convergence of artificial intelligence and robotics represents one of the most significant investment opportunities of the coming years. 2026 is anticipated to be a pivotal inflection point when AI-driven productivity gains first become visible in macroeconomic data, marking the transition from theoretical potential to tangible economic impact. Global Robotic market expects to experience significant growth, driven by powerful, irreversible demographic forces, particularly aging populations and persistent labor shortages across developed economies. Furthermore, the geopolitical pressures that reshape the global supply chains also play a key reason for robotization. With the previous automation waves confined to factory floors, this new frontier extends across healthcare, logistics, consumer services, and ultimately into unstructured environments through humanoid robotics. The integration of generative AI as the “brain” to robotics’ “body” enables machines to perceive, learn, and adapt in real-time, dramatically expanding the addressable market beyond traditional industrial applications.

Market Dynamics and Structural Drivers

Labor scarcity has evolved from a cyclical challenge to a structural economic imperative. Workers aged 55 and older now constitute 24% of the U.S. labor force, with participation rates for those 75 and older projected to trend higher. The U.S. Bureau of Labor Statistics forecasts 6.7 million new jobs by 2033, lead to a potential threat of labor shortage. This demographic reality is mirrored across developed economies, creating an unavoidable automation imperative. Simultaneously, supply chain vulnerabilities exposed during the pandemic and exacerbated by geopolitical tensions have accelerated reshoring initiatives. The development of automation become economically viable by offsetting the high labor costs to ensure the competitiveness of the domestic manufacturing.

The market segmentation reveals diverse growth trajectories with service robots represent the largest segment and projected to experience an exponential growth in the coming years, driven by logistics, medical, and consumer applications. Collaborative robots (Cobots) is expected to be the fastest-growing category, enabling human-robot collaboration and democratizing automation for small and medium enterprises. Industrial robots remain the core market with growth accelerating due to AI integration. The emerging humanoid segment, while currently nascent, represents an enormous opportunity in the year to come as companies like Tesla, Figure AI, and Chinese innovators advance commercial viability.

Competitive Landscape and Regional Dynamics

The robotics industry exhibits distinct regional strengths within a triangular competitive framework. Asia Pacific dominates with 70% of global robot installations, anchored by Japan's unparalleled precision engineering ecosystem. Japanese manufacturers like FANUC and Yaskawa form part of the key industrial robotics leaders alongside Switzerland's ABB and Germany's KUKA. Meanwhile, Chinese champions are rapidly closing the technological gap through aggressive innovation and strategic acquisitions. Furthermore, China's strategic control over critical robotic supply chains, particularly rare earth minerals that essential for high-performance motors and precision components, coupled with its massive domestic market and manufacturing ecosystem, it will enable Chinese robotics companies to iterate rapidly, scale production efficiently, and develop vertically integrated solutions that combine hardware, software, and application-specific expertise at remarkable speed.

The United States maintains leadership in frontier AI research and semiconductor design, though it lags in embodied robotics manufacturing. The most promising strategic alignment may emerge from a U.S.-Japan partnership, fusing American AI capabilities with Japanese precision engineering to counterbalance China's state-led model. This geopolitical dimension adds complexity but also creates opportunities for countries with strong manufacturing infrastructure and favorable business environments.

Conclusion

Robotics, supercharged by artificial intelligence, represents a rare structural megatrend with at least decade growth potential. The convergence of demographic inevitability, supply chain reconfiguration, and AI breakthroughs creates a powerful investment thesis that transcends typical cyclical considerations. While near-term volatility is inevitable given the sector's growth profile and geopolitical complexities, the long-term trajectory is unmistakable. Companies and investors who position themselves ahead of the 2026 productivity inflection point will capture disproportionate value as the physical and digital worlds merge through intelligent automation. For investors with a strategic horizon extending beyond typical market cycles, robotics offers not just returns, but participation in one of history's most profound economic transformations.

