

QUARTERLY INVESTMENT REVIEW

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"We're seeing substantial asset inflation away from the dollar as people are looking for ways to effectively de-dollarise, or de-risk their portfolios vis-a-vis US sovereign risk."
Ken Griffin

"The multiples of technology stocks should be quite a bit lower than the multiples of stocks like Coke and Gillette because we are subject to complete changes in the rules."
Bill Gates in 1998

"I'm willing to go bankrupt rather than lose this race."
Larry Page, co-founder of Google

2025 was a gangbuster year for financial markets. Most equity markets delivered double-digit gains, and most bond markets also generated positive returns. Apart from oil and the grains market, commodity markets were strong, and precious metals enjoyed spectacular returns. For once the US market was not the best performer. After a decade and a half of dominating equity returns the US produced one of the weaker performances, and if the currency is taken into consideration that result was even further behind, as the US dollar fell approximately 10% during the year. Elsewhere strong results were widespread across European, Asia and the Emerging Markets. The MSCI World Index was up 19.5% in US dollars or 16.9% measured in Local Currencies, and the S&P500 was up 16.4%.

Given the political background in 2025 this result might seem surprising. President Trump initiated a trade war by imposing tariffs which bludgeoned the world trade system. In Europe, the UK and France endured rolling political difficulties centred on both countries inability to contain their debt problems. The Ukraine war continues, while the Gaza war has reached an uneasy truce. What accounted for the market's rise was good earnings growth in the US, while in Europe it was due more to a rerating. Underpinning all markets was an exceptionally supportive liquidity environment. Fiscal policies in all the major economies were benign – the US, China, Japan and most EU countries ran deficits of about 5% of GDP; low interest rates prevailed across the world; the US dollar weakened, which was particularly helpful for those Emerging Markets whose currencies were pegged to the dollar; and oil prices declined by close to 20% in US dollars and even more in other currencies, which has the effect of a giant tax cut for the world's consumers. 2025 thus represented a rare occasion when the global economy, even though it wasn't in recession, was stimulated by every lever at Governments' disposal. This stimulus looks set to continue into 2026 as Trump's One Big Beautiful Bill kicks in during January, as well as a promise of more deregulation. Germany's giant fiscal boost will also get underway, and OPEC have increased their production to keep energy prices subdued. Given the midterm elections in the US in November President Trump will do everything he can to juice the economy in the run up to that.

Such stimulus could trigger inflation, and the biggest danger to stock markets would be a selloff in the bond markets, particularly the long end, on fears that the incontinent profligacy of government spending is unsustainable. While bond markets were stable in 2025, they have been poor investments in the last decade due to mounting concerns about Western debt profiles. According to Gavekal, since July 2020 the real return on a constant 10-year duration US Treasury bond has been minus 33%, and minus 37% for a German bund. Many Western countries debt to GDP ratios have risen above 100% and have annual deficits of 5–7%. The interest cost on Government debt, for example, now exceed £110bn in the UK and \$1 trillion in the US. As these debts spiral ever higher bond investors are being presented with the equivalent of investing in a share that yields 4% while it is annually increasing its share count by 7%. It was a striking feature of 2025 to see the complete failure of governments' attempts to rein in these deficits. Trump campaigned a year ago on a promise to slash government spending, but Elon Musk's DOGE effort collapsed in three months. The UK and France failed to remove even minor items of welfare spending from their budgets. It appears to be impossible to control the excesses in the public sector in these countries. In this context the change of Federal Reserve Chairmanship when Jerome Powell retires in May may be one of the most significant in history. The new Chairman will be chosen by President Trump on the basis that they will be expected to set rates significantly below current levels. Coming at a time when inflation is above target, deficits are at record levels, and global confidence in US policy is fragile, investors will have to grapple with how markets react to this new regime at the Fed. Meanwhile Governments will continue to overspend. The likelihood is that this spending will only be controlled when there is a failed bond auction which will force them to economise.

The US equity market's superior returns have overwhelmingly stemmed from the extraordinary performance of its technology sector and particularly the largest companies, commonly referred to as the Mag 7. Since November 2022 when ChatGPT was released the US stock market has added \$30 trillion in market capitalisation as the profits promised by AI (Artificial Intelligence) have come to obsess investors. As a result, the largest stock, Nvidia, has a larger weighting in the MSCI World Index than the entire Japanese market. In order not to fall behind in the AI race the leading companies are spending gigantic sums. Forecasts estimate that they will spend \$566 billion in 2026, following \$441 billion in 2025. Projections for the next several years suggest it will continue at these levels. Unlike the internet boom which rewarded successful operators for minimal capital investment, the AI build out is capital intensive and the returns uncertain. The datacentres that are at the heart of AI are subject to rapid obsolescence, with their useful economic life estimated at less than eight years. The relentless innovation in the sector could mean that whatever is cutting edge today is overtaken in the next few years leading to costly updates and overhauls, making it even more challenging to earn a satisfactory return on today's investment. When money is allocated so fast in what remains a speculative industry the risks become much higher. There is little doubt that AI will be a transformational technology, but as with the railways and the internet much of

the early capital invested may come to grief. The concern is that because the Mag 7 have been so entwined with the rise in the market if they fail to execute a satisfactory return on their enormous investments this failure will undermine the market. Their health has become the health of the entire market. Equally concerning is if this investment does justify itself then where will this profit come from? The most likely source is that it will derive from companies shedding labour. This uncertainty on how AI will be deployed into the economy means that firms have already reduced hiring, particularly graduates. PwC have reduced graduate hirings by 35-40% for example. As firms work out how to use it, these jobs freeze may morph into firings. Historically when technology has made people redundant, they have found new jobs, but the speed of change this time may be quicker, making the transition harder. Eventually the impact will be on the older generation who have less transferable skills and the effect of this could be cataclysmic. This is likely to become an increasing political problem.

