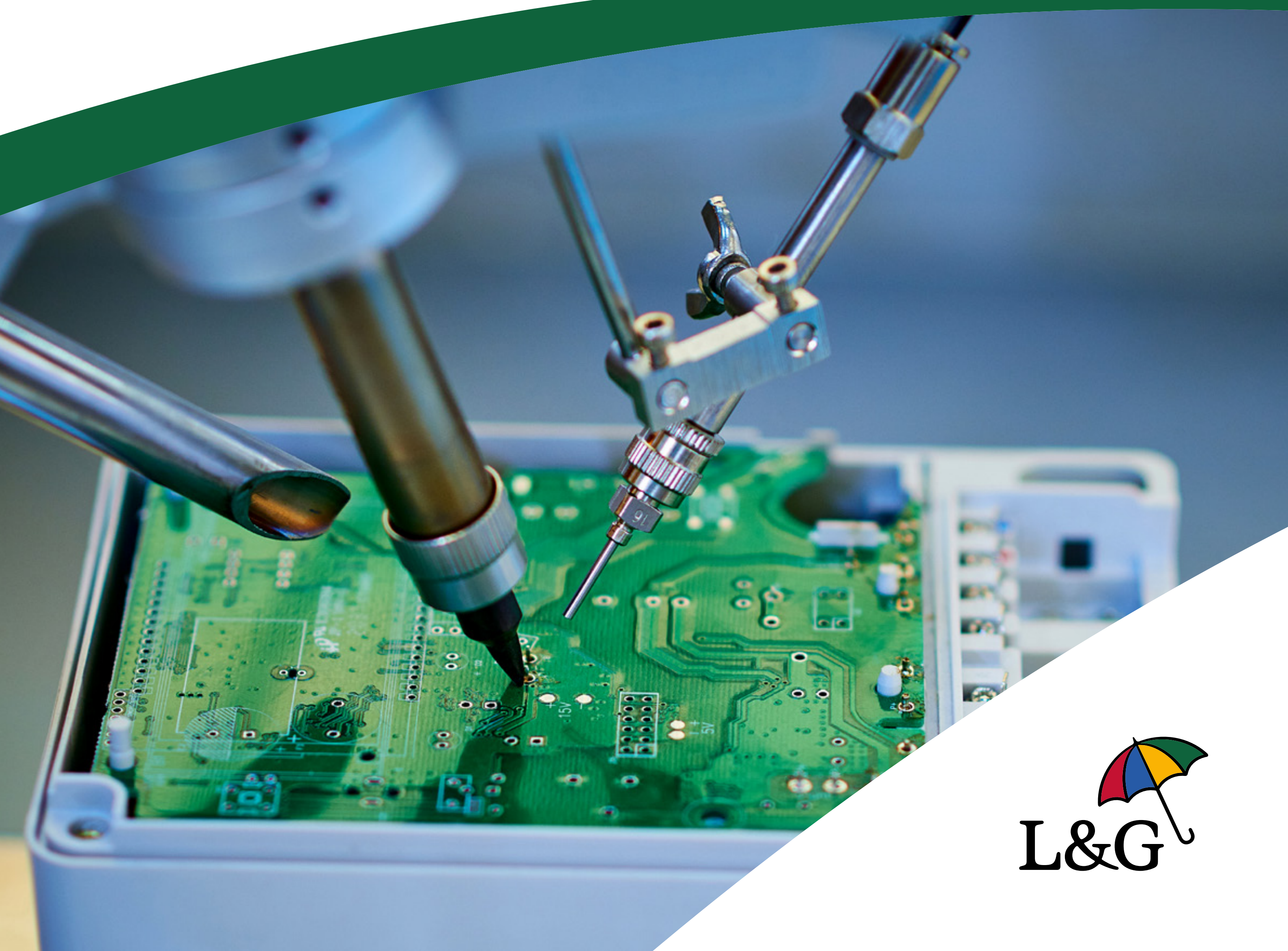
2026 global outlook

Risk and reward amid an AI revolution



L&G

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Foreword

We devote much of our outlook to tackling key questions for investors raised by this period of extraordinary technological change.

Sonja Laud
Global Chief Investment Officer

Bill Hughes
Global Head of Private Markets

The first half of this decade has been characterised by a global pandemic, multiple geopolitical crises and dramatic developments in artificial intelligence. The latter trend seems set to dominate the second half.

Investor hopes for far-reaching applications of AI have certainly led risk assets in 2025. Albeit narrowly focused gains have driven many markets to significant returns, as at the time of writing, even after the recent pullback in some of the more speculative areas of the investment universe, such as crypto.

We share in some of this excitement. Economists have long debated the macro consequences of technological change. Joel Mokyr, an economic historian and recent Nobel laureate, has shown that innovations like railroads, automobiles and personal computers have had transformative effects.

AI is likely to prove just as transformative as it reinvents the ways in which we live, work and play – if not even more so, in our view. And yet, as we noted back in 2023, just as this new industrial revolution based around human-AI collaboration ushers in vast opportunities, it also presents manifold risks.

Key questions

As investors, we can prepare for some of the probable implications of AI, such as the explosion of public and private debt issuance to support the so-called 'hyperscalers'. But we accept that many of the questions raised by the era-defining technology remain unanswered.

That is why much of this outlook, which includes views from across our global Asset Management business, is devoted to the theme. Key takeaways include:

- AI may have a far bigger impact on the economy and markets than historical parallels suggest
- The US economy will likely determine which of a wide range of scenarios for global growth plays out in 2026
- Carefully constructed index, equity and or multi-asset strategies could help investors overcome AI-related challenges and concentration risk
- Amid the focus on fiscal challenges, fixed income investors can take comfort in the notion that the US is still seen as the 'cleanest dirty shirt'

Even as the spring's tariffs-related volatility recedes into distant memory, we recognise that both geopolitics and domestic politics retain their ability to wrong-foot markets.

As such, we explain why we seek to shun 'reckless prudence' in an increasingly uncertain world, as well as offer an optimistic take on emerging markets and discuss how innovative exposure can be achieved.

We also show how an evolution in liability-driven investing seeks to balance preservation and growth objectives.

Our futures

As we consider what the next five years and beyond may bring, our purpose at L&G feels ever more relevant: "Investing for the long term. Our futures depend on it."

With foundations stretching back to 1836, we have seen more than one period of transformational change. Throughout them all, we have sought to capture the opportunities, and manage the risks, on behalf of our clients.

> "Just as this new industrial revolution based around human-AI collaboration ushers in vast opportunities, it also presents manifold risks."

Economics

The US swing factor

The world's largest economy will likely determine which of a wide range of scenarios for global growth plays out in 2026.

Tim Drayson
Head of Economics

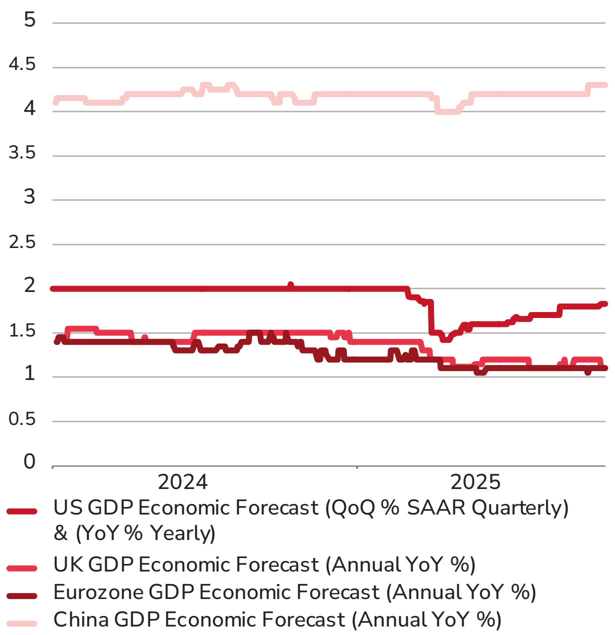
Global growth has been surprisingly resilient since the spring, despite the uncertainty caused by disruptive US trade policy. Growth has been aided by rapid AI spending and positive wealth effects on consumption from surging big tech stocks.

Looking ahead, consensus forecasts reflect a return to equilibrium in a number of economies during 2026, with global growth around trend, unemployment close to its natural rate, inflation potentially on a path towards target and many central bank rates moving to near 'neutral'.

While central forecasts appear clustered around this view, there are a wide range of scenarios; these mostly reflect the US economy as the swing factor.

In the near-term, consensus expects a couple of softer quarters in the US as tariffs feed through into higher prices and this squeezes real incomes. But growth is expected to recover through 2026. Tariffs are seen as a one-off price level effect, which will fade, while consumers should receive a moderate boost to annual disposable income from rebate checks in the spring, given tax cuts in the One Big Beautiful Bill passed earlier this year.

