MOOD SHIFT

Market sentiment changed in the early weeks of 2026. Doubts crept in about the big bets on AI that had sent US tech stocks shooting up in 2025 and buoyed global markets. Expectations also faltered that the Federal Reserve would move quickly to cut interest rates, once a new Chair takes office in May. Overall, US equities barely budged. How come – and will the shift in sentiment last?

Downward pressure in one part of the equity market in January and February – the previously golden Magnificent Seven and other large tech companies – was offset by investor enthusiasm elsewhere. Ironically, beneficiaries of the AI investment boom that took off in 2025 were among those doing well. That includes the power and construction industries needed to satisfy AI's enormous demand for "compute." The S&P 500 ended February down 1.0% for the month, and up 0.5% for the year to date.

A drop in the "Magnificent Seven" of -6.8% for this year weighed on overall indices. The size of the Mag 7 means their moves still overwhelm the weighted index. A somewhat different picture emerges from the equal-weighted S&P 500, which adjusts for the remarkable concentration in the overall indices in a few big names. The equal-weighted measure has risen by 6.7% so far this year.

AI: NOT SO SIMPLE?

IIn 2025, evidence of the power of AI and extraordinary speed of innovation dominated markets. Now, there is more differentiation. As developments in AI and AI research continue at a rapid pace, expect more shifting views of likely winners and losers in this competitive space. As overall concerns around an AI bubble increase, this differentiation among winners and losers will increase too. Views differ on basic questions such as which tasks AI will be most useful for, which jobs may be "at risk" from widespread adoption of AI, and which businesses will be helped – or hurt – by the boom in AI capability. Investors need to remain agile, and informed.

At a macroeconomic level, there is a dispute about whether productivity gains from AI will lead to higher or lower interest rates for a given inflation objective. Incoming Federal Reserve Chair Kevin Warsh has pointed to the successful period of monetary policy in the 1990s when former Fed Chair Alan Greenspan argued that rising productivity in the US allowed for easier money than many believed. The reasoning: greater supply in the economy would reduce inflationary pressure. Others point out, however, that with productivity gains coming alongside sharply higher demand from capex investment, equilibrium interest rates will be higher, not lower, than otherwise.

And while most analysts still expect AI to lead to transformational change over time, it is not clear whether the technology is already leading to a productivity spurt. Jobs barely grew in 2025 while growth held up, suggesting a rise in productivity. But the respected Yale budget lab's Martha Gimbel wrote on February 19 that the data is inconclusive.

Many thought that the existence of mega cap technology firms, with protective "moats" around their profitable products, was a damper on innovation that kept these companies safe from competition. Part of this year's market shift reflects doubts about this view. Larger firms are being challenged by newcomers in what has become a fierce battle for users and revenues, as pointed out this week by Harvard economist and former Obama adviser, Jason Furman.

At the same time, the shift to borrowing by profitable tech companies such as Alphabet and Meta that used to have plenty of cash to meet investment needs – and pay dividends – is making these companies look more like other indebted firms and less like automatic cash machines with profits to spare to build cash piles and boost share prices with buybacks. The superior credit ratings for mega caps are safe just now, according to a February S&P Global ratings report on borrowing by the hyperscalers: Six questions and Six Answers. But with a possible $600 billion to be spent in 2026 on capex, credit markets will be affected. Notably, news surfaced recently that Blue Owl failed to secure $4 billion in debt financing for a data center project with CoreWeave as the anchor tenant. Apparently, CoreWeave's non-IG credit rating raised concerns regarding their ability to fulfill their lease agreement. Blue Owl released a statement stating that their commitment to the deal is solely providing the bridge financing, while CoreWeave emphasized that the project remains fully funded and on track.

SOME THINGS STAY THE SAME

While some market moves are new, one theme from 2025 has lingered into 2026. Equity markets outside the US have outperformed, whether measured in dollars or domestic currency. By several broad measures, the dollar has weakened slightly in 2026. That leaves it weaker against most currencies and, as discussed below, it has materially weakened against select crosses. Some see this as unsurprising, given high valuations in the US. Uncertainty about the direction of the US is also a factor.