Quality Investing – a Rebound Candidate and a Diversifier

Key Takeaways

- 2025 was a difficult regime for Quality: markets rewarded risk appetite, momentum and optionality over discipline.
- Quality underperformed largely because of what it didn't own (concentration effects) and factor headwinds, not weak fundamentals.
- Definitions matter: "Quality" varies by index methodology, creating meaningful differences in sector and stock exposures.
- The 2026 setup looks more balanced: expectations are lower, valuation gaps have compressed, and dispersion may rise.
- Quality remains a strategic allocation: a long-term compounding style that tends to matter most when volatility and selectivity return.

Quality investing experienced another year of relative underperformance in 2025, lagging the MSCI World as markets continued to reward momentum, leverage and earnings optionality. At first glance, this outcome may appear counterintuitive: economic uncertainty remained elevated, geopolitical risks persisted, and financing conditions were still materially tighter than in the pre-2022 era. Yet markets overwhelmingly favoured cyclicality and growth optionality, while the defining attributes of Quality — balance-sheet strength, earnings stability and cash-flow visibility — were largely overlooked.

This underperformance does not reflect a deterioration in the fundamentals of Quality companies. Rather, it is the result of a very specific macro and factor regime, one that has historically been unfavourable to the Quality style. Understanding this distinction is critical when assessing the outlook for 2026.

What Quality is — and what it is not

At its core, Quality investing seeks to identify companies with sustainably high profitability, resilient earnings and conservative financial structures. These characteristics tend to deliver superior outcomes over the full market cycle, particularly during periods of stress or economic deceleration. However, Quality is neither a defensive proxy nor a momentum strategy. It is explicitly designed to avoid excessive leverage, unstable margins and business models that rely on optimistic growth assumptions.

Importantly, there is no single, universally accepted definition of Quality. While there is broad consensus on the underlying principles, index construction differs meaningfully across providers. Quality strategies can vary significantly depending on whether they prioritise return on equity, margin stability, balance-sheet metrics or earnings variability. These methodological differences translate into divergent sector and stock exposures — and, by extension, different performance outcomes over shorter horizons.

This lack of standardisation is not a weakness, but it does complicate short-term comparisons and reinforces the need to analyse Quality through a cycle-aware lens rather than a calendar-year scorecard.

Why 2025 was a difficult environment for Quality

The macro backdrop of 2025 combined several elements that historically weigh on Quality performance.

First, risk appetite remained exceptionally strong, particularly in U.S. equities. Markets rewarded earnings acceleration, operating leverage and exposure to transformational themes such as AI. Stocks with low and variable margins significantly outperformed those with high and stable margins, a pattern that is strongly correlated with elevated risk appetite. This dynamic is the mirror image of the environment in which Quality typically excels.

Second, falling U.S. real yields played an important role. As 10-year TIPS yields declined, markets increasingly favoured long-duration growth and optionality over near-term cash generation. As a result, stocks with high free cash flow and strong balance sheets — core Quality characteristics — underperformed those with weaker financial profiles but greater perceived upside. This relationship, well documented in factor research, helps explain why Quality lagged even as financing conditions remained structurally tighter than in the previous decade.

Third, market concentration amplified the effect. A narrow set of mega-cap stocks delivered a disproportionate share of index returns, and many of these companies were structurally underrepresented in Quality indices due to valuation, leverage or earnings volatility considerations. The underperformance of Quality in 2025 was therefore as much about what it did not own as about what it did.

Quality was selective — not absent

It is important to note that Quality did not stand aside from structural growth themes. Both in the U.S. and in Europe, Quality strategies were meaningfully exposed to areas where profitability and capital discipline aligned with long-term growth, such as semiconductor equipment, selected industrials and healthcare. These exposures contributed positively in 2025 and demonstrate that Quality is not inherently anti-growth.

BNP Paribas AM's European research underscores this point. In Europe, Quality strategies tend to tilt toward companies with pricing power, global revenue exposure and resilient margins, rather than pure defensives. While this positioning has at times lagged during sharp risk-on rallies, it has historically delivered superior risk-adjusted returns across cycles, particularly when growth slows or dispersion rises.

Why the setup for 2026 looks more balanced

Looking ahead, several elements suggest that the risk-reward profile for Quality is improving.

First, expectations are low. After an extended period of underperformance, valuation differentials between Quality and lower-quality segments have compressed.