Consensus GDP forecasts for 2026, since 2024



Source: MacroBond, L&G as at 19 November 2025.

Assumptions, opinions, and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

The euro area has been more sluggish, but growth is expected to strengthen gradually from a turn in the global manufacturing cycle, with the potential for earlier rate cuts boosting interest-rate sensitive parts of the economy and government spending in defence and infrastructure gaining traction, notably from Germany.

As the chart shows, China is expected to grow in the 4-5% range with government support and a diminished drag from the property sector.

We see the UK as being relatively more vulnerable to weaker-than-expected growth, given tightening fiscal policy. However, this could trigger more interest rate cuts than the two priced by the Bank of England over the next year from 4% in November, in our view.

Downside and upside risks

Downside risks revolve around concerns the US labour market could weaken further, in our view. So far, the slowing in employment growth reflects both demand and supply factors, with immigration flows abruptly halting. But if layoffs were to increase, consumer job fears would intensify, likely triggering a pullback in spending. It is not clear that the Fed would be prepared to cut interest rates fast enough to fully offset this dynamic, especially if inflation is rising.

Tariff pass-through has proven more muted than expected so far, but this could be a delayed effect. Inventories were built in anticipation of tariffs; once they are depleted, firms might feel more compelled to raise prices.

Geopolitics remains another source of risk. For example, should the Supreme Court rule that the President has overstepped his authority in using the International Emergency Economic Powers Act to impose tariffs, this could inject a fresh round of uncertainty in US trade policy.

Upside risks mainly reflect the potential for continued strong investment in AI and business adoption, which could boost economy-wide productivity, as noted elsewhere in this outlook.

However, the AI roll-out has a number of challenges. There is a danger of over-investment. If return expectations are not met, AI-related equity prices could correct, delivering a shock to household wealth. Alternatively, the pace of change might be so fast that AI automation leads to job losses. The disruption could undermine consumer spending, even as firms potentially expand margins through efficiency gains.

> "Downside risks revolve around concerns the US labour market could weaken further."

Asset Allocation

Building resilient portfolios in an uncertain world

Why we seek to shun reckless prudence in favour of clearly reasoned strategic allocations.

Chris Jeffery
Head of Macro Strategy, Asset Allocation

Robin Martin
Global Head of Investment Strategy and Research, Private Markets

David Chapman
Head of Multi-Asset, L&G – Asset Management, America

In a twist on the author Leo Tolstoy's famous adage, we'd argue that "all bullish investors are alike, but all bearish investors are bearish in their own way". Investment managers can always point out reasons to worry, but the nature of the concern shifts over time.

The regular survey by Bank of America of fund managers is a good reflection of the zeitgeist.

With 2026 nearly upon us, the following are top of the list: AI valuation concerns, nebulous fears about private credit and the perennial angst about the inflation outlook. Geopolitics is also never far from investors' thoughts, given the simmering tensions.

Known unknowns

A number of these drivers are better characterised as existential uncertainty rather than risk. Risk refers to situations where the probabilities of outcomes are known or can be measured; uncertainty describes scenarios where these probabilities are unknown or difficult to estimate. Uncertainty is fundamentally less quantifiable and more challenging for investors to manage.

The only way to avoid all such worries is to take shelter in cash, but that is not a recipe for either liability- or inflation-beating returns. In fact, it is compensation for taking exposure to these unquantifiable uncertainties that can drive excess returns. The sensible framing of the problem is to think about how they can be mitigated without forgoing the most important opportunities.

In the current environment, we think there are four important risk axes where investors can legitimately debate whether simply avoiding the risk portends supernormal returns or whether its crystallisation could trigger stagnation or, even worse, a genuine market relapse.

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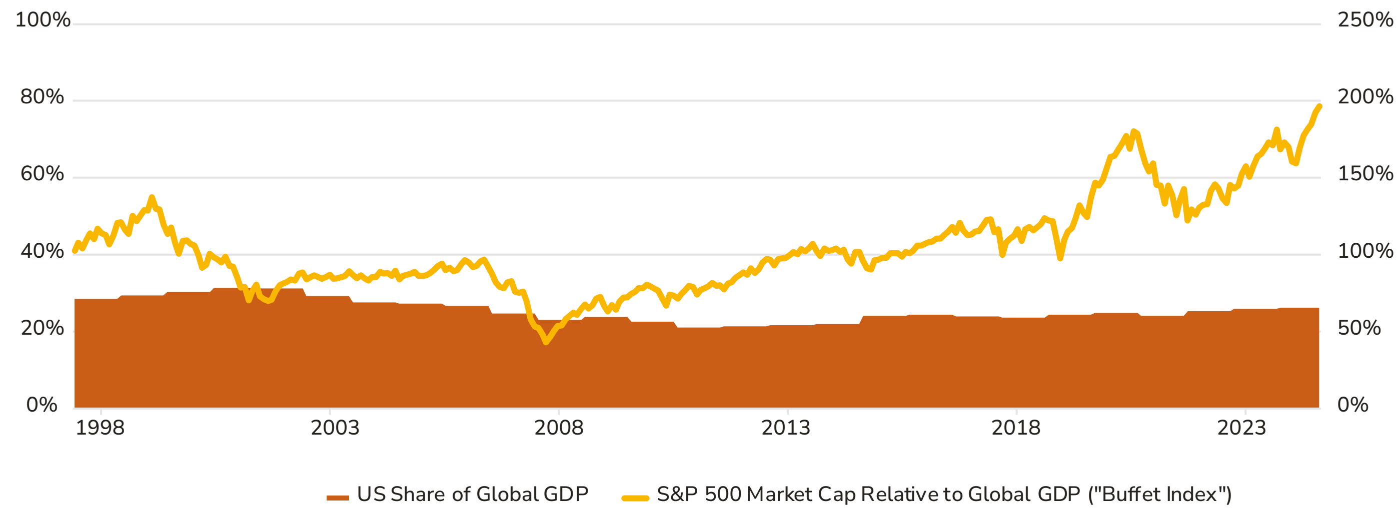
Those four are:

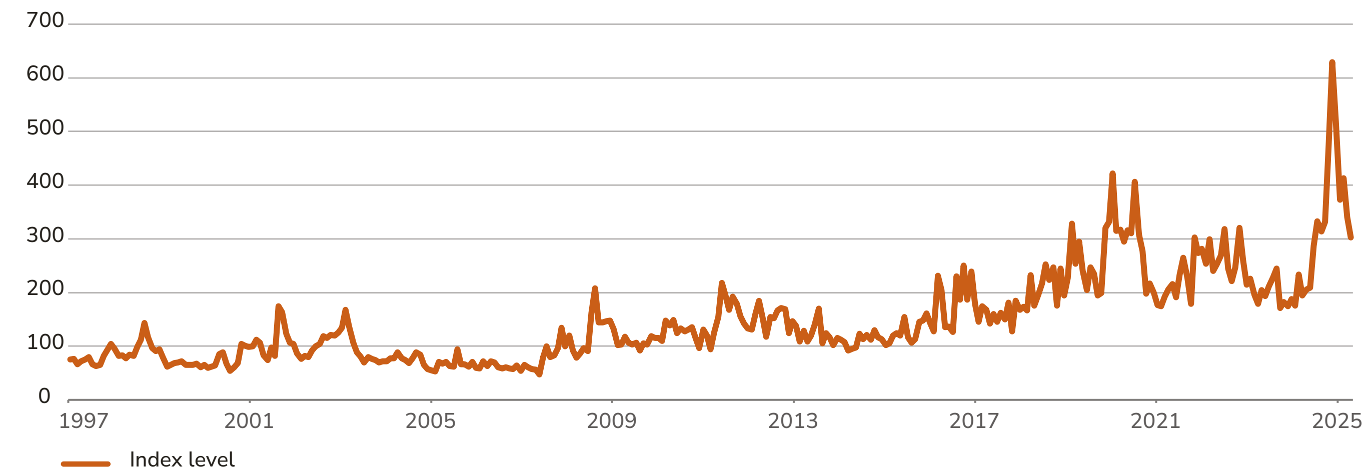
- **Bubble trouble.** At the end of the third quarter in 2025, according to Bloomberg data, the market cap of the so-called 'Magnificent Seven' stocks in the US exceeded the market cap of the MSCI EAFE index, representing the 700 largest stocks in Europe, the UK, Japan and the Asia-Pacific. Debate is swirling about the validity of comparisons to the concentration risk of the dotcom boom in the late 1990s.
- **Political peril.** The political outlooks for the US, UK, EU and China continue to be endlessly scrutinised, with attention inevitably skewed towards the former. The US heads to mid-term elections in November 2026, and a Republican 'clean sweep' victory would offer up the prospect of additional radical reshaping of the US government in the final two years of the Trump administration. We think a Democrat victory in either House of Congress would imply that two years of legislative paralysis beckons.

