



THE YEAR AHEAD

# 2026 BEST IDEAS



January 2026

All investments involve risk, including the possible loss of capital.

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## KEY THEMES

Fiscal dominance, structural growth, AI-driven productivity gains, and the convergence of public and private markets emerge as key themes with far-reaching implications across asset classes:

### 1. The Era of Fiscal Dominance... and the End of Central Bank Innocence

Geopolitical rivalry is expensive. Record defense budgets, expanding industrial policy, and rising populism will compel major economies to run historically high deficits. Accompanying demands for low monetary policy rates erode central banks' inflation-fighting credibility. Repriced term premia will increasingly determine the level of long-term rates.

### 2. Carry On: Lean Into Structural Growth

Steeper yield curves, stretched market valuations, and economies reconfigured for structural growth warrant diversified portfolios constructed for carry and income.

### 3. Productivity Boost Redux

The \$7 trillion global AI buildout threatens near-term over-investment risks. Yet, historical precedent suggests it will ultimately seed a productivity boost that determines growth trajectories, debt dynamics, and the future winners and losers across global industries and corporations.

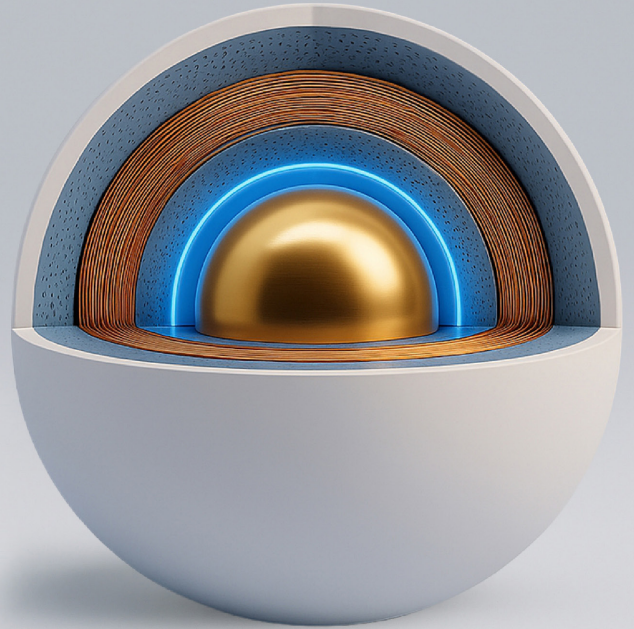
### 4. The Convergence of Public and Private Markets

As the delineation between public and private markets fades, expanding sources of capital can support borrowers' credit profiles. As risk and return profiles converge, investors will benefit from assessing relative value across the public and private credit continuum.

With these themes in mind, PGIM's annual Best Ideas report explores some of the most appealing investment opportunities of 2026, leveraging our breadth of expertise to present investors with a diverse set of strategies for constructing more resilient portfolios.

## CARRY & CONVERGENCE

# THE COMPELLING CONVERGENCES IN A CREDIT INCOME APPROACH



The convergence of public and private credit sharpens the focus on how these assets may perform in an individual portfolio. A portfolio with the flexibility to allocate to a manager's best ideas across the public and private credit continuum highlights the following four points:

- The rationale for investing in public and private assets in a single portfolio;
- capturing liquidity premia in a flexible portfolio oriented for credit income;
- diversification benefits for asset correlations and the portfolio;
- and the complementary benefits of bespoke lending across private markets.

## The Rationale for Portfolio Convergence

Unto their own, the asset classes that may be combined in a flexible credit portfolio comprise significant size and growth. From a fixed income perspective, the global public credit markets represent a \$31 trillion opportunity set, while the \$2 trillion global private credit market is expected to double in size by 2030.<sup>1</sup>

The combination of public and private assets not only provides the portfolio with access to more borrowers, but it also opens the opportunity set across borrowers' capital structures. For example, an AI-related hyperscaler may have outstanding public debt, securitized construction loans, and direct loans

related to its data-center buildout. A portfolio manager seeking exposure to the name would consequently seek the optimal relative value amongst those outstanding securities.

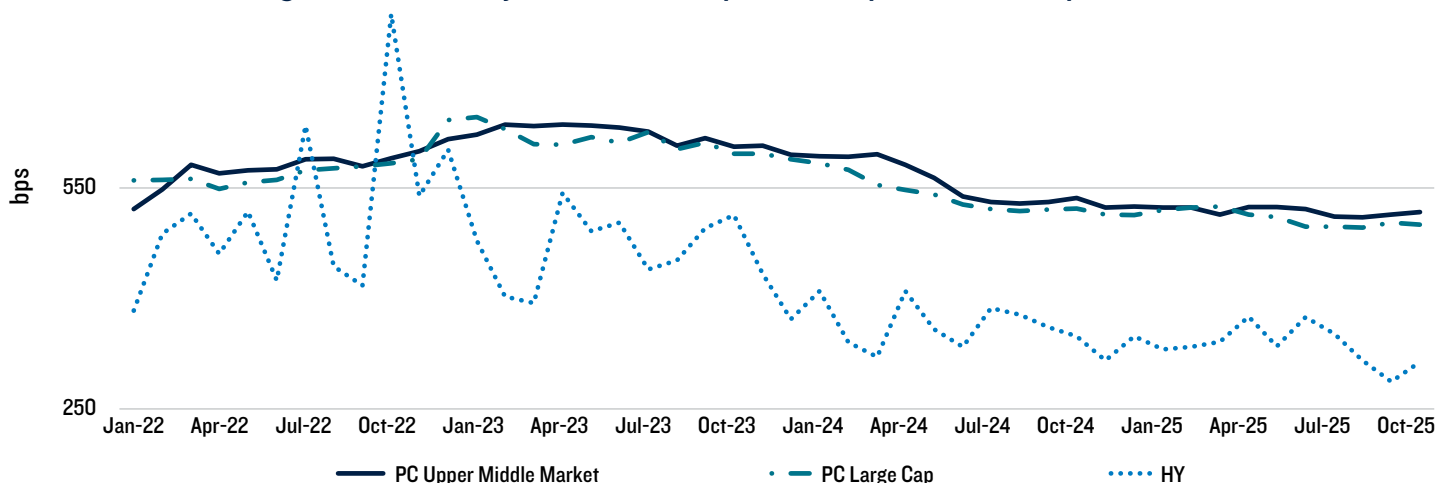
In a portfolio oriented for credit income, the implementation of investment ideas across asset classes varies. For example, on the public credit side, our current allocation approach is generally neutral on duration and focused on carry amid historically tight credit spreads. On the private credit side, we are seeking complementary exposure to non-sponsored borrowers, lien protection, and add-on transactions with existing borrowers ([see our latest fixed income insights here](#)).

Furthermore, specific allocations to public and private assets may depend on market conditions and relative value considerations. While private credit yields continue to exceed those of comparable public assets, that dynamic changes over time and supports a relative value approach across public and private assets.

Exhibit 1 shows that, in the COVID aftermath, public credit spreads—including those in the high yield bond market—exceeded private credit spreads for much of 2022. At that time, a relative value approach may have pointed to a public

1. Preqin as of September 30, 2025. All figures are nominal.

## Exhibit 1: The shifting relative value dynamic between public and private credit spreads



Source: Bank of America Securities.

credit overweight relative to private assets. Given the public market’s elasticity to macroeconomic and broad credit market events (i.e., periods where spreads widen and subsequently mean revert), when these events occur, marginal portfolio adjustments tend to favor investments in public assets.