Public equity markets have been performing well but private equity and debt have had a much more difficult period, and this opaque area of the market may cause waves in 2026. Indeed, Private Equity funds have underperformed the S&P500 over most time periods since the 2008 crisis. An inadvertent feature of that crisis was to overregulate public markets, which drove a lot of investment into the less regulated private markets, and as a result the private equity industry boomed. There are estimated to be 19,000 private equity funds in the US (compared to 14,000 McDonalds). The industry was further boosted by the long period of ultra-low interest rates which enabled private equity firms to buy companies financed by low-cost debt. It also received greater inflows than previously as allocators liked its low volatility characteristics. From being almost unheard of forty years ago private equity is now a mainstay of institutional portfolios, and it is underwritten by significant leverage. Until five years ago the industry encountered little adversity, but rising interest rates and overinvestment have caused a major logjam. Private equity groups have taken far more companies into their funds than they can sell into the public markets even with the stock market as buoyant as it is. These funds have the privilege of being able to value their companies at their own discretion (and charge fees at these valuations), but they are having great difficulty finding buyers at these elevated prices. As exiting their investments becomes harder, and they are supported by debt, there is more pressure to reduce the prices. If price discovery is forced on these funds, then they are likely to show significant losses. While it won't have a direct impact on public markets, if substantial losses are realised it will affect the institutional investors who are exposed to them who will need to raise their liquidity from elsewhere and the most likely source of that is the public markets.

After such a strong year and the uncertainty surrounding AI which has dominated so much of the stock market performance, where should investors look for opportunities? For the first time since 2017 global equities ex-US materially outperformed their American counterparts. This broadening effect is likely to continue as investors diversify by geography and style to become less AI and US-centric. This should be supported by local factors. For example, in Japan and South Korea companies are pursuing more shareholder friendly policies, Europe is benefiting from monetary easing and fiscal

support, and the weakening dollar provides further assistance. Emerging Markets look well positioned as they are seeing good earnings growth and equities are reasonably priced. With most investors having concentrated their portfolios in the US the rest of the world has been ignored and as a result is offering attractive values. As one strategist described it 'most people have between zero and nothing in Emerging Markets'. It won't take much of a change of sentiment to make these markets move. Commodities are also a way of playing the devaluation trade as governments attempt to print their way out of decline. Hard assets that governments can't print do well in times of monetary inflation. The price rises in coal, gas, uranium, copper, gold and silver exhibit this. The construction of datacentres and infrastructure in booming countries like India require commodities at a time when the mines producing these materials have suffered from underinvestment for a decade as environmental concerns have held development back. Competition for these assets is hotting up as China and the US both need these resources, so the outlook for strategic metals appears to be well underpinned. Perhaps the most interesting opportunity is in the oil market, which has been in a three-year consolidation due to subdued global growth and large supply increases from OPEC. The longer the price remains at these lower levels, the more damage will be done to future supply as producers have pulled back on spending on new capacity. OPEC's spare capacity is now limited, and while the rest of the world isn't running out of oil it is running out of oil that can be produced below \$60. Energy stocks offer an attractive hedge against geopolitical risk as well as inflation, have cheap valuations and there is a total lack of interest by investors. It would take little positive news to spark their revival. Another area that could perform well independent of the health of the general economy is the biotech sector. The long-term performance of biotech is exceptional, but the 2020's have been an unusual period in which it has not done well. Many investors avoid the sector because it is perceived as volatile, the science is complex, and the development of the drugs take years and are subject to a complicated regulatory process. However, it is an area where AI is reducing costs and speeding up and enhancing product development. The combination of new technologies and cost declines is unleashing a wave of new treatments that can underpin a new cycle in what is a huge market.

Investors' conundrum has been that to perform well they have had to hold a small group of American technology related companies whose valuations have risen to historically high levels. Now these companies are engaged in an arms race with each other to dominate the emerging AI era, spending vast sums on projects where it is difficult to model what the return on investment will be. The prospects of the Mag 7 look much less clear than before. Equally it is important to avoid those companies that may be damaged by the effects when AI is deployed. Meanwhile there are plenty of companies in less glamorous sectors that can benefit from the gargantuan capex that is currently underway. Investors will have to go further afield than they have been used to in the last decade and probably must withstand more volatility. 2026 is likely to be a year where it pays to be much more diversified by geography and sector than has been the case recently.

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