GALT & TAGGART

CREATING OPPORTUNITIES

Global capital markets

1Q26 update

January 2026

Capital Markets 1Q26 Update

Summary

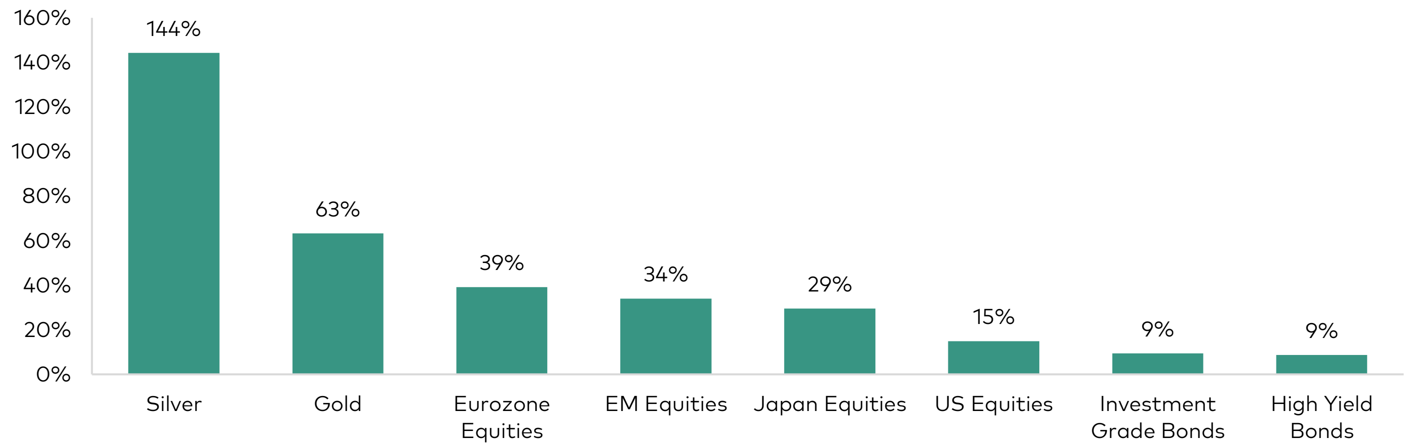
- US Interest rates are starting to fall, but high long-term risk premiums are keeping long-term yields stable. As a result, bond returns are coming mainly from interest income and holding bonds over time, not from rising bond prices.

- Stock markets are no longer led by just a few big companies. Instead, gains are spreading across different industries and company sizes.

- AI is entering a stage where infrastructure is in the spotlight. Companies' profits and valuations now depend more on storage, electricity, and power grid capacity.

- In Asia, countries are moving in different directions. China is supported by government policy but still faces problems in real estate. Japan is doing better thanks to higher interest rates and stronger corporate governance, which is helping its market improve more steadily.

Select asset class returns, YTD



Source: Bloomberg
YTD – 31/12/2025
Silver: iShares Silver Trust (SLV); Gold: SPDR Gold Trust (GLD); Eurozone Equities: iShares MSCI Eurozone ETF (EZU); EM Equities: iShares MSCI Emerging Markets ETF (EEM); Japan Equities: iShares MSCI Japan ETF (EWJ); US Equities (small-cap): Russell 2000 (RUT); Investment Grade Bonds: iShares Investment Grade Corporate Bond ETF (LQD); High Yield Bonds: iShares High Yield Corporate Bond ETF (HYG)