For as long as the US has the largest and most dynamic economy and the most liquid capital markets, money will continue to flow in. But volatile policies make investors interested in hedging their bets.

Policy uncertainty about domestic and foreign issues has only deepened this year.

At home, the Supreme Court ruled on February 20 that the President's main tool for tariff policy was not constitutional, triggering many requests from importers for refunds of tariffs imposed over the past year. These will likely be addressed only slowly. And gloomy consumers who ultimately paid for tariff-related price increases are unlikely to see any of the refund. However, FedEx has indicated it will refund its customers - although the details of how that will be accomplished are still being determined.

It is likely that by using other trade authorities, the Administration will be able to reinstate tariffs at similar levels to those in place before the Supreme Court decision. Immediately after the decision, President Trump announced imposition of new temporary tariffs, under another emergency authority, set initially at 10 % across the Board, although the President said he plans to raise to 15%. Market participants mostly took the upset in stride.

Overseas, after seizing Venezuela President Maduro in a daring and successful raid in early January and threatening Denmark that the US needed to take over Greenland, the White House is now pressing for change in Iran. The threat of military action remains, following the massacre of possibly over 30,000 Iranian protesters in 2 weeks. Significant US military forces have amassed and President Trump has called for regime change. On balance, many believe that regime change in Iran could unleash major growth in the region given the high level of education and human capital with the enormous brain drain of Iran's top tech and health care leaders who have founded or run many companies such as Data Bricks, Uber, Novo Nordisk, TheKey, and Summit Therapeutics. President Trump continues to look for options and is concerned about the risk of a disruptive war.

Political events elsewhere have also played a role in boosting market performance relative to the US. In Japan, a decisive victory for Prime Minister Sanae Takaichi's party in the February 6 election bolstered confidence in her leadership – albeit adding to worries among some about likely further deficit spending that will push up Japan's already large debt burden. Financial markets gave a thumbs up. Long-present fears of an upset in the JGB market as monetary policy is gradually normalized seem overdone for now. The Bank of Japan will likely proceed with caution as it raises rates, mindful of the Prime Minister's watchful eye. More on Japanese rate moves below.

In Europe, there are also reasons for cheer. Major European nations have taken over funding for Ukraine from the US and pledged to boost defense spending. Much of the spending for Ukraine goes to buy American equipment. But looking ahead, Europeans will want to spend more of their defence budgets at home. There is growing investor interest in European defense and defense technology companies.

Finally, investors have been moving back into emerging markets, as described below. That is – emerging markets outside China, which continues in the doldrums and is flat year-to-date. Some hope that growth will be supported by renewed interest in building commercial ties across regions in reaction to US withdrawal and tariffs. In addition to the EU-Mercosur, Brazil and India have been in talks. AI supply chain linkages have also been a major tailwind for emerging markets including Taiwan and Korea, but other catalysts exist as well. In particular, MSCI Korea is up nearly 60% year-to-date after doubling in 2025, driven not only by SK Hynix and Samsung Electronics, but also various other companies including from the broader manufacturing and defense industries. The government has also begun encouraging corporate reform through its own version of a "Value Up" program. Outside of Asia, Brazil, Egypt, Hungary, Mexico, South Africa, and Peru have all risen more than 15% driven by a mix of improving investor sentiment and strengthening currencies.

EQUITIES

Global equity markets have carried forward an important shift in leadership into 2026. International and emerging markets outperformed meaningfully in 2025 after several years of US dominance, and that momentum has extended into the early months of this year. In Japan, so-called "Sanaenomics" has coincided with renewed investor optimism, pushing the Nikkei 225 to a historic high of 58,000 in February. In Europe, the STOXX 600 reached record levels despite muted GDP growth, underscoring how positioning, valuation, and capital flows can matter more than macro momentum in the short run. Valuation differentials remain striking: MSCI EAFE trades near 15x forward earnings versus roughly 23x for the S&P 500, leaving ample room for continued relative performance if earnings merely hold steady. As detailed above, emerging markets have also delivered strong returns, reflecting resilient domestic consumption, stabilizing inflation trends, and a more constructive global monetary environment. The moderation in the US dollar has helped ease external financing pressures and improved relative earnings visibility across several regions.