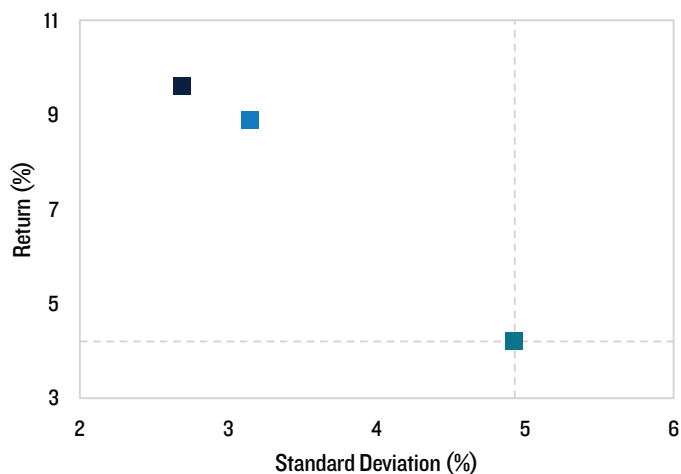
However, the respective views on individual asset classes belie the compelling opportunities when these assets are combined in a complementary portfolio. For example, Exhibit 2 provides a risk/return perspective on a portfolio with the flexibility to invest across public and private assets in comparison to a portfolio dedicated to public high yield bonds and the U.S. Aggregate Index, respectively.

Our representative portfolio returned 9.6% from the start of 2024 through Q3 2025, exceeding the returns from high yield bonds and the Aggregate Index, with a lower standard deviation of returns.<sup>2,3</sup> The performance of the representative portfolio amounts to a Sharpe ratio of nearly 1.70, well in excess of those for public high yield and the Aggregate Index.

### Capturing Liquidity Premia

Given the prolonged tightening in public credit spreads in the post-COVID environment (albeit with periods of volatility, e.g., the collapse of Silicon Valley Bank in early 2023), all-in private credit yields have recently exceeded those in comparable public markets. That excess is primarily attributable to the illiquidity premium in private credit.

## Exhibit 2: The potential performance benefits of a flexible credit income-oriented portfolio



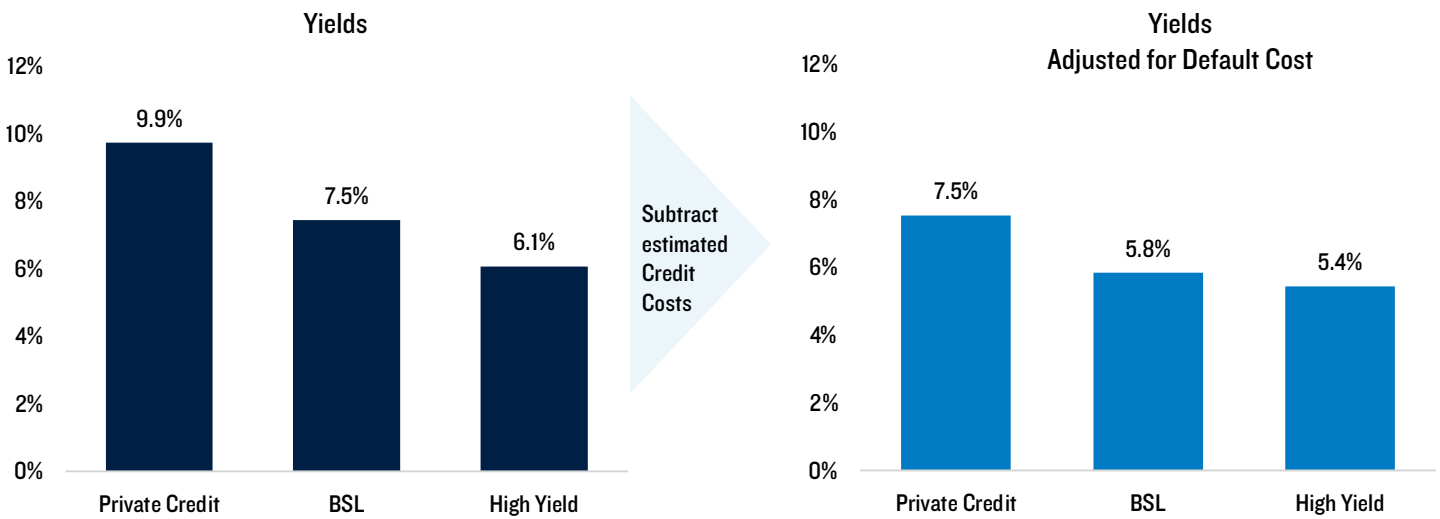
1/1/2024 – 9/30/2025	Return (%)	Standard Deviation (%)	Sharpe Ratio
A Flexible Credit Income Portfolio	9.60	2.69	1.68
High Yield	8.87	3.15	1.20
U.S. Agg	4.20	4.93	-0.04

Source: All data as of 9/30/2025, unless noted otherwise. Source of index data: PGIM using data from Bloomberg. All indexes are unmanaged. An investment cannot be made directly in an index. U.S. Agg: BBG U.S. Aggregate Bond Index; High Yield Bonds: BBG U.S. High-Yield - 1% Issuer Cap Index. Source of portfolio data: PGIM

2. The private credit exposure in the representative portfolio totaled nearly 20% in notional terms as of September 30, 2025. Public securitized credit, high yield, and bank loans comprised the majority of the remaining notional allocations at the time.

3. The lower standard deviation of returns in private credit is primarily due to the sector’s non-mark-to-market characteristics.

### Exhibit 3: Context Around Private Credit's Illiquidity Premium



Source: PGIM. As of January 2026.

Exhibit 3 takes a high-level approach of decomposing that illiquidity premium with an initial step of factoring in default costs. When doing so, the effective yield on private credit declines 240 bps to 7.5%, while the yields on broadly syndicated loans and high yield decline by 170 bps and 70 bps, respectively. An additional adjustment for fees could also factor into a public/private yield comparison.

### Diversification, Correlation, and Information Ratio

Taking the effects of an expanded opportunity set a step further, a portfolio with the ability to invest across the public/private credit continuum should also be more diversified compared to those focusing on specific, individual asset classes. That diversification carries implications for cross-asset correlation and, consequently, the portfolio's information ratio.

Given private credit's non-mark-to-market characteristics and bespoke lending terms, the asset class exhibits a relatively low level of volatility. When combined with public credit in a dedicated portfolio, the addition of private credit allocations—potentially ranging from asset-based finance (ABF) to private credit secondaries—lowers the correlation

across the portfolio's assets, and the volatility of returns should decline as a result.

When viewed from the perspective of a portfolio's information ratio—with volatility being the denominator—the reduced volatility lifts its information ratio, indicating the potential for greater risk-adjusted returns in an actively managed portfolio.

### The Benefits of Bespoke Direct Lending

The focus on opportunity sets and diversification applies across the private credit universe as well. Sponsored and non-sponsored borrowers generally present different credit attributes, and a portfolio seeking the optimal risk-return profile and level of diversification may consider lending to both segments of the private credit market.

Non-sponsored companies comprise about 90% of the middle-market direct lending market. While these loans can be more difficult to source—indicating that this segment may be underserved by many direct lending funds and highlighting the value of a broad sourcing network—they may have beneficial attributes when combined in a holistic credit income portfolio.

For instance, non-sponsored allocations may be more focused on non-change-of-control deals given the potential credit

implications that could surface with an acquisition or merger. Furthermore, when compared to loans to sponsored entities, non-sponsored loans generally consist of better, negotiated terms at lower leverage levels with better information disclosures to the lender.