Bubble trouble: S&P 500 market cap versus global GDP



Source: Bloomberg, L&G calculations as of 31 October 2025.
Past performance is not a guide to the future.

Political peril: Global Economic Policy Uncertainty Index



Global Economic Policy Uncertainty Index: Current Price Adjusted GDP, Index, Monthly, Not Seasonally Adjusted. Source: Federal Reserve Bank of St. Louis, as at September 2025.

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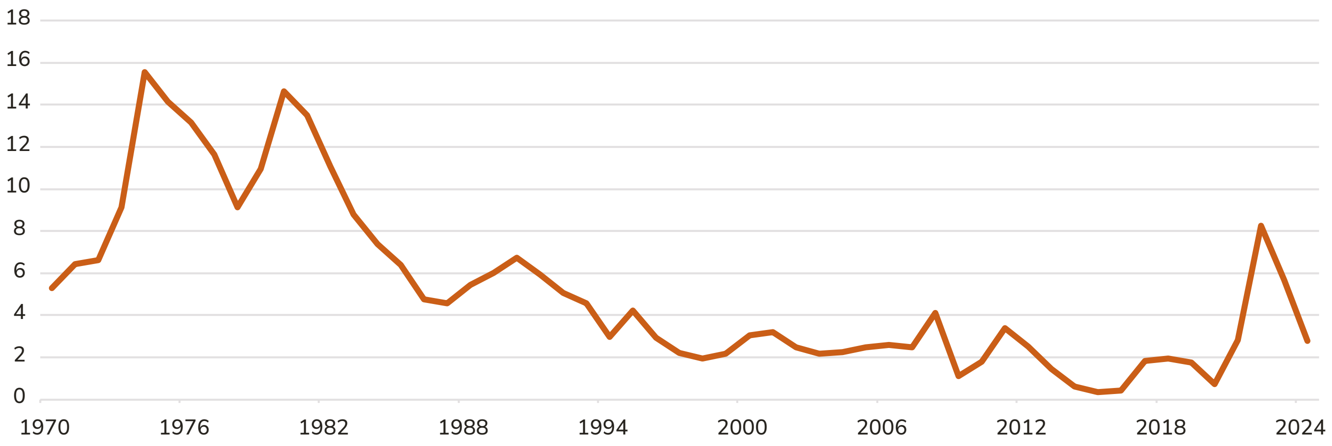
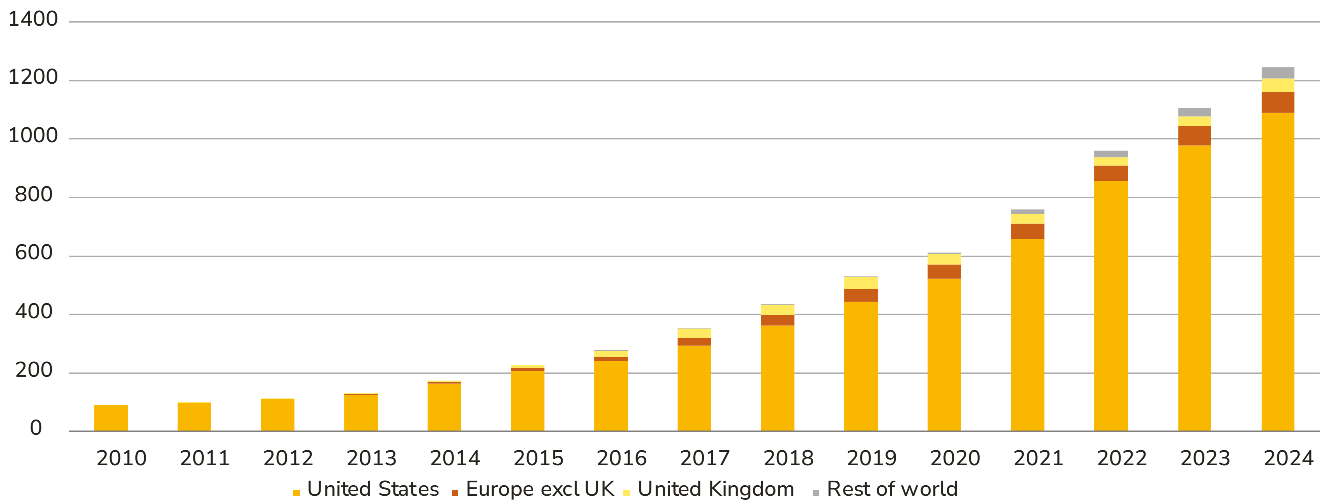
- **Inflation irregularities.** The aftermath of the pandemic, combined with the Russian invasion of Ukraine, drove inflation across the OECD to levels not witnessed since the 1970s. Having been let out of the box so recently, it may be hard for investors to completely move on from inflation concerns.
- **Minsky memories.** The growth of private financing is a double-edged sword. Wider participation in private credit and equity increases the opportunity set for a broad range of investors, but fosters concerns about the rapid growth of financing outside of the most regulated channels. That inevitably draws comparison with previous episodes of rapid credit growth and the risk of overextension among both borrowers and lenders.

Inflation irregularities: Inflation, consumer prices for OECD members, percent, annual, not seasonally adjusted



Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, as at 18 November 2025.

Minsky memories: private credit loans outstanding ($ bn)



Source: BIS Quarterly Review as at 11 March 2025.

What do we do about these concerns?

There is extensive evidence that the perception of higher uncertainty leads to heightened risk aversion and amplifies behavioural biases such as familiarity and home bias.[1] It is linked to the idea of 'reckless prudence' – insufficient risk-taking to realistically meet long-term objectives. We'd argue that's almost the opposite of what is needed.

Instead, we aspire to build 'resilient portfolios'.

What does that mean? We can divide a list of initiatives that we can use to think about this into strategies at the total portfolio level and those which operate at the asset-class level.

At the total portfolio level, steps include:

(1) **Adding alternative public assets:** broad commodity ETFs can offer liquidity and simplicity, while synthetic commodity exposure can enhance capital efficiency. Investors typically have a small, if any, allocation to commodities, which can diversify traditional exposures to equities and fixed income.

(2) **Adding private assets:** investors have long looked to private markets with the aim of enhancing portfolio outcomes through a combination of complexity and illiquidity premia, in addition to diversification. Certain market segments offer access to industry sectors and business types that are hard to access via public markets, such as social and affordable housing. We think affordable housing can be attractive to clients who take a very long-term view in portfolio construction and value the prospect of stable, inflation-linked returns over liquidity needs.

(3) **Adding alternative risk premia** may be increasingly attractive for targeting returns as the risk / reward outlook for equities becomes ever more challenging. Investors seeking to clear a return hurdle may be compelled to move beyond traditional asset classes in search of consistent, repeatable outcomes.

1. See Prospect Theory: An Analysis of Decision under Risk, by Daniel Kahneman and Amos Tversky (1979)
2. **It should be noted that diversification is no guarantee against a loss in a declining market.**

(4) **Risk-conscious hedging** of unacceptably poor outcomes may seem uncompelling given the historically poor carry – the return or cost of holding the position. However, we see equity hedges as priced fairly (relative to their own history) going into 2026. Prospectively, though, the four risk axes outlined above seem poised to pull portfolios strongly away from central expectations in any one of those directions. Direct hedging ensures resilience in the face of those risks.

Within established asset classes:

(5) **Sector and geographical diversification**[2] can be achieved through active risk taking or strategic benchmark design and selection. In recent years, sectors and markets with less challenging valuations generated strong absolute returns while being largely overshadowed by US large cap tech. Active asset allocation can help identify ample opportunities outside the mainstream. In private markets, asset owners are increasingly considering complementing US exposures with allocations to Europe and, selectively, APAC.

(6) **Decorrelated niches:** as an example, within private credit, there is a spectrum of risk-return profiles. Many investors now have substantial allocations to sub-investment grade lending. Although returns have been healthy, this does come with associated credit risk. The investment grade space in private credit, which has long been used by insurers to match liabilities, has a track record of credit quality being substantially insulated from the economic cycle.

We will conclude with another, unaltered quote from a Tolstoy novel: "All the variety, all the charm, all the beauty of life is made up of light and shadow". By accepting the shadow of uncertainty, and harnessing the light of strategic allocations, we seek to construct truly resilient portfolios for our clients.

> "There is extensive evidence that the perception of higher uncertainty leads to heightened risk aversion and amplifies behavioural biases."

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Credit markets

Fiscal fault lines: how debt sustainability fears may shape 2026

How after years of fiscal largesse, the ‘debasement trade’ has gained significant momentum, just as AI fuels an extraordinary wave of capital investment.