Fixed Income

Easing, but not a bond bull market

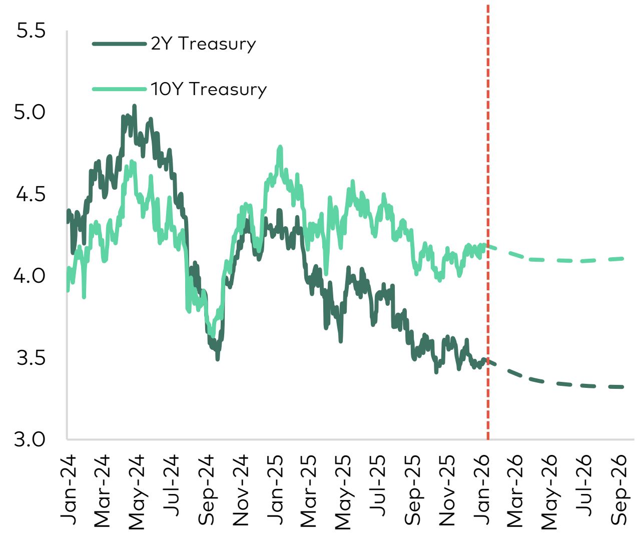
Federal Reserve began a mild rate-cutting cycle in September 2025, lowering the policy rate to 3.50%–3.75% as of December. It emphasized that any further cuts would depend on incoming data. Markets expect more cuts in 2026, but long-term US Treasury yields have stayed within a narrow range, showing limited confidence in a strong rally in long-term bonds. At the start of 2026, the yield curve shows easing at the short end, while uncertainty and higher risk premiums keep long-term yields elevated.

In Europe, monetary policy is closer to stability rather than a new, long cutting cycle. The ECB has raised its growth and inflation forecasts, signaling a more optimistic outlook for 2026. Interest rates are expected to remain broadly unchanged, with no major policy shifts. The ECB is also expected to continue quantitative tightening in 2026, reducing excess liquidity, which leaves limited room for further rate cuts.

Investment implications

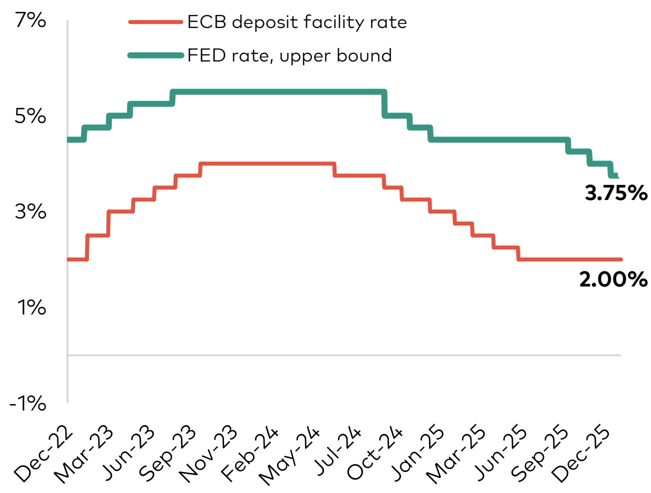
Risk is still high, so bond returns are likely to come more from interest payments than from price gains. Portfolios should focus on short- and medium-term bonds to earn steady income and small time-related gains. Long-term bonds should be added only occasionally, mainly when yields become more attractive. Credit exposure should stay safe, focusing on investment-grade bonds and stable asset-backed securities. Avoid taking extra risk for higher yields until markets calm and long-term bond risk decreases.

US 10-year and 2-year treasury yield, %



Source: Bloomberg
*Dashed lines show the forecast after January 2026.

Fed and ECB interest rates



Source: Fed, ECB

Equities

Breadth is back: markets move beyond a single winning trade

As markets enter 1Q26, artificial intelligence remains an important long-term theme, but stock market leadership is no longer concentrated in just a few large companies. Stock performance is becoming more uneven as correlations fall. Earlier gains were driven by a small group of large-cap stocks, but in 2026 investors are paying more attention to differences across sectors, company sizes, and valuations.

This shift is already visible - in August 2025, the Russell2000 rose 7.3%, while the Nasdaq100 gained only 1.5%. This shows how expectations of lower interest rates can quickly benefit smaller, more rate-sensitive companies.