Historically, such phases have preceded periods of relative stabilisation or recovery, even without a sharp macro downturn.

Second, the macro environment is likely to become more selective and dispersion-driven. As growth normalises and the initial enthusiasm around capital-intensive themes matures, markets typically become more discriminating, placing greater emphasis on earnings visibility, balance-sheet resilience and return on capital. This is precisely the environment in which Quality tends to reassert its relevance.

Third, structural forces still favour Quality over the medium term. Higher geopolitical uncertainty, more fragmented supply chains and a structurally higher cost of capital increase the value of robust business models and financial flexibility. Quality plays a crucial role as a stabiliser within equity portfolios, offering diversification benefits that become more apparent when volatility rises.

Quality as a strategic allocation

Quality investing is not a short-term tactical trade. It is a strategic allocation designed to compound returns over time while mitigating downside risks. Its tendency to lag during euphoric, momentum-driven phases is not a flaw, but a feature of its discipline.
For investors, the key challenge is therefore behavioural rather than analytical. Quality often tests patience when markets reward leverage and optimism. Yet history consistently shows that abandoning Quality at such moments tends to be pro-cyclical and value-destructive.

Quality underperformed in 2025 because markets did not value discipline. That does not mean discipline has lost its value.

As we move into 2026, the combination of compressed valuations, evolving macro dynamics and rising dispersion argues for maintaining — and justifying — a structural allocation to Quality. Not as a bet on a sharp rotation, but as a deliberate choice to prioritise durable earnings, financial resilience and long-term compounding in an increasingly complex investment landscape.

Europe at a Crossroads

Key Takeaways

- Europe's challenge is primarily structural, not cyclical: productivity, innovation scale and capital-market depth lag the US and China.
- The key constraint is execution and integration more than affordability; inaction carries the highest long-term cost.
- Public markets often struggle to express Europe's transformation because indices are tilted toward mature sectors and fragmented champions.
- Europe's strategic renewal is most clearly expressed through infrastructure and energy systems, where investment needs are unavoidable.
- For investors, Europe can be approached through a broader toolkit, including private markets, where implementation and manager skill drive outcomes.

Europe enters 2026 at a pivotal moment. Fifteen years after the sovereign debt crisis, many of the legacy distortions that shaped European asset allocation have faded. Valuation gaps between styles have narrowed, financial fragmentation has receded, and the euro area has weathered successive shocks without systemic rupture. Yet this apparent stabilisation masks a deeper reality: Europe remains structurally behind the United States and China in productivity growth, innovation, strategic industries and capital-market depth.

As highlighted in Mario Draghi's report on European competitiveness, this underperformance is not cyclical. It reflects long-standing weaknesses in how Europe mobilises capital, scales innovation and coordinates investment across borders. Europe does not lack savings, skills or industrial heritage. It lacks execution, integration and strategic focus. This is the essence of Europe's crossroads: the constraints are now political and institutional rather than financial.

A clear diagnosis: Europe's competitiveness gap is structural

The Draghi report delivers a sober assessment. Europe's productivity growth has lagged persistently, its share of global innovation has declined, and too few companies have reached global scale in strategic sectors such as digital infrastructure, AI, semiconductors and advanced manufacturing. Capital markets remain fragmented, energy costs structurally higher than in the US, and investment levels insufficient relative to Europe's ambitions.
Crucially, this diagnosis comes with an important clarification: Europe's problem is not affordability. Debt dynamics are manageable, private savings are abundant, and fiscal space exists. The real cost

lies in inaction. Failure to invest risks locking Europe into a low-growth equilibrium, reinforcing political fragmentation and eroding strategic autonomy.

This shifts the debate from “can Europe afford to act?” to “can Europe afford not to?”

Why public markets struggle to express Europe’s transformation

Despite this strategic urgency, European public markets have struggled to reflect meaningful progress. Equity indices remain dominated by mature sectors, with limited exposure to high-growth, capital-intensive transformation themes. Fragmentation, regulatory complexity and conservative capital allocation have constrained the emergence of large, investable champions.