At the same time, US equities have been rocked by extreme volatility tied to artificial intelligence. The S&P 500 software and services index has fallen 23% year-to-date – its worst start on record – and nearly $1 trillion in software market value was erased in a three-day stretch earlier this month as investors reassessed the durability of legacy business models. Former market leaders Intuit and Salesforce have declined roughly 46% and 30%, respectively. The speed of the repricing reflects what we view as a unique "innovation paradox" where investors are simultaneously fearful of too much AI investment and too much AI disruption.

On one side is concern that the scale of AI-related capital expenditures may fail to generate commensurate returns. Hyperscalers are projected to spend approximately $600 billion collectively on AI infrastructure in 2026, raising anxieties that today's record capital expenditures could become tomorrow's stranded assets if application-layer revenues fail to scale quickly enough. On the other side lies the fallout from "Creative Destruction." If AI agents can automate coding, accounting, or customer service at marginal cost, traditional subscription-based software may see pricing power erode rapidly. A lesser-known but telling statistic illustrates the imbalance: in the first six weeks of the year, for every dollar of incremental market value attributed to AI hardware, roughly four dollars have been erased from software and services equities. The market appears to believe disruption is arriving faster than monetization.

We suspect the reaction has been exaggerated. Innovation cycles rarely follow a straight line, and history suggests that periods of overinvestment and dislocation often sow the seeds for the next phase of durable growth. That said, uncertainty remains high. As capital-intensive AI infrastructure buildouts collide with rapidly evolving application economics, volatility is likely to persist. The key for investors will be distinguishing between structural impairment and temporary repricing in a market still grappling with how to value transformative technology in real time.

FIXED INCOME

So far in 2026, and particularly in February, interest rate markets in the US have not conformed to most investors' and traders' expectations. Going into the year there was a bias for a steeper yield curve based on expectations of lower policy rates, a back-up in longer dated rates or both simultaneously due to the monetary and fiscal considerations discussed above. Paradoxically, the opposite has happened. The yield curve has flattened with shorter-dated rates rising slightly amid increasingly hawkish Fed rhetoric and longer dated yields falling. The moves in the front end, while small, have been telling. Throughout the month of February markets have gone from pricing in a definite 25 basis point reduction from the Fed in June of 2026 to that meeting being more of a toss-up. Still, markets expect two 25 basis point cuts by the end of the year.

In aggregate, these moves have been positive for fixed income investors, with the Bloomberg US Aggregate index rising 1.5% year-to-date, outpacing the equity markets as measured by the S&P 500 – how's that for the death of the 60/40? Still, US bonds have underperformed their global equivalent, driven largely by a weaker dollar (more on the dollar in the following currency section).

One market for which performance has not been surprising is Japan. While, as mentioned above, bonds have not had cataclysmic losses, markets continue to expect more tightening from the Bank of Japan and the yield curve has responded accordingly, with the 10-yr yield moving nearly 100 basis points last year and continuing that march higher so far. The rest of the curve has largely moved in lock step with most points an additional 10-15 points higher through February – boosted by Prime Minister Sanae Takaichi desired fiscal expansion.

CURRENCIES

As discussed above, the weaker dollar theme continues although strength against the yen and the euro have limited the declines in broad dollar indices to -0.7% for DXY and -1.4% for Bloomberg's BBDXY. A look under the hood reveals more striking moves across other developed and emerging market currencies. There have been outsized gains in the Australian Dollar, Norwegian Krone, and Swiss Franc, rising 6.7%, 6.2%, and 3.2%, respectively, against the Greenback. In emerging markets, the Brazilian Real, Mexican Peso, and even the "frontier" Nigerian Naira, have stood out to an equal degree. There is a long list of additional currencies that have strengthened considerably, but suffice to say international diversification continues to be a profitable theme. While not traditional currencies, two other common stores of value - namely Gold and Silver - have continued on a strong run in February and in 2026 despite their sharp corrections in January.