Matthew Rees
Head of Global Bond Strategies – Unconstrained

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Head of Multi-Sector Fixed Income & Investment Strategy, L&G – Asset Management, America

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Solutions Strategist,
L&G – Asset Management, America

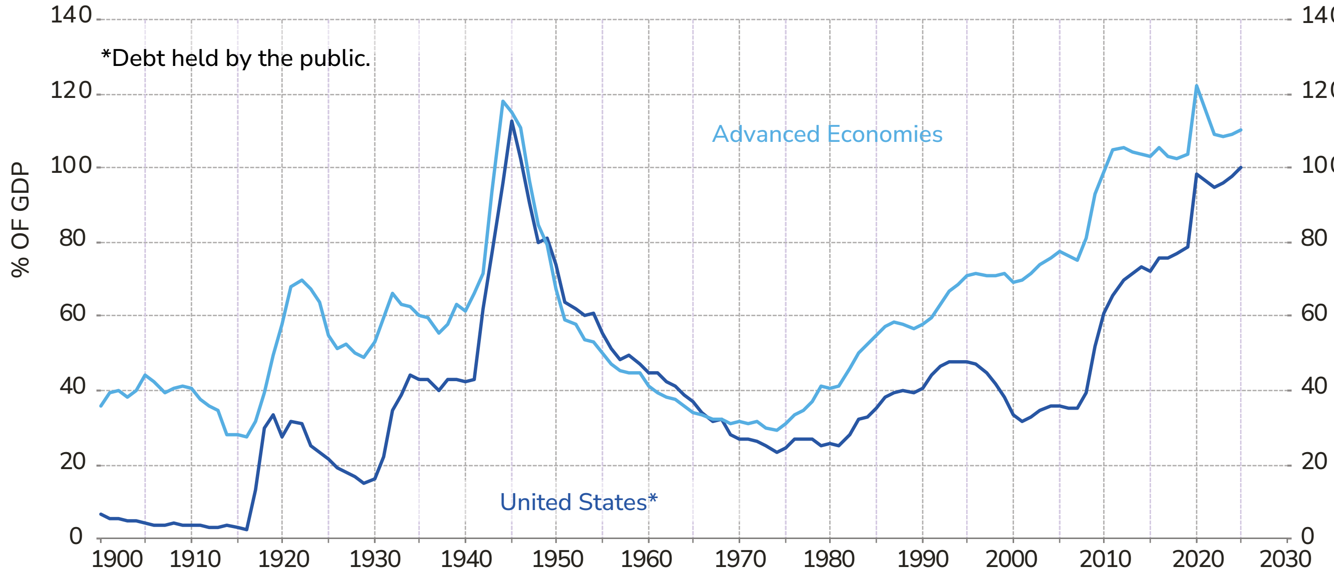
Lushan Sun
Head of Cross-Asset Research, Private Markets

A surge in government debt during the pandemic enabled developed economies to survive the crippling impact of lockdowns on economies. But it also reminded politicians that giving money to the electorate sometimes translates into votes.

Perhaps unsurprisingly, therefore, debt has reached levels not seen since the Second World War.

In the US, despite persistent calls for fiscal consolidation by Democrats and Republicans, there appears to be little appetite to curb spending, and the fiscal deficit remains elevated.

Gross public sector debt/GDP



Source: CBO, IMF; Minack Advisors
As at 31 October 2025.

Enter the bond vigilantes

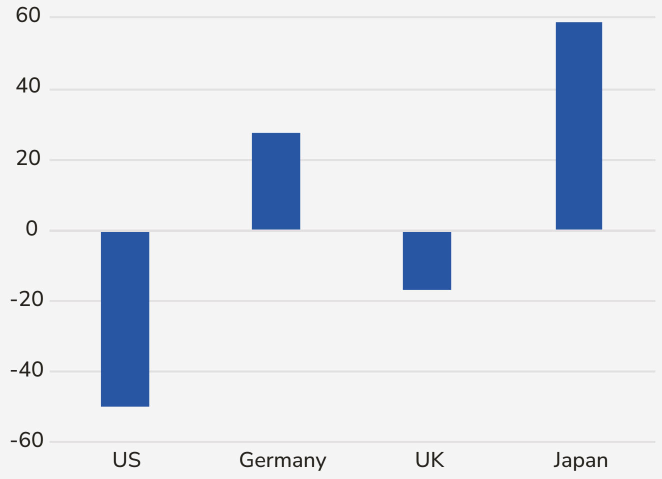
The post-pandemic boom coincided with an energy price spike following Russia’s invasion of Ukraine, leading to inflation and rising rates. The ‘bond vigilantes’ returned amid concerns about inflation and debt sustainability, resulting in a sharp increase in longer-term funding costs.

In the US, worries around a looming debt crisis spiked shortly after the tariffs-related ‘Liberation Day’. However, although US largesse has dominated headlines, investors have become increasingly wary of the deteriorating fiscal position of other G10 markets.

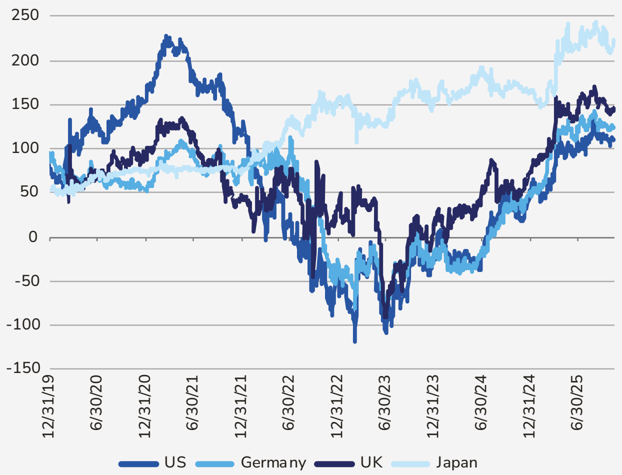
The material repricing in the term structure of rates is not just a US phenomenon – term premiums have risen even more abroad.

US Treasuries have outperformed developed-market peers over the past year

G-4 YTD change in yields (basis points



Evolution of G-4 2s30s yield curves (basis points)



Source: Bloomberg, L&G Research, as of 12 November 2025.
Past performance is not a guide to the future.

For some time, we have believed that governments are not incentivised to issue the most expensive debt. And this is what has happened over the past few years – the proportion of shorter-dated debt has increased.[5]

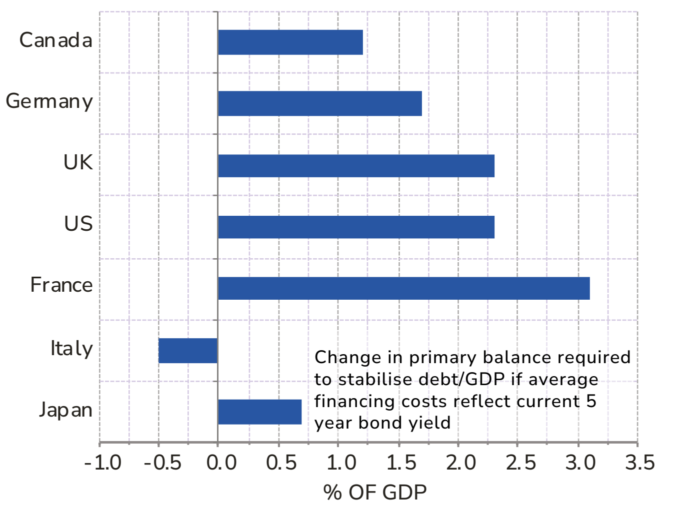
Keeping the peace with bondholders

Although fiscal austerity is not politically fashionable, the stirring of the bond vigilantes is nudging some governments to respond.

The UK is aiming to maintain a fiscally neutral budget by the end of parliament, while the new Japanese premier is also trying to contain expectations over huge fiscal spending.

Apart from France, the budget adjustments required by governments are not massive by historical standards, but we are not yet seeing many signs that increasingly populist governments will accept the pain.

Budget adjustment required to stablise debt/GDP



As at 31 October 2025. **Assumptions, opinions, and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

In the US, the One Big Beautiful Bill Act is projected to increase the deficit by $3.4 trillion over 10 years, according to the Congressional Budget Office, largely owing to reduced federal tax revenues. Consequently, the technical backdrop will remain a headwind for Treasuries.

While the end of quantitative tightening should provide some modest relief, price-sensitive buyers will likely continue to demand additional compensation to take down long-term debt amid elevated policy uncertainty and two-way inflation risks.

What happens next?

The rollover of debt mountains could become an issue for countries whose average debt maturity is short. Most developed markets are not yet near this position, but that could change over the next few years.

Apart from an unexpected outbreak of fiscal austerity, investors should also watch out for indications of financial repression or engineering to finance deficits.

We note that the US promotion of stablecoins (often backed by short-term government debt) and the easing of US bank capital regulation (enabling banks to hold more treasuries) should help the government fund its fiscal deficit.

Finally, a return of quantitative easing could also assist in financing deficits, but this would most likely require some form of market or economic shock. Governments (and investors) should be careful about what they wish for!