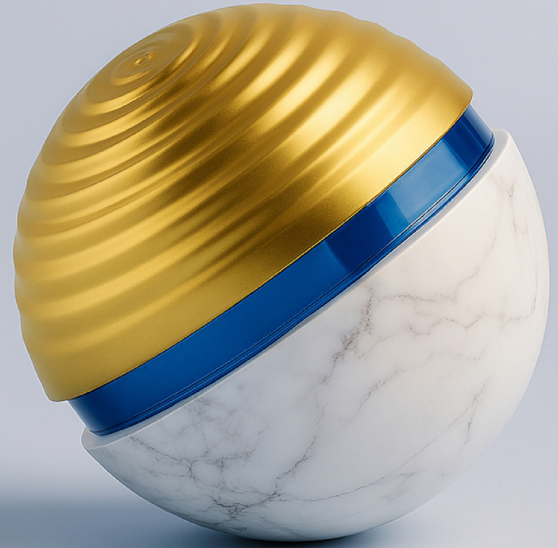
The flexibility to select between sponsored and non-sponsored deals generally avoids conflicts of interest that can occur in captive origination deals. The ability to choose from origination types means that portfolio exposure is evaluated on risk and return prospects as opposed to pre-determined criteria, such as lending volume objectives.

## **Concluding Thoughts**

The fading delineation between public and private credit markets carries broad investment implications. It not only underscores the ongoing convergence of risk/return profiles, but it also highlights the strategic rationale for a flexible, credit-oriented portfolio. The ability to capture illiquidity premia, harness the diversification benefits of an expansive opportunity set, and establish bespoke lending terms highlights the importance of allocating across the credit continuum in a continually evolving investment landscape.

## CONVERGENCE OF PUBLIC & PRIVATE MARKETS

# THE CASE FOR PRIVATE CREDIT SECONDARIES



With the growth and maturation of private credit, financing the global economy has undergone massive change. Borrowers are increasingly moving outside traditional financing channels for flexible solutions that meet their capital needs. For investors, private credit can act as a source of stable income and attractive risk-adjusted returns, complementing traditional fixed income allocations. A broad range of strategies, including direct lending, mezzanine financing, distressed debt, and opportunistic credit, offer diverse opportunities. Alongside this expansion of the private credit universe, the secondaries market is a growing opportunity that has been gaining traction in recent years, reflecting demand for liquidity solutions and an agile approach to managing credit exposures in a dynamic environment.

As private credit allocations grow, credit funds mature, and the realization pace from these investments slows, limited partners (LPs) and increasingly general partners (GPs) are turning to the secondaries market to alleviate liquidity pressures and strengthen portfolio management in an evolving credit landscape.

### An Expanding Market Opportunity

The credit secondaries market is expanding quickly. It grew at a CAGR of 46% between 2020 and 2024, outpacing private equity secondaries.<sup>1,2</sup> This growth is driven by several factors. Private credit AUM increased by approximately half from 2020 to 2024, eclipsing \$1.7 trillion, and is forecast to hit \$2.8 trillion by 2028 (Exhibit 1). Meanwhile, credit

secondaries volumes account for less than 1% of total private credit AUM—smaller than the 2-3% share that private equity secondaries have built.<sup>3</sup> This suggests that credit secondaries have plenty of room to grow as adoption increases.

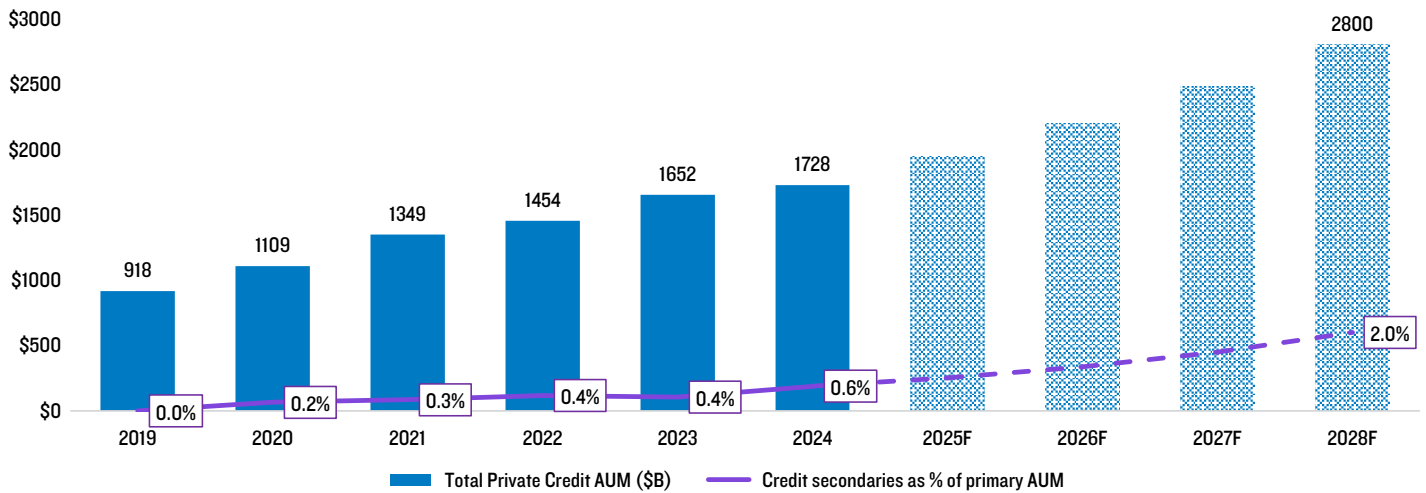
Although private credit investments are typically self-liquidating, repayment timelines have become increasingly unpredictable. The use of loan maturity extensions, amend-and-extend transactions, and payment-in-kind (PIK) interest have prolonged fund lifecycles and slowed distribution cycles. M&A activity, which has historically served as a catalyst for early exits, has decelerated, also extending loan maturities. With some investors experiencing delayed cash flows, these market trends reinforce why the secondaries market may become an increasingly valuable

1. Evercore. (2025, July). H1 2025 Secondary Market Review. <https://crain-design-hub.s3.us-east-1.amazonaws.com/pi/Evercore-H1-2025-Secondary-Market-Report.pdf>. Accessed December 2025.

2. Evercore. (2025, February). FY 2024 Secondary Market Review. <https://www.evercore.com/wp-content/uploads/2025/02/Evercore-Full-Year-2024-Secondary-Market-Survey-Results.pdf>. Accessed December 2025.

3. Macfarlanes. (2025, May 22). Unpacking Private Credit Secondaries. <https://www.privatecapitalsolutions.com/insights/unpacking-private-credit-secondaries>. Accessed December 2025.

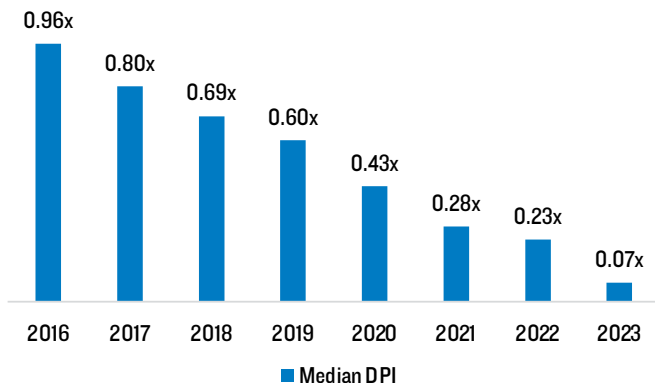
## Exhibit 1: Private Credit AUM Continues to Grow



Source: Preqin (AUM) and Evercore 2024 and H1. Forecasts may not be achieved and are not a guarantee or reliable indicator of future results.

## Exhibit 2: A Slow Realization Pace from Private Credit Funds

Private credit median DPI by vintage



Source: Pitchbook, "Continuation Funds Find Their Footing in Private Credit," published June 27, 2025. Data as of Q3 2024.

mechanism for managing liquidity and duration risk in private credit portfolios.

The slow realization pace from private credit funds, which has led to delayed cash flows and growing mismatches between asset maturities and fund terms, adds to the appeal of the secondaries market—as evidenced by a lower-for-longer median distribution to paid-in capital (DPI) that has settled below 1.0x since 2016 (Exhibit 2).