As a result, public markets often underrepresent the areas where Europe must invest most: energy systems, infrastructure, industrial modernisation and innovation at the SME and mid-cap level. This disconnect explains why investors frequently perceive Europe as structurally unexciting, despite the scale of its investment needs.

This is not a failure of opportunity — it is a failure of market transmission.

Private markets as Europe’s transmission mechanism

Private markets are therefore not a tactical allocation in Europe; they are a structural necessity. They provide the channels through which Europe’s strategic priorities can be financed and monetised.

Three areas stand out.

- Infrastructure and energy transition form the backbone of Europe’s renewal. Decarbonisation, energy security and grid modernisation require sustained investment well beyond public budgets and listed utilities. Private infrastructure capital plays a decisive role here, particularly in small and mid-sized assets that offer growth alongside long-term visibility. Regulated or contracted cash flows, strong policy alignment and tangible assets create an attractive risk-return profile, while contributing directly to Europe’s strategic objectives.
- Private debt benefits from Europe’s bank-centric financial system and regulatory constraints. As banks retrench, private lenders increasingly finance the real economy, particularly SMEs and mid-sized corporates. Well-structured private debt strategies offer seniority, covenant protection and floating-rate income, making them especially relevant in a moderate-growth environment. In Europe, private debt is less about leverage-driven returns and more about disciplined capital provision.
- Selective growth and venture capital capture Europe’s innovation where public markets cannot. While Europe lags in scale-up funding, this creates significant dispersion between managers. Top-tier platforms with deep local ecosystems, industrial partnerships and operational expertise can access innovation in deep tech, healthcare, automation and productivity-enhancing technologies. Here, selectivity is paramount — returns are highly skewed, but the upside can be substantial.

Risks: execution matters more than ambition

The European private markets opportunity is compelling, but it is not without risks. Political and regulatory execution remains uneven. Permitting delays, grid bottlenecks and fragmented regulation can affect timelines and returns. Geographic fragmentation adds complexity and reinforces the need for local expertise.

These risks do not negate the opportunity; they increase the value of manager selection. In Europe more than elsewhere, returns depend on sourcing, structuring and execution — not on beta exposure.

Rethinking European exposure

Importantly, increasing exposure to Europe does not necessarily require an overweight in listed European equities. For investors with the appropriate risk tolerance and time horizon, complementary exposure through private markets may offer a broader and more diversified way to participate in Europe's long-term potential, in some cases more efficiently than a purely public-market allocation.

A robust structure typically combines:

- Infrastructure for long-term, policy-aligned cash flows
- Private debt for income, downside protection and real-economy exposure
- Selective growth / venture capital for asymmetric upside

This allocation benefits from diversification across asset types while remaining anchored in Europe's structural investment needs. Importantly, it shifts the focus from macro timing to capital deployment over time, aligning investor horizons with Europe's transformation cycle.

Europe stands at a crossroads between managed stagnation and strategic renewal.

For investors, this argues against broad optimism or outright dismissal. Europe in 2026 is not about chasing beta, but about allocating capital where structural necessity and political will intersect — with infrastructure emerging as the most credible long-term bridge between Europe's challenges and its potential.

Carry Is Still King – In a World Beyond Spread Compression

Key Takeaways

- 2025 confirmed that carry can deliver attractive total returns while improving portfolio resilience in stress episodes.
- Income quality matters: higher-quality carry (e.g., BB high yield) tends to protect better when volatility spikes.
- Volatility can be a source of carry itself when approached dynamically and with risk controls.
- Dividend strategies lagged mainly for style reasons in a pro-cyclical, growth-led year; the long-term role remains intact.
- In 2026, carry becomes more about active income construction (selectivity, diversification, stress-testing) than spread compression.

As we entered 2025, we argued that the investment landscape would not be dominated only by capital gains, but increasingly by income. In a world of elevated yields, resilient growth and tight valuations across risk assets, carry was set to become a central driver of portfolio returns. One year on, market developments over the past twelve months have broadly supported this assessment. Not only did carry deliver strong absolute performance across most income-generating asset classes, it also proved its value precisely when markets were tested, reaffirming its role as a cornerstone of robust portfolio construction.