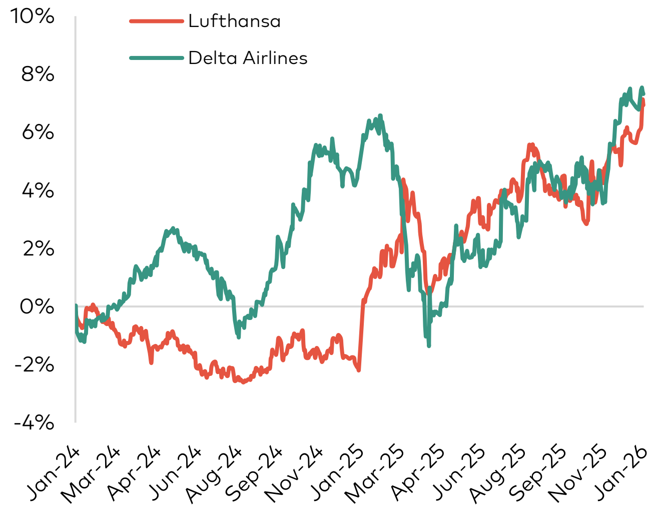
Sector differences are also clear. In 2026, spending patterns are split: higher-income consumers remain more stable, while budget-sensitive travel is weaker. Airlines reflect this trend through a higher share of premium travel. Delta increased its premium revenue by 9% y/y to c. 43% of total passenger revenue, helping to support margins. Lufthansa expects about 6% growth in international flights in 2026, while growth in short-haul routes will be much smaller.

In healthcare, opportunities in 2026 look more long-term as AI adoption spreads, which may widen the gap between winners and losers. The S&P 500 healthcare sector fell 5% in 2025, while the broader market rose more than 7%, leaving the sector on a forward P/E of 16.2. This suggests selective value as stocks move less in sync.

Investment implications

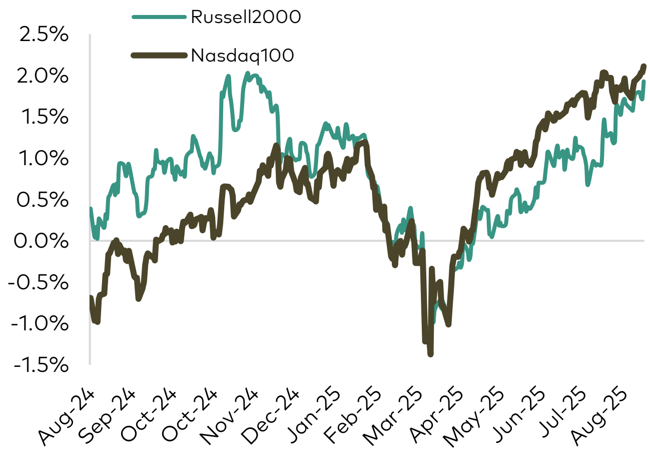
In 2026, markets are likely to reward active stock selection and regular rebalancing, rather than simply holding a few dominant names. Investors should keep a core exposure to broad equity markets, while adding targeted positions in rate-sensitive stocks that may catch up and in quality cyclical companies with improving fundamentals and pricing power. Paying attention to valuations remains important, especially where optimism is already priced in. Strong balance sheets and stable earnings should be prioritized, as market leadership can change quickly when correlations decline.

Total return of selected stocks



Source: Bloomberg
*Total return - how much an investor earns if they hold a stock, accounting for both price changes and dividends, assuming dividends are reinvested.

Index value change of selected indexes



Source: Bloomberg
*Index value - shows how a simple example portfolio of selected stocks is doing, with each stock given a set weight and adjusted over time so results stay comparable

Equities continued

AI's second wave: focus shifts to storage and power

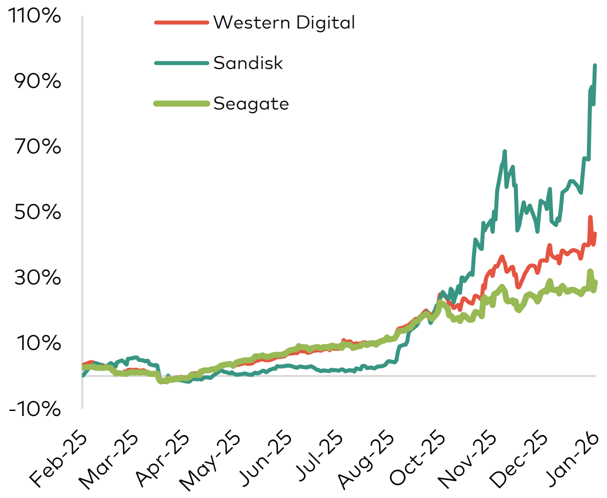
As AI enters its next stage, attention is moving from software and big tech platforms to the physical infrastructure needed to run AI systems. Investment in AI is still strong, but growth is increasingly limited by real-world constraints - especially data storage and electricity. Storage companies led the market in 2025: Sandisk rose nearly 580%, while Western Digital and Seagate gained more than 200%, as demand for storage surged with AI development. This shows that as AI models grow bigger and more data-intensive, hardware is becoming as important as software.