Growth in the credit secondaries market has also been supported by GP-led transactions as more GPs tap the market to enhance DPI and lock in returns for their LPs. While LP-led transactions have been the dominant driver of

secondaries activity, GPs are fueling growth as they seek to diversify their investor base, manage the lifecycle of funds, or create continuation vehicles that extend the holding period of attractive assets and provide existing LPs with the opportunity to cash out or reinvest. Dedicated capital inflows supported a significant increase in GP-led secondaries activity in 2024 and the first half of 2025, contributing to overall market growth.

Success in navigating the evolution of credit secondaries will require expertise in origination and structuring, the ability to underwrite and customize a wide range of transactions, and established relationships with issuers, intermediaries and sponsors.

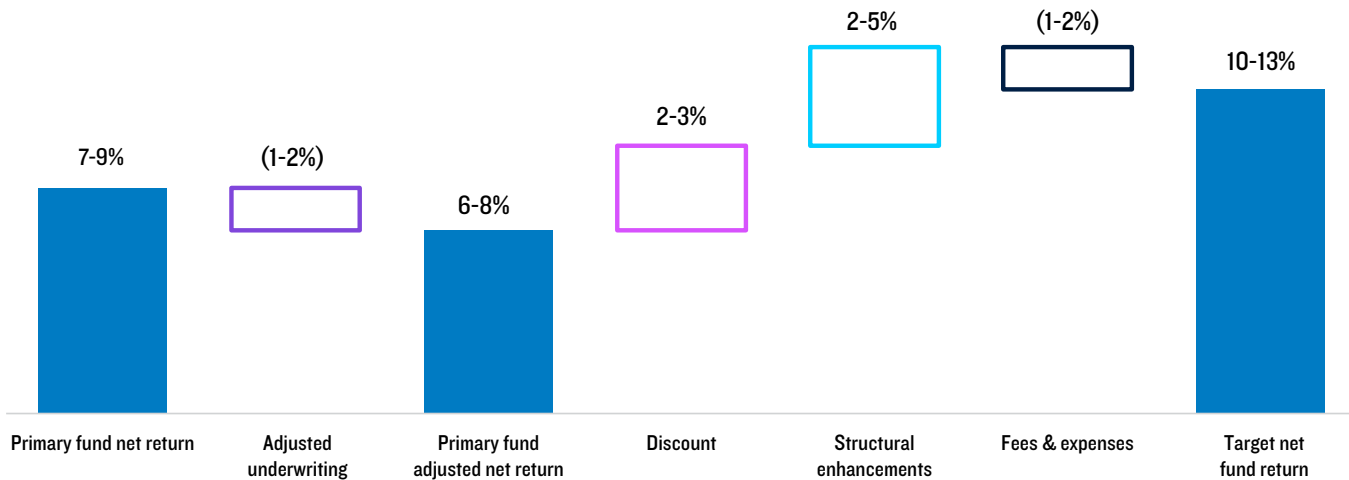
## Utilizing Secondaries to Enhance Credit Portfolios

There are several key portfolio benefits to utilizing the credit secondaries market, including:

- 1. Risk-return profile:** Investors providing liquidity through credit secondaries are often compensated in the form of a discount off the current net asset value (Exhibit 3). As a result, direct lending investors can tap the secondaries market for an immediate uplift in return for comparable direct lending portfolios.
- 2. Diversity in assets:** Through credit secondaries, investors are gaining efficient access to a broad swath of direct lending funds with exposure to an array of GPs,

## Exhibit 3: Enhancing Credit Portfolios Through Secondaries

Illustrative Target Net Return Breakdown



Note: The data shown is for illustrative and educational purposes only. The market targets shown address private credit secondaries broadly and do not reflect the actual performance of any specific fund, manager, or strategy. They are based on general market observations and high-level assumptions regarding discounts, structural features, fees and expenses, and loss adjustments that may vary meaningfully across transactions and time periods. There is no guarantee that any objective or target will be achieved. An investor can lose some or all investment. Targets are subject to significant limitations; actual results can differ materially due to changes in interest rates, inflation, credit losses, market liquidity, manager selection, portfolio construction, and transaction terms. Target returns are presented net of typical carried interest, management fees, and fund-level expenses where noted. This research is not an offer, solicitation, or recommendation for any security or strategy and does not constitute investment advice. It should not be relied upon for making investment decisions without independent analysis and consideration of investor-specific objectives, constraints, and risk tolerance.

managers, economic sectors, global regions, vintages, and issuers. A typical direct lending fund might have around 60-80 underlying loans, for example, versus the hundreds of loans in a typical credit secondaries fund.<sup>4</sup>

- 3. Risk management:** As a secondary buyer, investors get a transparent view into most assets and underlying loans, limiting blind pool risk. Meanwhile, risks can be priced in to mitigate future losses, as discounts provide investors with a buffer to manage potential headwinds. Credit secondaries also offer an entry point that aligns with more seasoned loans that have demonstrated solid performance. Roughly 75% of loans that experience payment defaults do so within the first three years.<sup>5</sup>
- 4. Large supply-demand imbalance:** While there is plenty of flow into credit secondaries, only a subset of this capital has been allocated. This imbalance allows investors to be a selective buyer of attractive assets and quickly deploy capital.

## Summary

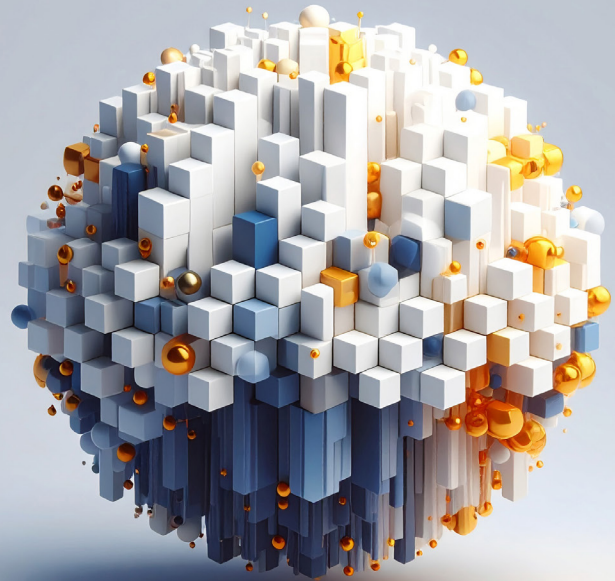
Private credit secondaries are becoming increasingly valuable to CIOs as a strategic portfolio management solution that enables them to fine tune credit exposures as market dynamics evolve. As a secondary buyer of attractive assets, investors may seek to complement or enhance returns relative to a traditional credit strategy, particularly with a focus on middle-market loans that tend to offer better terms and higher yields. Investors navigating the fast-developing credit secondaries market may benefit from working with managers that have longstanding relationships, advantages in sourcing deals, and deep underwriting expertise across the credit spectrum.

4. IEQ Capital. Private Credit Secondaries: An Evolving Opportunity for UHNW Portfolios. <https://ieqcapital.com/resources/private-credit-secondaries-for-uhnw-investors/>. Accessed January 2026.

5. Proprietary PGIM data as of December 31, 2024. Represented as a % of total defaulted AUM (outstanding \$ as of the date of default).

CARRY ON: LEAN INTO STRUCTURAL GROWTH

# GLOBAL LIVING: TAPPING INTO STRUCTURAL GROWTH



Around the world’s major cities, strains in housing provision continue to be a major theme (Exhibit 1). Many common factors contribute to this: high mortgage rates and stretched affordability are constraining ownership; urbanization and inward migration flows to cities are pushing up demand; and planning constraints and elevated building costs are holding back new supply. Housing shortages are growing and in an increasing number of cities there is a lack of modern, fit-for-purpose stock to meet the needs of households.