A Year That Validated the Carry Regime

The most striking confirmation of our 2025 Key Call came from credit markets. Despite initial widespread concerns over tight spreads and late-cycle dynamics, the riskiest segments of the bond market delivered strong risk-adjusted returns.

Our preference for U.S. BB-rated high yield bonds proved particularly effective. Over the year, the BB segment delivered a return of +8.4%, outperforming both B-rated bonds (+7.8%) and CCC-rated bonds (+7.7%). Crucially, this outperformance came with materially lower drawdowns during periods of stress. During the volatility shock triggered by the announcement of new U.S. tariffs, BB bonds experienced a maximum drawdown of –2.6%, compared with –3.2% for B-rated and –4.6% for CCC-rated bonds. This episode once again illustrated a fundamental principle of carry investing: income quality matters as much as income level.

Emerging market debt provided another strong illustration of this discipline. Our decision to focus on hard currency EM bonds, while avoiding local currency exposure, initially penalised performance early in the year. However, during the second half of 2025, U.S. dollar appreciation weighed on local currency emerging market debt, changing the relative performance dynamics in favour of hard currency bonds. Hard currency debt gradually recovered and ultimately delivered a return of +11.6%, outperforming local currency debt by +3.5% over the full year.

Volatility as an Ally, Not an Enemy

One of the defining features of 2025 was the return of episodic volatility, notably around political and trade-related announcements. Rather than treating volatility as a threat to income strategies, we deliberately used it as an opportunity. The sharp spike in implied volatility following tariff announcements allowed us to significantly increase exposure to short-volatility carry strategies at highly attractive entry points.

As volatility normalised and markets rebounded, these positions delivered strong returns, materially boosting the yield of income-oriented portfolios while maintaining a high degree of downside protection. This experience reinforced a key message for income investors: carry is not limited to coupons and dividends. When approached dynamically, volatility itself becomes a powerful and repeatable source of income.

Dividends: A Style Headwind, Not a Structural Setback

Not all income sources performed equally in 2025. Sustainable dividend strategies faced a challenging backdrop in 2025. Their defensive and quality bias proved less effective in a pro-cyclical market environment, where investor preferences shifted decisively toward growth, momentum and more cyclical exposures. The strong, tech-led rally and the dominance of growth stocks favoured companies with higher earnings momentum rather than those prioritising balance-sheet strength, cash-flow visibility and capital discipline. As a result, high-yield and dividend-oriented factors lagged broader equity indices, particularly during periods when market leadership narrowed and risk appetite remained elevated.

This underperformance should be understood primarily as a style effect, rather than a deterioration in fundamentals. Dividend-paying companies continued to generate resilient earnings and cash flows, and in many cases delivered solid absolute returns. Their relative lag reflects a market environment that temporarily rewarded cyclicality over quality, rather than any loss of relevance of dividend strategies within a diversified portfolio.

Looking ahead to 2026, the outlook for dividend stocks remains constructive. As inflationary pressures, geopolitical risks and monetary policy uncertainty continue to shape market dynamics, volatility is likely to persist. In such an environment, companies with reliable cash flows, disciplined capital allocation and sustainable dividends tend to regain appeal. While market leadership may continue to rotate, dividend strategies offer a combination of income visibility and diversification benefits, particularly given their lower exposure to highly concentrated growth segments.

We therefore remain committed to a disciplined, dividend-focused approach, emphasising quality, balance-sheet strength and payout sustainability. In an evolving market environment, this focus remains well suited to delivering steady income alongside long-term growth potential, while enhancing portfolio resilience as investors navigate the uncertainty that lies ahead.

Private Credit: Noise Versus Fundamentals

Private credit fulfilled its role as a stabilising force within income-oriented portfolios, delivering steady and diversified returns in line with expectations. Toward year-end, concerns resurfaced around the asset class, with some commentators warning of systemic risks.

We do not see this as a systemic issue, but rather as a reflection of where we stand in the credit cycle. Dispersion between robust and fragile strategies is increasing, which supports a disciplined and diversified approach: diversified exposures across geographies, sectors and strategy types, with a clear preference for senior, well-structured transactions backed by strong fundamentals. Targeting returns of cash +5% to 7%, without excessive leverage or covenant erosion, remains fully appropriate in the current environment.