> “Investors can take comfort in the notion that the US is still seen as the ‘cleanest dirty shirt’.”

The role of Treasuries in 2026

The ‘debasement trade’ has become increasingly topical amid the surge in gold and crypto prices. While fears over government debt and expansionary monetary policies eroding the purchasing power of fiat currency are not without merit, we still see a place for US Treasuries.

With yields well above post-global financial crisis averages, and the US policy rate generally viewed as modestly restrictive, we believe short-dated Treasuries can serve as an effective hedge should risk assets come under duress and / or the economy tip into recession.

Moreover, if this year is any indication of the market’s assessment of fiscal risk, investors can take comfort in the notion that the US is still seen as the ‘cleanest dirty shirt’.

AI spending in focus

In tandem with the sovereign debt dynamics discussed above, AI is fuelling an extraordinary wave of capital investment.

The AI capex boom is well underway, and even with tech companies funding a healthy portion from their free cash flows, the revolution will be heavily funded by debt. This deluge of supply is not only likely to exert widening pressure on spreads, but may also put upward pressure on risk-free rates.

According to Morgan Stanley,[6] global data centre expenditure is projected to reach about $3 trillion by 2028, which translates to ~$1 trillion in annual investment demand by 2028. For context, the total capital expenditure of all S&P 500 companies in 2024 was only about $950 billion. Most importantly, Morgan Stanley expects $800 billion of supply to flow through private credit markets by 2028.

At the same time, the recent bankruptcies of First Brands and Tricolor have created a lot of anxiety over the health of the private credit market. In fact, both were deep sub-investment grade (“IG”) borrowers – so their bankruptcy had little impact on IG private credit. They also sought most of their financing from banks and working capital funds; sub-IG private credit exposure was very limited.

Idiosyncratic cases like First Brands point to emerging cracks, but there’s no clear evidence at the moment pointing to broader stress in sub-IG private credit, in our view. Default rates in direct lending remain low and falling interest rates should support debt servicing. Nevertheless, recent events have been a useful wakeup call and once again emphasise the importance of robust underwriting and portfolio diversification. We think investor caution should drive better underwriting standards, which could lead to improved credit performance for future vintages.

2025 is the year when the AI revolution truly reached private credit. Several multi-billion deals were announced, including Meta’s $29bn AI data centre financing and Microsoft’s $30bn partnership with BlackRock.* This is not a fleeting trend: we expect further growth in private credit financing of digital infrastructure in 2026. The surge in debt supply could shift negotiating power in favour of lenders, which would be welcome news for investors after several years of spread compression and covenant erosion.

However, there are plenty of risks associated with the sector – cost volatility, obsolescence risk and overcapacity, to name a few. For investors, we believe the opportunity lies in targeting private credit strategies that capture the structural tailwinds of AI-driven infrastructure, while maintaining disciplined risk management in a rapidly evolving market.

5. Refer to chart C on page 28 of the 2025 OECD Global Debt report.

6. As at July 2025

*** For illustrative purposes only. Reference to a particular security is on a historic basis and does not mean that the security is currently held or will be held within an L&G portfolio. The above information does not constitute a recommendation to buy or sell any security.**

The next wave of liability-driven investing

Christopher Wroblewski
Co-Head of Solutions Strategy, L&G – Asset Management, America

We show how an evolution in approach seeks to balance preservation and growth objectives, by widening the investment toolkit.

Defined benefit (DB) pension plans have long relied on liability-driven investing to manage risk and align assets with liabilities. As the landscape of DB pension plans continues to evolve, we are entering its next wave: LDI 3.0.

LDI 3.0 builds on the evolution of the strategy over the past two decades. In the early stages, plan sponsors opted to simply extend the duration of their fixed income using longer duration market-based benchmarks. In the US, the next phase of LDI involved a more customised approach to credit and Treasury strategies to better align with the liability risk profile, most commonly involving a long credit allocation and a custom Treasury portfolio to hedge interest rate risk.

As funding ratios for corporate DB plans have improved in recent years, many DB plans are fully funded or in surplus, with fixed income the dominant class within their asset allocations. As corporate DB plans mature and fixed income allocations grow, plan sponsors have more flexibility to improve diversification and potentially seek more yield while still meeting their hedging objectives.

Enter LDI 3.0, which involves broadening the fixed income toolkit beyond traditional investments to potentially enhance yield and improve diversification.[7] It comes as more companies are planning to keep their overfunded plans compared to prior years amid growing recognition of the opportunities that exist from managing the plan in run-off mode. Indeed, according to a Mercer survey in June, 50% of US plan sponsors do not intend to terminate their DB plans in 2025, up from 36.7% in 2023.

7. **It should be noted that diversification is no guarantee against a loss in a declining market.**

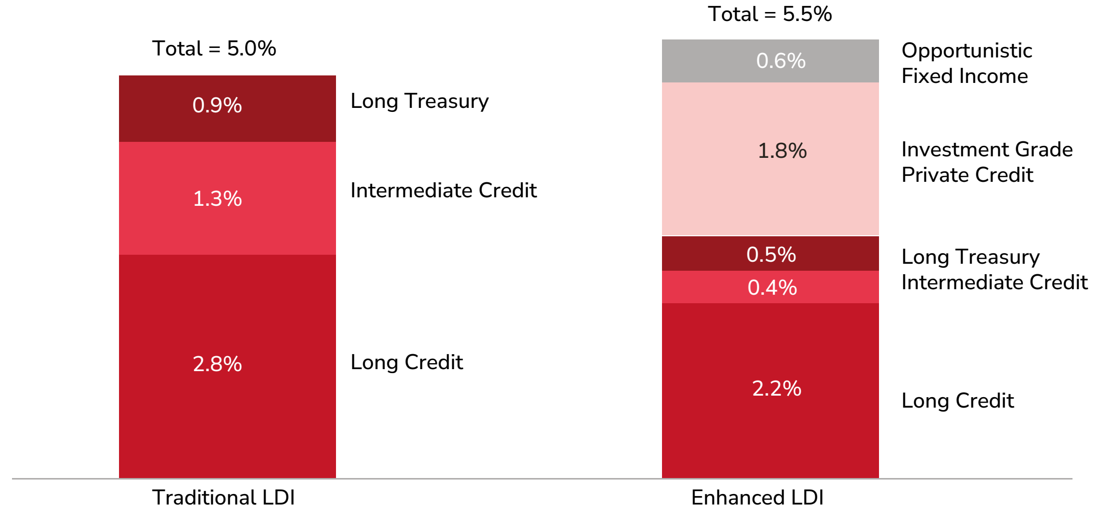
LDI 3.0 takes its inspiration from how insurers structure their investments to balance preservation and growth objectives, widening the LDI investment toolkit to include:

- **Short duration fixed income** to enhance collateral efficiency and optimize liquidity and yield objectives
- **Opportunistic fixed income** to improve diversification and unlock uncorrelated sources of return potential
- **Securitised assets** for potential spread pick-up while maintaining high credit quality
- **Investment grade private credit** to gain yield potential and diversification

To be sure, there is no one-size-fits-all solution. Circumstances matter, and we think LDI programmes should be considered from a holistic point of view. However, as the chart shows, we find that the enhanced fixed income portfolios that characterise LDI 3.0 can potentially lead to enhanced yields and improved funded status outcomes while also lowering drawdown exposure.

The bottom line: LDI has long sought to minimise volatility and improve funded status outcomes. As DB plans continue to evolve and mature, so should the LDI strategy.

The potential yield pick-up of enhanced LDI



Source: L&G – Asset Management, America and Bloomberg. Data as of September 30, 2025. Traditional LDI represents a portfolio of 50% long credit, 30% intermediate credit and 20% custom Treasury. Enhanced LDI represents a portfolio of 40% long credit, 10% intermediate credit, 30% investment grade private credit, 10% custom Treasury and 10% opportunistic fixed income.

Assumptions, opinions, and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested.

DC pensions

Addressing under-saving for retirement

Given strains on government finances, how can the pension industry meet this growing challenge?

Jayesh Patel
Head of UK DC Distribution

According to the Department for Work and Pensions (DWP), around 12.5 million UK adults, or 38% of the working-age population, are currently under-saving for retirement.[8]

There are important nuances within that cohort. For example, ethnic minorities face a significant pensions savings gap – our research suggests that they are under-saving by as much as 54% compared to white British Defined Contribution (DC) pension savers.[9]

Given mounting pressures on government finances and the wind down of DB pensions, we believe DC schemes must evolve to address pension adequacy. To improve retirement outcomes, smarter investment strategies are essential, in our view. DC schemes are increasingly diversifying beyond traditional asset classes to unlock growth.

Approximately 90% of UK DC pension savers currently remain in default investment funds,[10] driving renewed attention to enhancing these offerings – a trend set to continue in 2026.