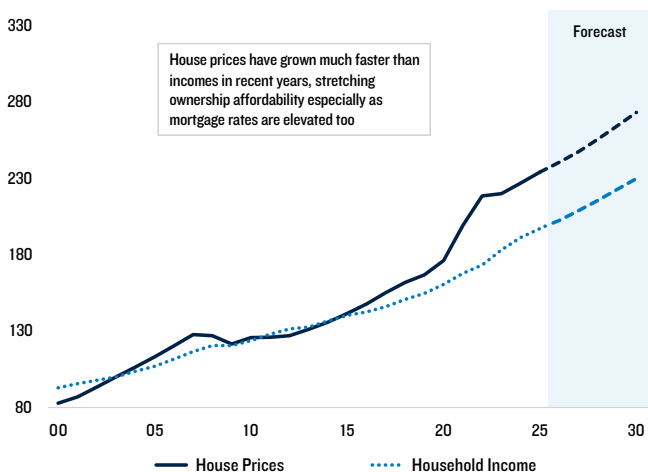
Real estate investors have a role to play. Today’s living markets represent a compelling opportunity based on the basic needs-based nature of underlying demand that provides cashflow predictability and a relatively low risk profile.

At the same time, market requirements are evolving, adding to strains. Aging demographics imply a growing need for

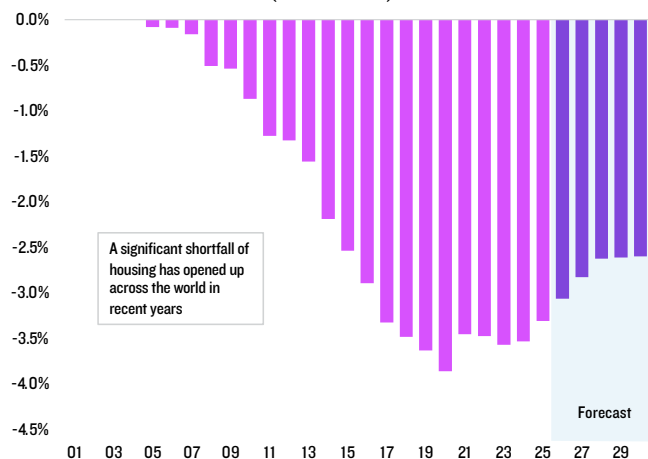
age-restricted and senior-living products, while students and fresh graduates drive a need for the provision of compact living spaces, including student accommodation and co-living. In many parts of the world, rental housing demand is rising, notably for families that traditionally have leaned toward ownership.

## Exhibit 1: Constraints on Global Housing Provision and Affordability

Global House Prices and Household Income (Index: 2003=100)



Estimated Housing Shortfall, Major Global Economies (% Households)



Sources: Oxford Economics, CoStar, PMA, U.S. Census Bureau, PGIM. As of January 2026. Forecasts may not be achieved and are not a guarantee or reliable indicator of future results.

The structural nature of the growth in housing needs supports expectations that elevated occupancy will continue, and there is scope to drive asset-level rental growth against a backdrop of rising household incomes.

## Regional Dynamics Differ

While there are common factors around the world, differences in local market dynamics—including regulations, occupier preferences, supply cycles and institutional participation—means that the investment opportunity set varies across and within regions.

**In the United States**, suburban locations are well-positioned to benefit from shifting demographics and rising wages among higher income earners. Demand for more living space and quality schools, coupled with ownership affordability constraints, is supporting single-family rental demand. Low-vacancy suburban submarkets in gateway cities offer the strongest prospects, while occupancy in Sunbelt markets is lower after a prolonged period of supply growth.

Senior housing represents a significant opportunity, fueled by rapid growth in the 80+-year population that is expected to continue for years to come, notably in lifestyle-driven Sunbelt markets including cities in Florida, Arizona, and Texas. Rent momentum is being sustained by a constrained pipeline and improving affordability among senior households on the back of elevated asset prices and high income levels. Operating expense growth is also cooling as wage pressures moderate.

**The story across Europe** varies (although demand for new housing units in most major cities is significant) while supply growth has been held back by elevated build costs, high borrowing rates, and planning restrictions in recent years. Rental growth is expected to broadly track household income growth in years to come, although this story comes under threat in cities with rent controls (Paris, major German cities) and where apartment rents rose sharply in recent years (Madrid).

Institutional depth is low in Europe, and the entry point for equity investors is typically via development rather than existing portfolios. In 2025, development remained restricted by tight profit margins, but recovering values, falling interest rates, and stabilizing construction costs are increasing the viability of traditional residential formats. High-density

living concepts, including student accommodation and micro-living, remain an attractive route to deployment as development margins are higher and rental growth is less affected by regulation.

**In Asia-Pacific**, ownership and rental affordability is stretched in cities across Australia and Japan—the main institutional investment markets for living in the region—alongside a supportive city-level demographic story. Growth in international student numbers is expected to remain strong across the region, although the prospect of tougher entry requirements or caps, such as in Australia, require careful underwriting.

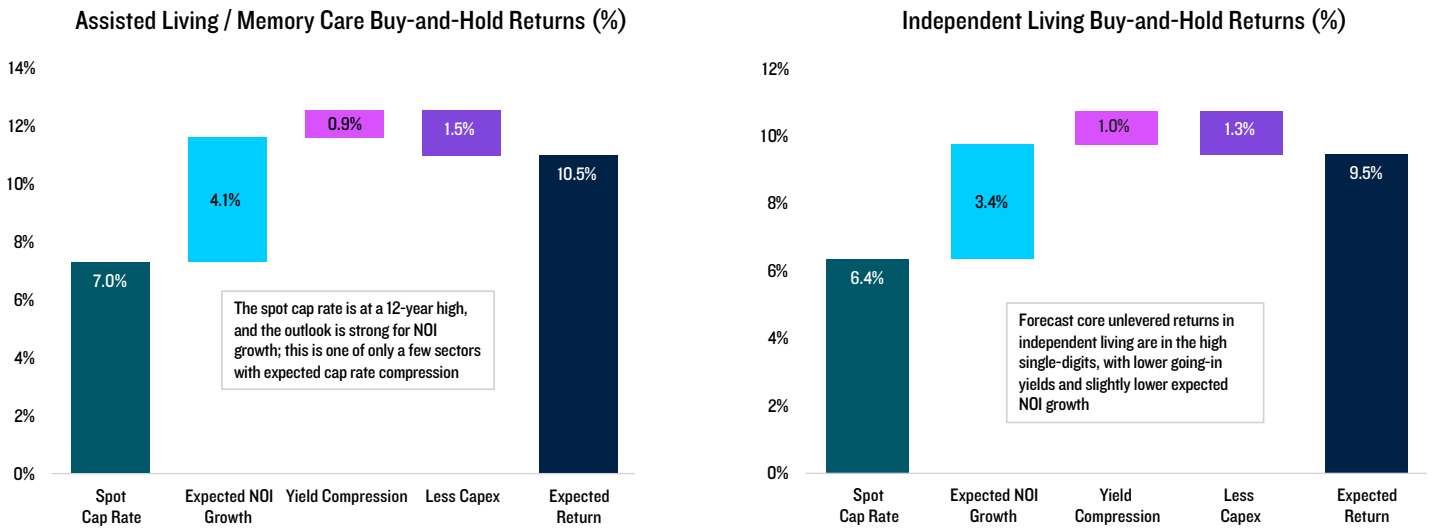
At the other end of the age spectrum, Singapore, Seoul, Melbourne, and Brisbane are all expected to record a sharp increase in senior population in the coming years. Accrued increases in housing wealth make the expanding senior living market affordable to many households.

## Traditional Versus Operational Investment Model

Living-sector investment is becoming more operational, reflecting two main factors. First, management platforms that handle leasing and maintenance at scale can drive rental growth and minimize expenses, while adding other amenities can push rents higher than the wider market. Even traditional for-rent residential assets need an operational overlay to be successful. The second is that non-traditional living sectors are gaining in share and importance, with platforms for student accommodation, senior housing and micro-living now a clear part of the institutional investment universe. High tenant churn is a feature of such assets, making sales and marketing efforts key to maintaining occupancy and driving income growth.