Carry in 2026: From Spread Compression to Active Income Construction

Looking ahead to 2026, the carry environment is evolving. Credit spreads across most segments are less attractive, and the “easy” gains associated with post-hiking-cycle normalisation are largely behind us. This does not mark the end of the carry regime, but rather its transition into a more demanding and selective phase, where returns increasingly depend on portfolio construction rather than market beta.

Our focus therefore centres on total yield and expected return over a 12-month horizon, explicitly stress-tested across adverse scenarios. The objective is no longer to rely on spread tightening, but to assemble income streams resilient enough to absorb volatility shocks, episodic spread widening and currency moves without impairing capital.

Within fixed income, this approach favours segments where carry remains attractive and capital structures provide protection. Short-dated high yield and hard-currency emerging market debt continue to play a role where fundamentals remain sound. Senior loans deserve renewed attention, offering floating-rate coupons, senior secured status and historically resilient behaviour during periods of rate volatility. In a late-cycle environment, they provide an effective stabilising complement to more selective high yield exposure.

Regional diversification further strengthens income portfolios. US credit remains attractive with an emphasis on higher-quality segments. European credit, constrained by heavy supply, is suited to disciplined income harvesting rather than return maximisation. Asia credit, particularly outside China, offers carry with limited spread upside, requiring selectivity and shorter maturities. GCC credit stands out as one of the most resilient regional carry allocations, supported by strong sovereign balance sheets, improving credit quality and relatively low volatility.

Beyond traditional asset classes, Quantitative Investment Strategies (QIS) have become increasingly important components of income-oriented portfolios. By harvesting risk premia across equities, FX, rates and commodities, QIS strategies monetise volatility, term premia and relative-value dynamics independently of directional exposure. When integrated thoughtfully, they contribute to more diversified and repeatable carry streams, enhancing resilience in a world of tighter spreads and higher dispersion.

Finally, the political calendar also matters. Entering a mid-term election year, renewed episodes of market volatility should not be ruled out. Historically, such periods have often been characterised by temporary corrections followed by recoveries as uncertainty fades. In this context, volatility spikes may once again create opportunities to re-enter short-volatility strategies, as successfully implemented in 2025, reinforcing carry at attractive entry points.

In a world beyond spread compression, returns will be more selective and dispersion higher. Yet for investors willing to adopt a disciplined, stress-tested and multi-dimensional approach to income, carry remains not only relevant, but indispensable. The challenge for 2026 is no longer simply to find carry, but to construct it deliberately — across assets, regions and risk premia — while preserving capital.

Emerging Debt Local Currency as a Source of Income and Diversification

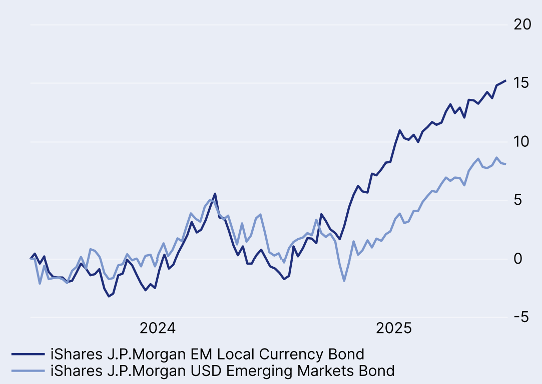
Key Takeaways

- EMD LC delivered exceptionally strong performance in 2025, outperforming most other credit asset classes.
- With yields close to 7%, EM local bonds provide an additional and attractive income source versus DM bonds and EMD hard-currency.
- While a weaker U.S. dollar can enhance returns, EMD LC has historically performed well across a wide range of USD environments.
- EMD LC can enhance portfolio diversification, and the universe is a fertile ground for active alpha generation.