Power is another key bottleneck. Utility stocks rose over 15% after the latest rate cut, led by companies like Constellation Energy and Vistra, as data centers are expected to need much more electricity. Corporate moves also reflect this trend: GE Vernova doubled its dividend and expanded share buybacks, linked to rising demand for AI-driven power equipment. AI's electricity needs are even bringing nuclear plants back online, such as Microsoft's long-term deal with Constellation to restart a Three Mile Island unit.

Investment implications

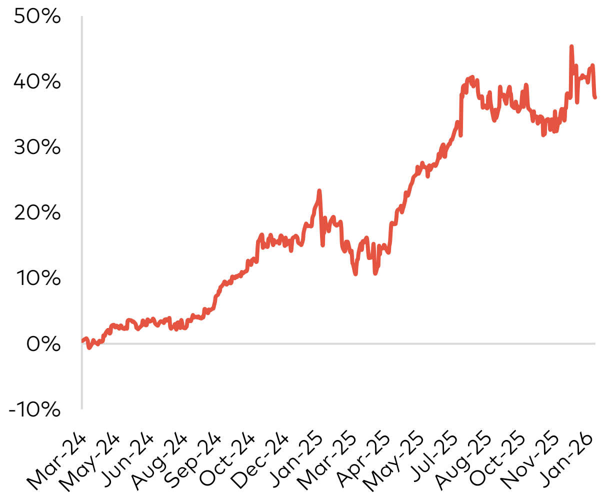
The next phase of the AI cycle is being shaped by practical infrastructure needs rather than hype alone. Companies providing storage and power are becoming key beneficiaries as AI spending translates into real demand. However, outcomes still depend on execution, regulation, and financial discipline, meaning careful selection matters as AI investment shifts from concept to physical reality.

Total return of selected stocks



Source: Bloomberg
*Total return - how much an investor earns if they hold a stock, accounting for both price changes and dividends, assuming dividends are reinvested.

Total return of GE Vernova



Source: Bloomberg
*Total return - how much an investor earns if they hold a stock, accounting for both price changes and dividends, assuming dividends are reinvested.

Asian Market

Asia diverges: China supports growth, Japan moves out of deflation

Asia's outlook in 2026 is increasingly shaped by country-specific trends rather than one regional cycle. This matters for interest rates, currencies, and stock markets.

In China, policymakers are targeting growth of around 5% and have shifted to a more supportive policy stance. The government plans more active fiscal policy in 2026, and the central bank has signaled rate cuts and lower reserve requirements to keep liquidity ample. While the policy direction is clear, the impact is uneven because weakness in the property sector continues to weigh on confidence.

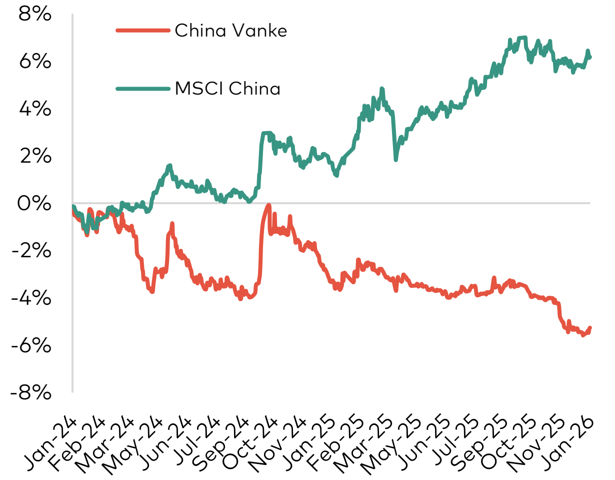
Property remains the biggest weakness. Markets usually treat policy announcements as temporary confidence boosts, not as proof of a lasting recovery. For example, news that authorities may support China Vanke in refinancing about 50 billion yuan (c. US$ 7bn) of debt led its Hong Kong-listed shares to jump more than 16%. At the more distressed end, Country Garden's main shareholder agreed to convert US$ 1.14bn of loans into equity, showing slow but ongoing balance-sheet repair.