Operational living sectors have several key advantages. One is demographic tailwinds. For example, in many countries, student numbers are rising, driving demand for purpose-built student housing, but also for compact apartments that serve a growing body of recent graduates in major cities. Perhaps the most notable opportunity is in senior housing for which growing 80+ populations—and the scale of asset wealth held by that generation—globally point to a need for increasing provision and, significantly, an ability-to-pay

## Exhibit 2: Strong Outlook for Senior Housing Returns in the United States



Sources: Green Street, PGIM. As of January 2026. Forecasts may not be achieved and are not a guarantee or reliable indicator of future results.

story that overcomes factors, such as elevated build costs. Unlevered gross total returns are expected to remain elevated in the U.S., for example, (Exhibit 2) for both assisted and independent living, where demand and rental growth projections are strong against a reduced supply pipeline.

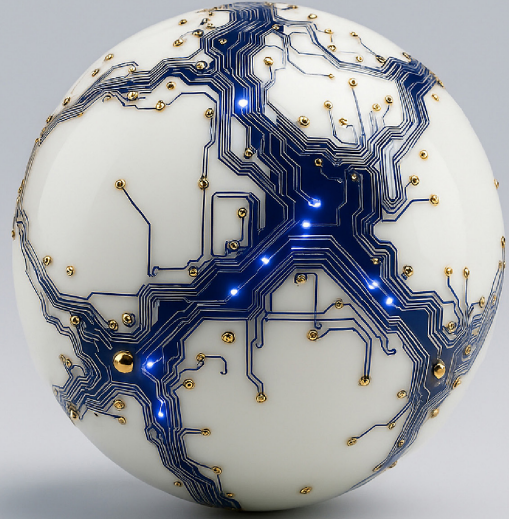
At the same time, high risks require operational expertise. Elevated rental growth assumptions stretch affordability, while operating models are vulnerable to such factors as staffing shortages, wage increases, and rising energy or equipment costs, all of which can erode margins, associated enterprise, and real estate valuations. As always, choosing well-established partners is key to deploying capital in these markets and mitigating the higher risks.

### Living as a Credit Play

The secure cashflows generated by living sector assets are particularly well-suited to credit investments. With banks in a structural retreat from the real estate sector globally, alternative private lenders are increasingly able to underwrite loans in the sector. For lenders with a higher risk appetite, there are several entry routes into the market. One is to finance new development, a strategy that is expected to grow as construction opportunities return to global markets in 2026 on the back of stabilizing build costs and rising values. There are also significant opportunities around transitional lending, including for modernization of older stock in the U.S., and retrofitting assets to meet ESG regulations in Europe.

## PRODUCTIVITY BOOST REDUX

# AI: ACHIEVING SCALE



**Artificial intelligence is the most far-reaching technological development since the creation of the internet. We believe AI represents a generational paradigm shift in how consumers and enterprises interact with and use computing services. For enterprises, AI offers enhanced efficiency, superior execution, strategic differentiation, and deeper insights. For consumers, AI provides instantaneous access to information, personalized content experiences, and advanced problem-solving capabilities.**

AI's potential has attracted investors, who have bid up AI-related stocks and pledged hundreds of billions of dollars to support AI capabilities. This has resulted in unprecedented market concentration and some skepticism, but we are not among the doubters. Our observations over the past year have confirmed our view that AI continues to develop effectively and rapidly, with enormous implications for the AI ecosystem and global economy. In fact, the extraordinary investments in AI infrastructure are already yielding results. The foundation for agentic AI applications is now in place, allowing consumers, creators, and enterprises to benefit from rapidly improving AI capabilities:

- Consumers are increasingly interacting with AI within various products across mainstream applications—everything from search to Instagram. Users have been able to ask increasingly sophisticated questions and receive more detailed, appropriate, and helpful responses.
- Multimodality models, which include images and video, offer advanced tools for creators. Advertisers, for example, can take one piece of media and create multiple variations that can be tailored to audiences.

- For enterprises, agents are now capable of doing longer-form tasks—in some cases doubling their capacity from 12-24 months ago—and workflows are being automated into minute-long processes that once took hours, if not weeks. This applies to a range of applications—from creative solutions to mundane, repetitive tasks—and frees employees to focus on higher-quality projects.

The growing sophistication of AI applications, and their growing use across the economy, has shifted investor focus increasingly to monetization. Monetization has already occurred for the companies that build the components of the AI infrastructure (e.g., Nvidia) and now, with the very large and fast deployment of AI infrastructure over the past two years, hyperscalers are well positioned. They will rent out increased compute capacity to customers (e.g., software companies, enterprises building custom solutions, consumers), where demand remains strong. We believe this will result in higher revenue for the hyperscalers and represents a transition in the deployment and monetization of AI.

Most importantly, monetization is occurring for the companies that develop AI applications and services—more than a dozen AI companies have gone from virtually zero to a billion dollars in annual recurring revenue over the last 18 months. We believe these companies have the potential to be more profitable over the long term, but currently their operating margins are being lowered by the high costs of compute. As costs for AI models get cheaper, in our view, and these model companies are able to deliver more intelligence more cheaply, profit margins should improve.

## More Efficiency, More Opportunity

Given the capabilities of AI agents today, one significant challenge for companies is getting their data organized so it can be used effectively by AI tools. We believe many firms will address this issue in 2026. This will be a meaningful opportunity for software companies that provide AI solutions and for the companies themselves, which should see significant efficiencies and opportunities from AI analysis.

We note “bubble-like” behavior in parts of the market, but the demand across the AI ecosystem is healthy and will continue at least in the short term. In prior investment cycles, such as the internet around 2000, a large amount of infrastructure was built but not used. In contrast, almost all of the GPU-related infrastructure is being utilized, resulting in well-publicized demand surges for AI components, expertise, and energy.

However, we are monitoring a few trends because of their potential impact on the AI ecosystem:

- AI models could become dramatically more efficient, cheaper to run, and require less compute to handle

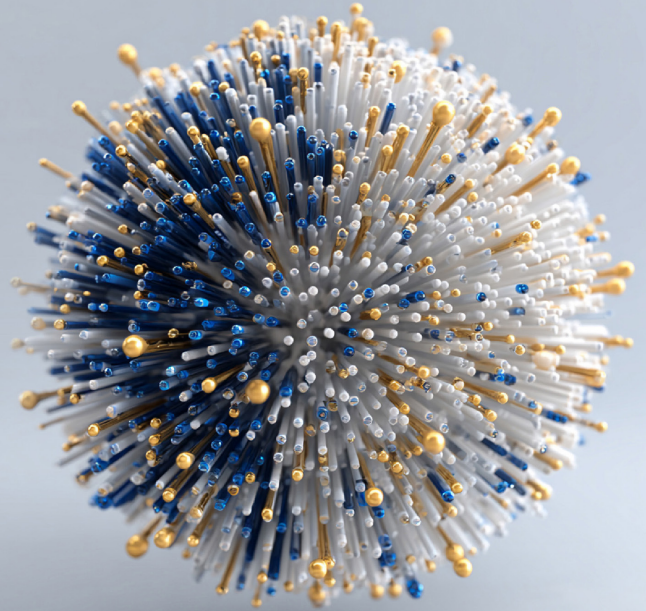
inbound requests or tasks. A step-change improvement could lower demand for, among other things, AI infrastructure and energy.

- Open-source models have become very effective, especially for certain tasks. If open-source models, which are free, offer capabilities that rival those from AI model providers, it could drive a revaluation of AI investments and prospects.
- AI continues to require enormous capital expenditures, and one of the major barriers to AI is the compute resources needed. Looking ahead, we believe the growth of capital expenditure is sustainable. The leading frontier model providers are very profitable and can, in our view, fund capex from operating cash flows. In addition, we believe the capex investments could result in major drivers of revenue growth which, in turn, could fund the investments.