Income opportunities

Delivering more income opportunities in the growth stages while balancing flexibility in the decumulation stage is key for modern-day defaults.

Approaching the decumulation phase, we favour placing greater weight on risk management by lowering the equity and increasing the dynamic asset allocation. Decumulation is likely to lead further innovation in 2026.

We believe private markets will continue to gain traction through innovative pooled vehicles that solve the daily pricing and liquidity challenges. These markets offer diversification and access to illiquidity premiums, with the prospect of boosting long-term returns.

L&G was one of the first asset managers to launch a diversified private markets strategy range designed for DC savers. While the primary goal is to improve member outcomes, this approach also channels pension capital into investments that support economic growth, infrastructure and social progress.

8. As at March, 2023
9. As at June, 2023
10. Source: DWP as at December, 2024

It should be noted that diversification is no guarantee against a loss in a declining market.

More broadly, global responsible investment integration and climate-aware investing has extended to encompass nature and social impact. At L&G, we have enhanced our offering to DC savers to these areas, with a focus on emerging markets. We've also allocated to thematic equities focused in areas of sustainability.

These are examples of how by using every lever at our disposal, seeking dynamic asset allocation and advanced risk management solutions, the pension industry can help support changing member and societal needs.

While investment innovation is vital, it alone won't solve pension adequacy. Just as essential are member support; financial education; personalised, tech-driven tools and nudges toward higher contributions.

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested.

Long-term themes

Is AI the answer?

While scepticism runs high, there's potential for AI to have far bigger impact on the economy and markets than historical parallels suggest.

Jason Shoup
Chief Investment Officer, Co-Head of Global Fixed Income, L&G – Asset Management, America

Matthew Rodger
Economist

James Tyrrell
Research Analyst

Ewan Bowerbank
Portfolio Manager

AI is the topic du jour, with concerns about bubble risk dominating headlines. Yet while AI-scepticism runs high, there's been a lot less focus on the implications should the technology deliver.

Historical parallels suggest a modest productivity boost translating into 30-50 basis points of gross domestic product (GDP) uplift for a decade, before the economy reverts to trend. But AI's potentially universal application and 'agentic' ability to replicate human output hint at a far bigger impact.

Long-term economic implications

If AI-powered computers can take on a wider set of tasks, demographic burdens in rich countries could lighten through automation in sectors like elderly care. AI could also reshape the debt sustainability profile for rich countries. If AI powers a run of growth and tax revenues similar to the stellar run of technology-enhanced global growth that substantially lightened the fiscal burden in the 1990s, today's fiscal anxieties could ease.

Meanwhile, big tech's push to build massive data centres could balkanise AI infrastructure, with global powers like the US and China capturing disproportionate benefits, even as AI applications could simultaneously democratise growth in more fiscally constrained regions.

With regards to the labour market, in typical capex cycles, job shedding is delayed until recessions force firms to realise productivity gains. Yet that may not be the case with AI, as it rivals humans in an increasingly larger share of tasks. The cadence of labour market effects from AI may catch many by surprise, with the potential risk that AI increasingly weighs on white-collar jobs even as productivity rises.

In the US, the labour market already looks fragile; companies have paused hiring given tariff uncertainty while anticipating AI productivity gains to come. A move to shed labour outright could squeeze median and youth consumers. Typically, such a scenario would impact growth and might lead to a recession. Yet if AI is delivering productivity gains and driving an investment capex boom, then GDP might remain near trend even as the unemployment rate rises – a very unusual scenario.

How markets could react to this scenario is tricky to predict. If median-consumer weakness drives disinflation and unemployment rises while growth stays near trend, the Federal Reserve could cut aggressively. Lower rates may not save jobs but could be risk-positive for markets.

11. For illustrative purposes only. The above information does not constitute a recommendation to buy or sell any security. Reference to a particular security is on a historic basis and does not mean that the security is currently held or will be held within a L&G portfolio.

Not a bubble but a sentiment surge

We believe two distinct concerns – that 'hyperscalers' may be overvalued and that AI may fail to deliver real productivity gains – often get conflated in the current debate about the technology. While the jury is still out on the long-term economic implications of AI, we believe bubble concerns about current valuations are overblown. Those concerns centre around the belief that hyperscaler valuations look so stretched that it's difficult to see how the sector can generate the required rate of returns to justify its massive capex.

Yet hypserscalers' huge stock gains over the last three years have come with a doubling of EBITDA and steady margins, not just multiple expansion. Nvidia[11] – a key enabler of AI – has seen its price-to-earnings (P/E) multiple compress from 39x to 29x, even as its total shareholder return soared by 998%, driven entirely by earnings growth rather than multiple expansion.[12]

If we aren't in a bubble on current valuations, and today's use cases support the current level of spending, it's worth considering whether we are in a sentiment bubble. Nvidia's CEO, Jensen Huang, speculated in September that global AI infrastructure spending may reach $3-4 trillion per annum by the end of the decade. This scale of spending is many magnitudes above what even the most bullish analysts are forecasting.

Amazon's Jeff Bezos has called the AI investment boom an "industrial bubble," not a financial one. All AI ideas are getting funded – good and bad. If the tech is real, then most of the value will accrue to the implementers, not the enablers.

As such, from a macroeconomic perspective, bad AI investments might be an acceptable cost to bear for the sake of fast innovation that could revolutionise the American economy. In addition, the AI spending boom does not look aggressive when compared to other technological revolutions. That said, some hyperscalers seem to be investing with the rationale that falling behind the AI-curve will present existential risk to their companies. That dynamic likely increases the risk of wasteful spending.

We do think AI has the potential to change businesses the way the Internet did, but at a much faster rate. Its impact will be broad and deep, with businesses previously considered to have impeachable economic moats brought under pressure. Numerous blue-chip companies could have their 'Kodak moment' simultaneously.

> "We believe two distinct concerns – that 'hyperscalers' may be overvalued and that AI may fail to deliver real productivity gains – often get conflated."

12. Source for hyperscaler and Nvidia metrics: Bloomberg as at November.

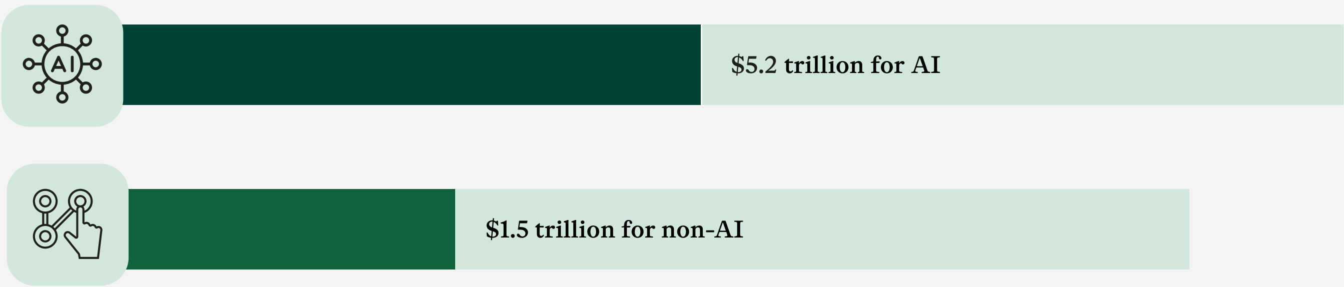
2026 | Global outlook

The revolution will be funded by debt

The AI investment boom is being is clearly being debt-funded. We see 2025 as a likely inflection point, where companies are transitioning from self-financing to more reliance on debt markets, spreading AI-related risks more broadly across the economy.

Everyone is now asking how much AI-related debt issuance is on the horizon after deals by Meta ($30 billion), Oracle ($18 billion), Google ($24 billion), according to Bloomberg as at November, and a handful of high-yield-rated data centre issuers recently.* A recent McKinsey report sees nearly $7 trillion of hyperscaler capex through 2030 ($5.2 trillion for AI and $1.5 trillion for non-AI). Morgan Stanley estimates $3 trillion over three years, while EpochAI estimates that the cost of the most expensive data centre could reach $100 billion by 2027. Even with hyperscalers still funding a healthy portion from their free cash flow, the implication is $500-800 billion of additional debt annually – or $2-3 trillion cumulatively by 2030.

Hyperscaler capex through 2030



Source: McKinsey, as at April 2025.