The emerging debt local currency (EMD LC) is a very large asset class, yet complex and often misunderstood. Common myths include that it is always high risk and volatile, that it is just a currency play, that it is only attractive if the U.S. dollar weakens, and that it is redundant if you already hold EM hard-currency (EMD HC) debt. In reality, EMD LC delivered exceptionally strong performance in 2025, posting its best annual returns since 2009 and significantly outpacing EM hard-currency debt. This performance reflected both favourable FX movements and robust domestic fundamentals, including supportive monetary policies, improving inflation dynamics, and healthy external balances. For developed-market investors, EMD LC offers an attractive niche for income generation and enhanced portfolio diversification—a win-win combination.

Hard vs Local EM Debt ETFs

Outperformance of EMD LC in 2025



Source: LSEG Datastream/ CBH Investment Management

An Additional Yield Engine from Local Markets

Adding EMD LC alongside existing emerging debt hard-currency exposure can meaningfully enhance portfolio income. Emerging local bonds offer higher nominal and real yields than most developed-market government bonds, reflecting both higher policy rates and improved inflation dynamics across many emerging economies. Yield to maturity at the index level is close to 7% at the time of writing, compared with roughly 4% for 10-year U.S. Treasuries. Importantly, these yields are also attractive in real terms, as emerging-market inflation expectations have converged toward those in developed markets. For investors already holding EM hard-currency debt, EMD LC adds an additional return engine driven by local rates and currencies rather than credit spreads.

The FX Effect: Risk or Opportunity?

Historically, a weaker U.S. dollar has been a tailwind for EMD LC, as FX gains contribute meaningfully to total returns. In 2025, for instance, EM local currency bonds returned over 17% in USD terms, supported by a roughly 10% decline in the dollar index during the first half of the year. A softer dollar not only boosts EM FX but also encourages emerging-market central banks to ease policy, supporting duration and overall bond performance. Looking ahead, the dollar is expected to remain range-bound or moderately weaker in 2026, which should continue to support EM local currencies. Even if this USD outlook does not materialize, historical evidence suggests the asset class mainly suffers during strong dollar rallies—an outcome we view as unlikely next year given current macro conditions.

Importantly, FX is not a prerequisite for positive returns. Even when the USD stabilized or strengthened slightly in the second half of 2025, EMD LC proved resilient, driven by domestic monetary cycles, inflation trends, and robust external balances. Over the past two decades, EM local currency bonds have delivered attractive median returns across a wide range of USD environments, demonstrating that the asset class can perform well even without a sustained dollar decline.

Different Drivers, Enhanced Diversification

For developed-market investors, EMD LC adds meaningful diversification even alongside existing EM hard-currency exposure. EMD HC behaves largely like a U.S.-centric credit asset, with returns driven by U.S. interest rates, credit spreads, and global risk sentiment, resulting in high correlations with U.S. and European investment-grade and high-yield markets. By contrast, EMD LC is shaped by domestic monetary policy, local inflation dynamics, and FX movements, leading to lower correlation with U.S. Treasuries and global credit. Historically, EM local bonds have shown volatility similar to developed-market government bonds, with relatively contained drawdowns and episodes of outperformance even in stable-dollar environments. They also provide duration exposure driven by domestic factors rather than global credit, enhancing overall portfolio diversification.

Although there is some country overlap between the two segments—particularly among larger EM sovereigns such as Mexico, Brazil, Indonesia, South Africa, and Poland—the regional mix differs materially. Local-currency indices are more weighted toward Asia and Central and Eastern Europe, reflecting deeper domestic markets, while hard-currency benchmarks are skewed toward Latin America, the Middle East, and frontier issuers reliant on external USD financing. Even within overlapping countries, the economic exposures differ, reinforcing the complementarity of EM local and hard-currency debt and strengthening overall portfolio diversification.

A Fertile Ground for Alpha

Recent inflows into EMD LC have been dominated by passive vehicles, which have consistently lagged active strategies, even relative to bottom-quartile managers. This underperformance reflects the deep heterogeneity of the EMD LC universe, where passive ETFs are structurally limited. In our view, active managers can capture meaningful alpha by dynamically adjusting exposures across countries, interest-rate cycles, and FX regimes. They can actively manage yield-curve positioning, separate FX from rates exposure using derivatives, and selectively access off-benchmark frontier markets, which often offer attractive carry, low correlation, and idiosyncratic return potential unavailable to passive vehicles.

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