Compared to prior waves of technology development, AI is still in a very early stage. However, AI is accelerating at a faster rate in historical terms. ChatGPT grew to 800 million weekly active users in two-and-a-half years; it took the internet about 12 years to achieve the same scale. In this environment, we believe it is critical to maintain perspective. Secular growth themes can stoke market enthusiasm and boost valuations but, in our experience, markets ultimately separate winners from losers. We have been applying our growth investing approach for more than five decades, and we believe that our focus on fundamentals, deep resources, and experience across multiple cycles of economic transformation leave our clients well positioned to benefit from the AI-driven revolution

## ERA OF FISCAL DOMINANCE

# EMERGING MARKETS: PILLARS OF OPPORTUNITY AND POTENTIAL



After years of lagging developed market (DM) returns, emerging market (EM) equities are reasserting their relevance. Energized by a weakening dollar and revised growth estimates, 2025 saw EM equities delivering their best calendar-year performance in nearly a decade. Despite these strong gains, we believe EMs remain significantly undervalued, underscoring the compelling entry point for investors today.<sup>1</sup>

In our view, there are three pillars underpinning the opportunity:

- **A constructive macroeconomic backdrop:** Tailwinds like a weakening dollar and easing global monetary policies are driving EM growth.
- **Historically wide valuation discounts:** EM equities are trading at levels not seen in decades, offering a rare value proposition.
- **A maturing corporate and policy landscape:** Structural reforms are finally converting robust GDP growth into tangible earnings gains.

## The Winds of Change: Dollar and Policy Trends

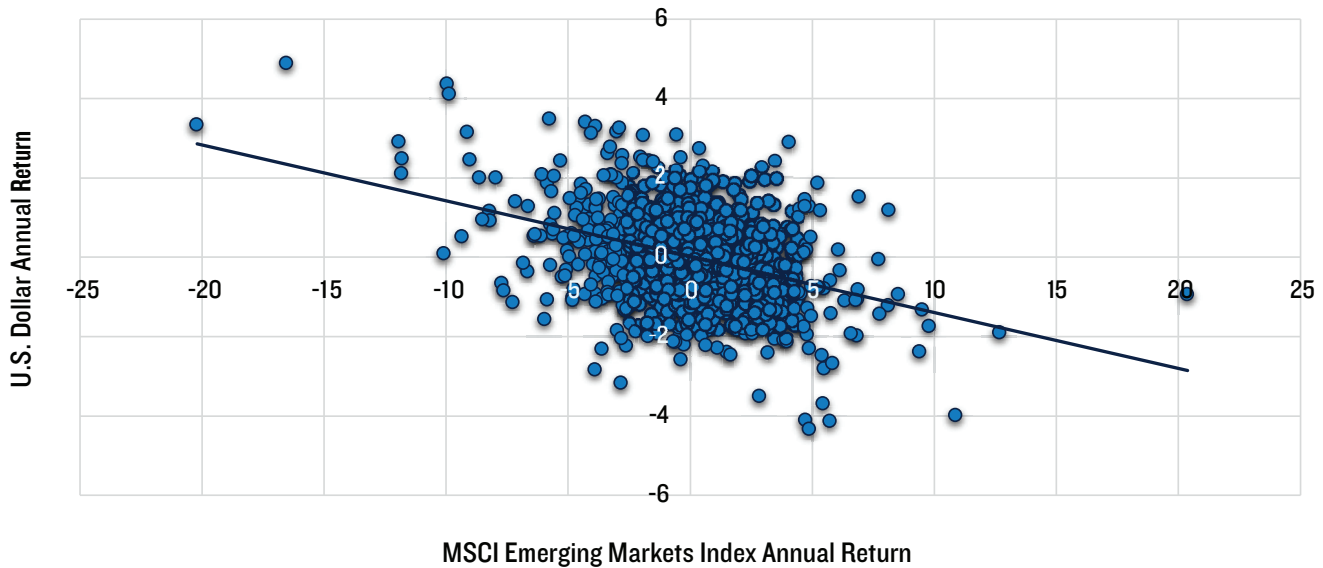
While the global macroeconomic backdrop remains rife with uncertainty, two macro levers that have historically influenced EMs are turning supportive. The U.S. dollar—long a headwind for emerging markets—is weakening, and historically, periods of dollar softness have coincided with

stronger EM equity and currency performance. With the Federal Reserve shifting into a cutting cycle, marked by three consecutive 25bps rate reductions in late 2025, the dollar's multi-year bull run appears to be peaking. A softer dollar has historically benefited EM economies due to the strong inverse correlation between the trade-weighted dollar and the relative performance of EM versus DM equities, as illustrated in Exhibit 1. As the dollar declines, the debt load for emerging economies—much of it denominated in U.S. dollars—could ease, creating room for fiscal stimulus and bolstering economic resilience.

Two other factors are also supporting the case for a weaker dollar: High carry makes EM currencies attractive relative to low-yielding developed market peers, and the U.S. dollar—now behaving more cyclically—is likely to weaken as U.S. growth slows. This environment should limit EM currency downside during U.S. growth shocks, while also enhancing their appeal amid stable or improving global risk sentiment.

1. MSCI. (2026). MSCI Emerging Markets Index. <https://www.msci.com/documents/10199/255599/msci-emerging-markets-index-usd-price.pdf>. Data as of December 31, 2025. Accessed January 2026.

## Exhibit 1: Emerging Market Returns Negatively Correlated With U.S. Dollar



Source: Bloomberg as of Nov 2025.

And while the dollar weakens, the EM/DM growth differential widens. Emerging markets have historically outpaced developed markets in real GDP growth, a trend that looks on pace to continue. The IMF raised its 2025 outlook<sup>2</sup> for EM and developing economies to 4.2%, reflecting resilient activity and policy credibility improvements across several EMs. In contrast, growth forecasts for DM hover at around 1.6%, with disinflation enabling monetary easing in some advanced economies—conditions that typically support risk assets and EM capital flows.

### Valuation Gaps: A Historic Opportunity

EM equities rallied for 10 consecutive months to start 2025, driven by strong earnings growth, optimism around artificial intelligence, and robust foreign investor demand. In September alone, the MSCI Emerging Markets Index rose 7%, buoyed by the Fed's first rate cut of the year. Beyond the positive macro trends, the valuation story is perhaps the most compelling. For much of the last four decades, EM and DM relative performance has oscillated in long, multi-year cycles, each lasting, on average, nine years. The current EM underperformance cycle, at approximately 13 years, is already notably longer than the historical average, setting the stage for mean reversion. Today, forward P/E spreads show EMs trading at more than one standard deviation below DMs—a valuation gap not seen since the dot-com era and one that has historically preceded strong forward returns (Exhibit 2).