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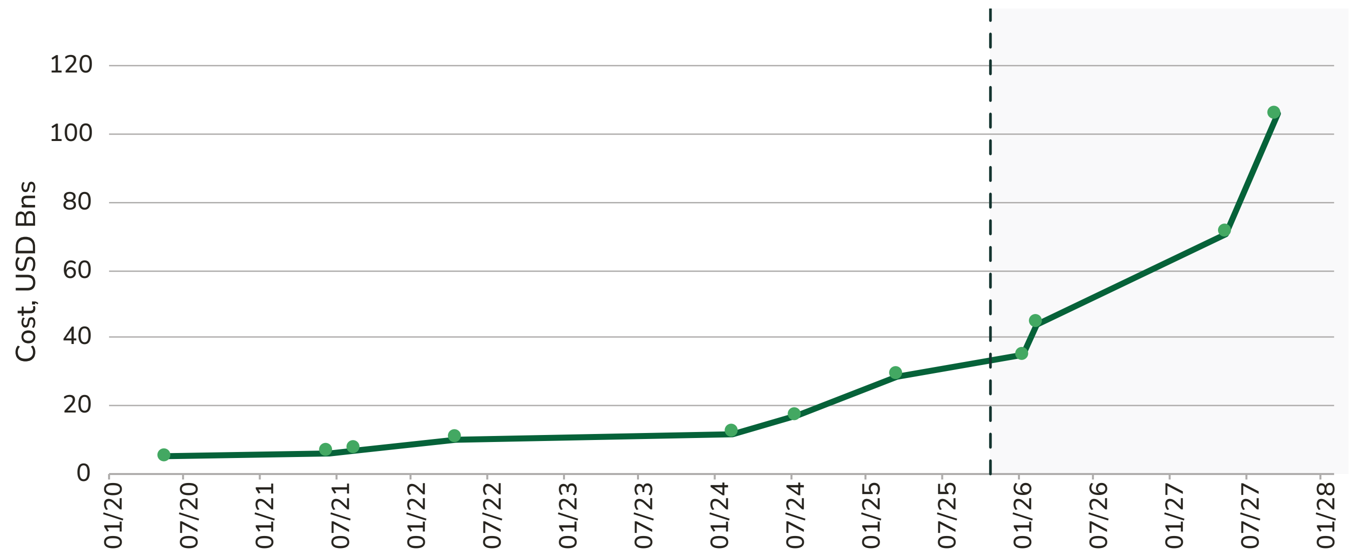
Frontier Data Centre Costs



Source: EpochAI, Frontier Data Centers as at November 2025.

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Here's one way to frame the debt financing requirement. Over the past decade, the US non-Treasury bond markets grew $1.5 trillion annually, according to Bloomberg data as at November. Adding $500-800 billion would boost net supply by 30-50%, our calculations indicate, pushing the total above $2 trillion for the first time and setting a record for the largest year-over-year percentage increase going back a decade.

A sub-plot to the supply story is the debate around which bond markets will see the most AI-issuance. To date, data centres have mostly been financed in securitized and private markets as off-balance sheet/limited-recourse/project-style financing. But the financing needs are now too big to bypass the greater demand available in public markets, as the recent surge in unsecured issuance from Meta, Google and Oracle illustrates. Indeed, there has been an increase in quasi-private transactions where large financing deals begin life in the private market and then get registered and marketed to public investors before pricing and distribution.

The rising capital intensity of AI infrastructure could accelerate public-private hybrid financing models. In a world where AI does drive significant growth, venture capital may see outsized gains, while enabling infrastructure – especially data centres – may command even higher valuations in private markets.

In this scenario, leverage in AI infrastructure may amplify returns rather than stress credit markets. However, a balanced view needs to be taken in times of uncertainty. With private markets today offering entry points across the risk-return spectrum, selecting investments that offer AI exposure and retain value in diverse exit scenarios becomes the challenge.

History often rhymes

Will AI echo Moore's Law, the dot-com boom, the gold rush or the railroad era? Perhaps a little of each. What is certain, in our view, is investor uncertainty and the need for diversification. The next decade will reveal whether the current boom is a bubble, a revolution or something in between.

In the meantime, while we are certainly on the lookout for AI disruption to the economy and markets, our base case for 2026 is that AI-driven capex and productivity gains continue to drive economic momentum, corporate profits stay resilient and companies refrain from shedding labour for now, in line with historical productivity booms where labour shedding comes later.

It should be noted that diversification is no guarantee against a loss in a declining market.

Diversification and the global AI growth story

How a carefully constructed index, equity and or multi-asset strategy could help investors overcome the challenges posed by AI.

Aude Martin
Head of Pooled Index Investment Specialists

For many investors, capturing AI growth appears to present a troubling compromise: is concentration risk simply the price of entry to the most compelling growth story around?

We believe this dilemma is illusory.

Although the leading names in AI are domiciled in the US, it's crucial to remember that AI is a global phenomenon, not a regional one. As a result, we expect AI growth to reflect current global GDP trends and divisions, with the US, China and Europe the driving forces, while also capturing growth elsewhere through distributed applications. Sovereign independence requirements will also drive domestic AI investment into data centres, as we are seeing play out now.

Increasing adoption in consumer, enterprise and cross-industry applications can also be expected to drive growth.

When we consider the current stage of AI evolution, we see several near-term developments that we believe should be on investors' radar screens:

- **Data centre capex diversification:** diversification beyond NVIDIA to Google* TPUs, AMD and custom AI chips, shift from general-purpose to application-specific processing architectures
- **Open-source distributed intelligence**: state-of-the-art small, local models, often open-source, are creating distributed intelligence layers
- **Enterprise deployment acceleration:** adoption is expanding from testing to full deployment phases. Complex AI systems are driving demand for robust oversight tools, creating entirely new categories of essential infrastructure for explainability, security and compliance
- **The inference economy:** AI infrastructure is expanding beyond traditional data centres into interconnected systems (edge devices, specialised processors and distributed networks)
- **Next-generation interface revolution:** multi-modal AI adoption through earbuds, augmented reality, wrist controllers and ambient computing is creating new platforms that transcend existing market-leading interfaces like smartphones, laptops, and tablets

For investors, the challenge is clear: AI is complex, multi-faceted and fast evolving. Picking individual winners is difficult, and concentration risk can be high in market-cap-weighted indices.

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We believe a carefully constructed index, equity and or multi-asset strategy can seek to overcome this. For example, to address concentration risk, an equal weight approach can be used to cap exposure to individual names in a transparent fashion while still providing access to underlying growth potential.

A diversified[13] approach that captures full AI value chain – from infrastructure providers to application innovators – is a pragmatic response to the pace of change we are seeing in AI. Rather than picking today's best-known names and hoping their success continues, investors could instead consider investing in a wide range of companies driving AI adoption across many sectors and geographies, providing much more rounded exposure.

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested

13. It should be noted that diversification is no guarantee against a loss in a declining market.

Emerging markets

Upside risk after a resilient 2025

We identify reasons for cautious optimism and discuss how we think innovative exposure can be achieved.

Raza Agja
Head of Emerging Market Sovereign Strategy

Erik Lueth
Emerging Market Economist

Jake Harper
Senior Investment Manager

Half a year after the US raised tariffs to levels not seen in a century, we are still to see a significant effect on emerging markets.

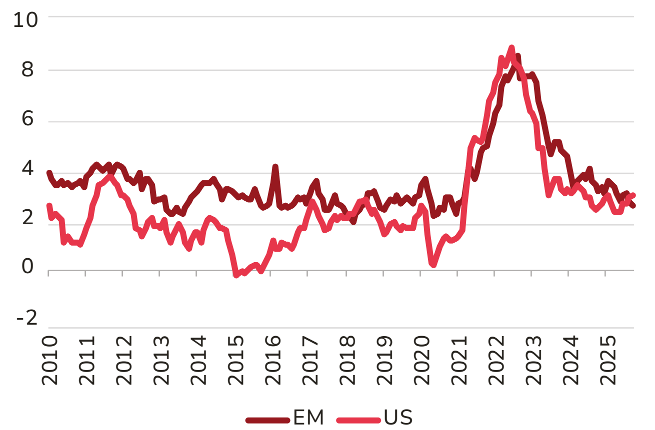
As at November, exports are growing above 10-year averages for each of the four regional groupings and China, according to Bloomberg data. In our view, front-loading and re-routing probably delayed Liberation Day's impact.

On the other hand, trade uncertainty should be significantly lower in the lead-up to the US mid-term elections and several large emerging markets (EMs) are still to negotiate tariffs down. We should also note that free-trade negotiations are mushrooming in the rest of the world – a pattern already observed during President Trump's first term.

Rate of change

Importantly, with inflation falling and now at par with G7 levels (see chart), we believe emerging markets will continue to cut interest rates. Some 40% of the top 20 cut over since the summer, as at November, with the rest staying on hold. This still needs to feed through to the real economy. On top of that, market consensus is that the US Federal Reserve is expected to ease by 100 basis points over the next 12 months.

Inflation
(Median)



Source: Macrobond, as at 19 November, 2025. Assumptions, opinions, and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Fiscal policy will likely be less accommodative, as the majority of emerging economies still need to return their fiscal balances to pre-COVID levels. Particularly worrisome, in our view, have been the fiscal dynamics in Poland, Colombia and to a lesser extent Indonesia. But there have also been success stories – notably Chile, South Africa and India. Government debt remains much lower in emerging economies than in their advanced peers, including when measured against taxing power.