Japan presents a very different picture. The country is moving further away from deflation, with major banks trading near or above book value for the first time in almost ten years, reflecting expectations of higher rates and better profitability. Corporate governance reform is becoming more visible, with changes at companies such as Toyota and Seven & I, and increased deal activity, including KKR and JIC's yuan 348bn bid for Topcon.

Investment implications

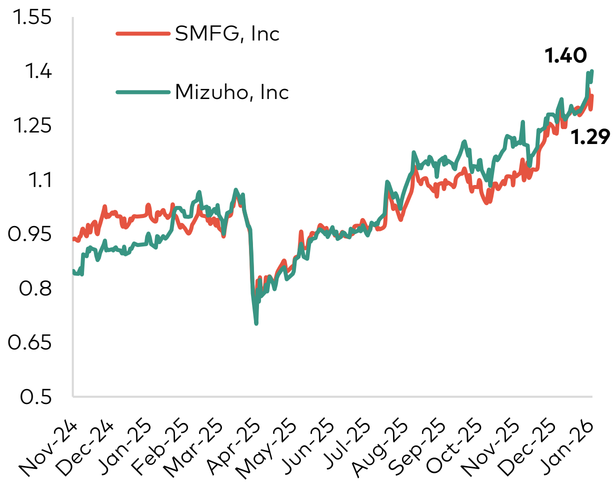
Asia's diverging paths suggest uneven market outcomes. China remains heavily policy-driven and volatile, while Japan's move away from deflation and improving corporate governance are reshaping valuations and increasing sensitivity to interest rates, currency moves, and geopolitical developments.

Total return of following stocks



Source: Bloomberg
*Total return - how much an investor earns if they hold a stock, accounting for both price changes and dividends, assuming dividends are reinvested.

Price to book value of selected banks, x



Source: Bloomberg
*Price to book value - shows how a company's market value compares to the value of its assets, based on its balance sheet.

Forecasts for 2026 and beyond

At the start of 2026, markets expect small US rate cuts that mainly affect short-term rates, while long-term yields remain high. As a result, bond returns are more likely to come from interest income and holding bonds over time, rather than from price gains.

In Europe, higher short-term German yields suggest mixed policy signals, so it makes sense to be careful with long-term bonds. Asset-allocation views remain selective: BlackRock is neutral on Europe, emerging markets, the UK, and China, and slightly positive on the US and Japan. This supports focusing on differences between markets rather than a broad global bet.

In bonds, the focus should be on steady income and safety, using short- and medium-term maturities and high-quality credit. Long-term bonds should remain a smaller part of portfolios.

FIXED INCOME

Yield forecasts (%)

	Last	1Q26F	2Q26F	3Q26F	4Q26F
US treasuries					
30-year	4.72	4.72	4.68	4.66	4.67
10-year	4.15	4.11	4.10	4.09	4.11
5-year	3.66	3.65	3.61	3.61	3.61
2-year	3.51	3.44	3.37	3.33	3.32
SOFR	3.77	3.49	3.29	3.20	3.16
German bunds					
10-year	2.76	2.77	2.82	2.88	2.92
2-year	2.03	2.06	2.10	2.13	2.16
EURIBOR	1.99	2.07	2.07	2.08	2.09

Source: Bloomberg

12-month outlook

S&P 500 Sectors	ETF	Outlook
Financials	XLF	Neutral
Materials	XLB	Neutral
Energy	XLE	Neutral
Technology	XLE	Neutral
Consumer Staples	XLB	Neutral
Communications	XLK	Positive
Utilities	XLV	Negative
Industrials	XLP	Positive
Health Care	XLRE	Positive
Real Estate	XLU	Negative
Consumer Discretionary	XLI	Negative

Source: Charles Schwab

6–12-month outlook

Equities	ETF	Outlook
US	SPY	Positive
Japan	EWJ	Positive
China	MCHI	Neutral
UK	EWU	Neutral
Emerging Markets	EEM	Neutral
Europe	IEUR	Neutral

Positive Neutral Negative

Source: BlackRock Investment Institute

Disclaimer

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