2. <https://www.imf.org/-/media/files/publications/weo/2025/october/english/text.pdf>

### From GDP to EPS: Governance & Fundamentals

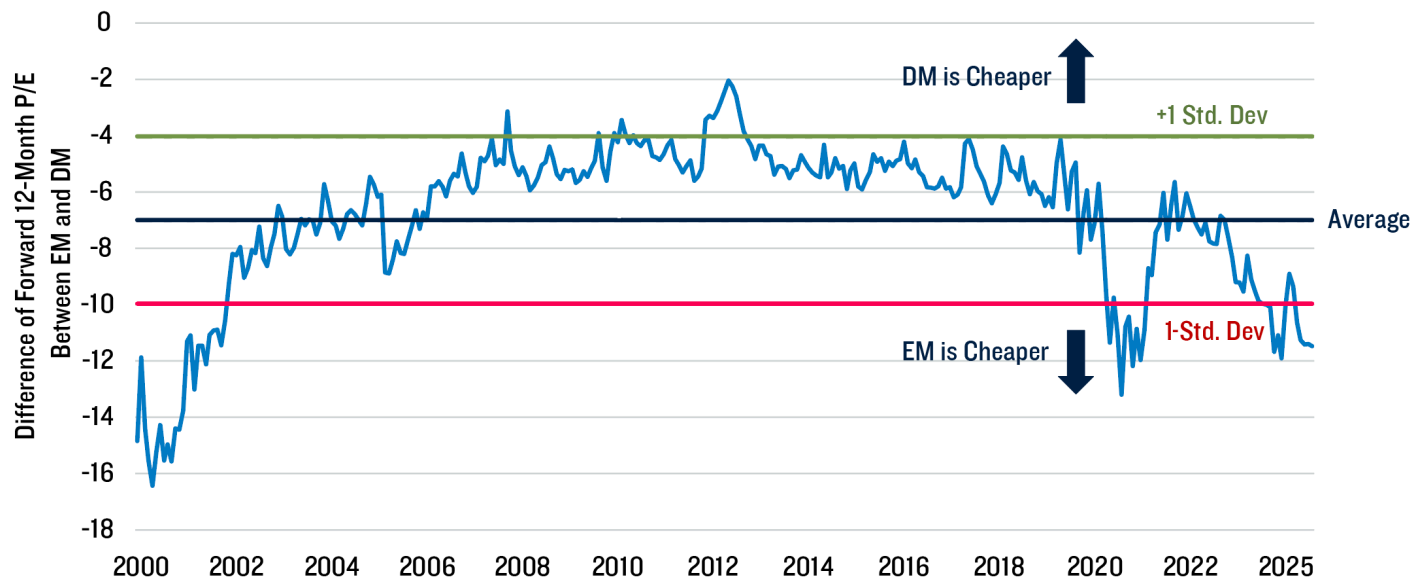
A key frustration of the past decade has been the weak translation of EM GDP growth into corporate earnings growth. Weaker corporate governance, poor capital discipline, and deficient shareholder protections have been the primary contributors to muted corporate earnings. However, the earnings drought in emerging markets appears to have bottomed out, with company fundamentals beginning to strengthen. This turnaround can be attributed to recent improvements in corporate governance and financial reforms that focus on greater capital discipline, enhanced shareholder value, investor protections, and information disclosure and transparency.

### Seeking to Unlock Alpha: The Role of Active Quantitative Management

The three pillars above suggest a structural shift is underway, one that presents a strategic moment for asset allocators who understand the current investment landscape. Inefficiencies inherent to emerging markets create fertile ground for employing a disciplined, active approach to unlock potential for alpha generation.

While the emerging market indexes offer broad exposure, passive approaches may leave return on the table and add

## Exhibit 2: Relative Valuations



Source: Bloomberg as of Nov 2025.

unrewarded risks. Our investment team's analysis identifies three enduring reasons to go active—and why quantitative processes are particularly well-suited:

### Capitalizing on Higher Return Dispersion

Emerging markets exhibit far greater stock return variability compared to developed markets, creating a wider spread between winners and losers. This higher return dispersion translates into opportunity: factor-based strategies have historically delivered stronger performance in EM than in developed markets, underscoring the value of disciplined stock selection. An active, quantitative approach can systematically identify and combine these factors into portfolios designed to harness this structural advantage. Over a 10-year period, key active factors—such as Value, Momentum, and Earnings Revisions—generated significantly higher cumulative returns in EM compared to developed markets (Exhibit 3), reinforcing why quantitative strategies thrive in these environments.

### Navigating Higher Transaction Costs

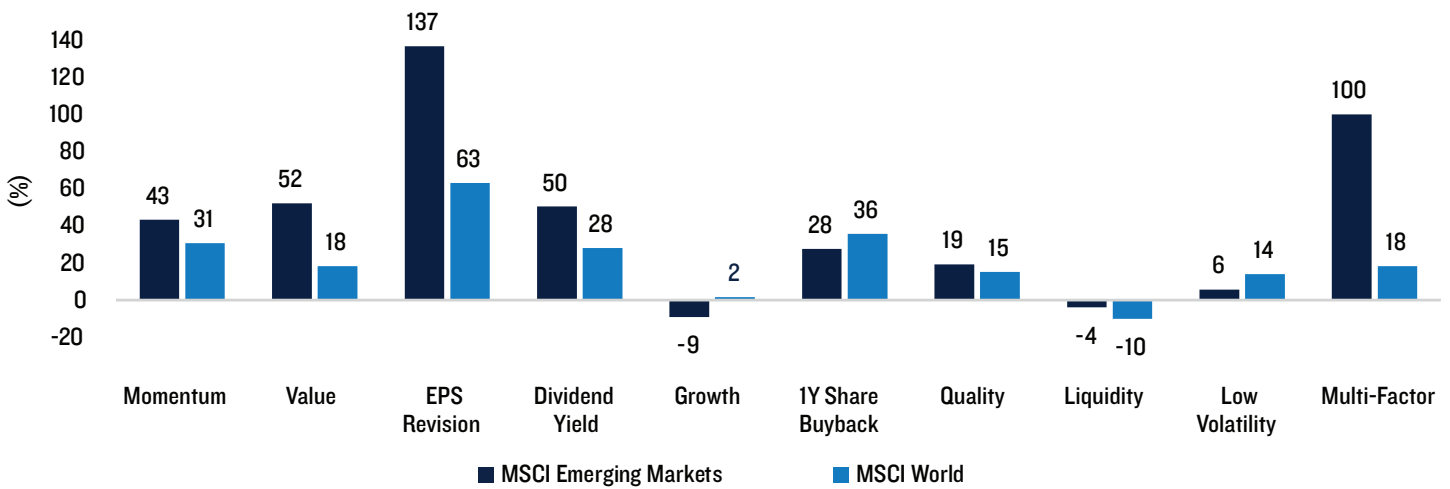
Passive, index-tracking strategies often face higher transaction costs in emerging markets due to frequent, index-driven trades and less liquid securities. In contrast, systematic active

managers can execute trades more strategically, incorporating cost-aware portfolio construction—sequencing trades, using liquidity forecasts, and exploiting information advantages—to offset costs with alpha. This advantage is particularly pronounced in markets with higher fixed costs and wider bid-ask spreads, allowing active managers to preserve returns that would otherwise be eroded by inefficient trading.

### Mitigating Sector Concentration Risks

Emerging market indexes are prone to significant concentration risk—by sector and by top positions—compared to developed benchmarks. For example, the MSCI Emerging Markets Index is heavily weighted toward Information Technology and Financials, creating vulnerabilities to sector-specific shocks. Systematically constructed portfolios help address sector skews, cap single name exposure, and build diversified, factor-balanced portfolios that seek to preserve upside potential while aiming to mitigate idiosyncratic shocks. Across the universe of investable EM stocks, a systematic approach can simultaneously scale the breadth of research, enforce robust risk controls, incorporate macro sensitive tilts (to currency and interest rates), and harness proven factor premia—critical for investing in a regime defined by dispersion and transition.

### Exhibit 3: Emerging Markets Dominate in Factor Performance



Bar order corresponds with order of the legend, and repeats.  
 Source: Bloomberg (Factors to Watch): Active Sector Neutralized Q1 Returns over 10 years as of Dec 2025.

### EM: Activate the Advantage

The confluence of historically attractive valuations, a supportive macro environment, and improving corporate fundamentals has created a powerful investment case for emerging markets. However, the unique characteristics of these markets—higher return dispersion, elevated costs, and

concentration risks—necessitate a more nuanced approach than passive allocation alone. An active, systematic approach is critical to navigating the complexities and unlocking the full potential of this compelling opportunity. For investors considering a reset of their EM allocation, we believe now is an opportune moment for activation.

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