Next year will see a number of elections that could mark crucial turning points. We believe a market-friendly pivot is most likely in Colombia. Brazil's election remains a toss-up at this stage, while Peru is likely to remain politically divided irrespective of the outcome. In Israel and Hungary, two leaders who have dominated politics for decades are fighting for survival.

As of October, the International Monetary Fund expects growth of emerging and developing countries to accelerate in 2026. We are sympathetic to this view, as risks look skewed to the upside. Capital flows to emerging markets have been lacklustre over the past decade. Hence, we believe the risk of a sudden reversal in capital flows – perhaps the quintessential crisis for such economies – is low. China has experienced a multi-year property and earnings recession, again suggesting that risks are asymmetric. Finally, we believe the US dollar is more likely to fall than rise given excessive valuations, which tends to boost EM growth.

The debt view

With resilient growth across emerging markets, upward revisions to forecasts, declining inflation, and a robust external sector, we maintain a constructive stance on emerging market debt (EMD) and anticipate continuing to buy on pullbacks as we head into year-end and 2026.

Our confidence is underpinned by structural improvements now being reflected in credit rating trends. Upgrades have outpaced downgrades in 2025, signalling positive momentum. There have been zero sovereign defaults in the last two years, and we expect aggregate default probability to be very low next year, whereas EM corporate default is forecasted at about 3% in 2026, according to J.P. Morgan as at November.

We have also observed investor sentiment towards EMD improving. Global liquidity conditions have strengthened, and after years of significant outflows, EMD funds are now seeing renewed inflows, EPFR data indicate as at November. Notably, crossover investor allocations to EMD have risen from 8% to 15% over the past three years, Bank of America, also as at November.

Given this backdrop, we see limited risk of a sharp widening in EM spreads. Despite record issuance this year, spreads have compressed, indicating strong demand for the asset class. Even CCC rated issuers such as Suriname, Laos, and the Republic of the Congo have successfully accessed markets, underscoring investor appetite for EM paper.

> "With resilient growth across emerging markets, upward revisions to forecasts, declining inflation, and a robust external sector, we maintain a constructive stance on emerging market debt."

Relative value

From a valuation standpoint, while spreads remain tight, we find all-in yields compelling and see them as a more reliable indicator of potential forward returns, in our view. We also expect solid EM fundamentals to help contain any spread widening.

With subdued growth, a softening labour market, and weak oil prices in the US, we, like other market participants, also anticipate continued rate cuts by the Fed. This should help keep rates from rising meaningfully, supporting our expectation of mid-to-high single-digit total returns in EMD for 2026.

Looking ahead, key risks for EM in 2026 are likely, in our view, to stem from US markets and macroeconomic developments – particularly a possible resurgence in inflation and elevated AI-driven equity valuations.

Recent volatility in US equities has already had spillover effects on EMD and broader risk assets in Q4 2025, and we remain cautious of similar episodes next year. Consequently, our positioning is more selective than in previous cycles, with a focus on idiosyncratic opportunities (for example, oil importers and precious metal exporters) rather than broad beta exposure.

Taking things private

An increasing trend we've noticed in 2025, and one we believe will persist in 2026, is the prominence of private debt investing when allocating to EMs.

So far, larger markets like China, India, Brazil and South Africa have been the focus of managers looking towards this type of exposure. Investment-grade countries in Latin America and Southeast Asia have also been on investors' radar. Anecdotally, we haven't seen much investment into lower-income countries where it is generally more challenging to find opportunities.

Innovation, innovation, innovation

One reason we believe private debt is a viable strategy for EM exposure is the capacity it offers for product innovation. By opting for private transactions, investors may be able to gain exposure to debt structures that offer the potential for attractive and uncorrelated returns, while supporting initiatives that have a real-world impact.

One such example is use-of-proceeds lending, which involves providing loans where the proceeds will be used in a defined way – for example, on an infrastructure or housing project. We have also observed the emergence of debt conversions as a way of allowing EMs to refinance their debt while supporting sustainability efforts.

These transactions – which are also referred to as 'debt conversions for nature' are investment grade and allow EM sovereigns to refinance their debt at improved financial terms. The caveat is that the borrower commits to utilising the proceeds from these savings in conservation efforts.

We believe other public goods can be used in debt conversions – notably, health, education, food among others.

We are also interested in the "A/B" loan programmes carried out by multilateral development banks (MDBs). Effectively these involve MDB's lending money via their commercial arms to corporates / financial institutions / infrastructure projects in emerging markets while selling the risk to investors. This provides investors with exposure to EM and the underlying transaction while seeking to benefit from the MDB's preferred creditor status.

A last structure we believe worth keeping an eye on in 2026 is outcome bonds. As the name suggests, returns from these instruments is linked directly to the success of specific development projects. We think there could be a strong pipeline for this kind of model developing in emerging markets, with potential returns linked to things like conservation efforts.

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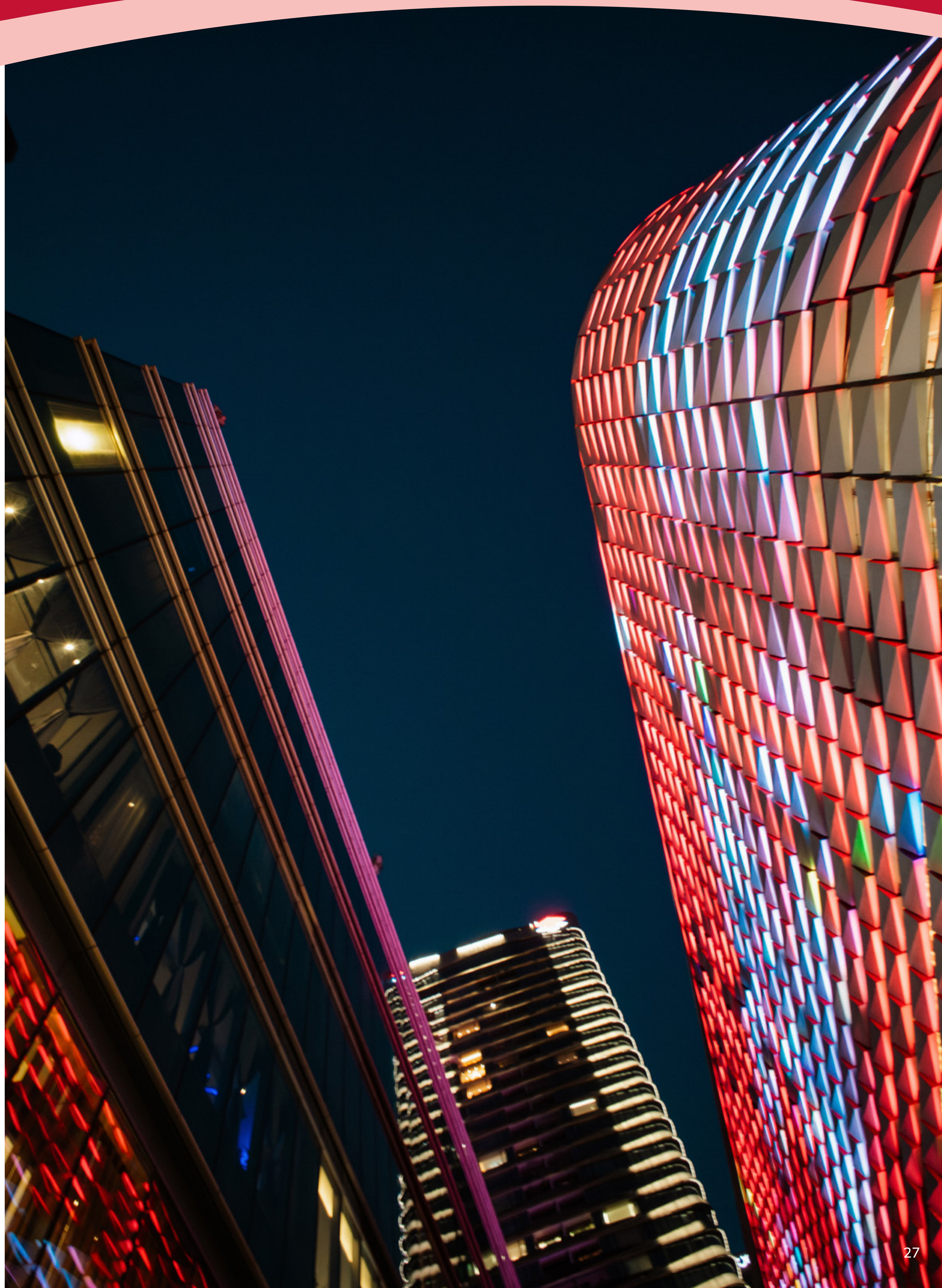

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Key risk

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested.

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