KEYSTONE

A Year of Resilience

KEYSTONE CAPITAL
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As we start a New Year, the global economy stands in a stronger position than many observers would have predicted just a few years ago. Repeated shocks ranging from pandemic disruption and energy crises to aggressive monetary tightening, rising trade barriers and geopolitical conflict have failed to derail global growth. Instead, the world economy has demonstrated a striking degree of adaptability. Growth remains steady, inflation has moderated without collapsing activity, and financial conditions are easing rather than tightening.

The outlook for 2026 is therefore broadly constructive. Global growth is expected to remain close to 2.6–2.7%, inflation is forecast to settle at a level modestly above pre-pandemic norms, and equity markets are likely to remain supported by earnings growth and lower interest rates. Yet, this is not a return to the old world of low inflation, frictionless globalisation and predictable policy responses. The coming year will be shaped by three powerful trends - artificial intelligence, global fragmentation, and persistent inflation, that are redefining how growth is generated and how portfolios must be constructed.

2026 can best be described as 'A Year of Resilience' with both promise and pressure. The promise lies in sustained economic expansion, transformative technological progress and supportive policy settings. The pressure comes from elevated valuations, high public debt, geopolitical uncertainty, and structural shifts that introduce greater volatility and dispersion across assets. Navigating this environment successfully will require flexibility, diversification and an evidence-led approach rather than rigid convictions.

STATE OF THE GLOBAL ECONOMY

The defining feature of the current cycle is resilience. Despite widespread expectations of a sharp slowdown following the most aggressive tightening of monetary policy in decades, the global economy has continued to grow at or near trend. Strong labour markets, healthy household balance sheets and a services-heavy growth model have cushioned the impact of higher interest rates. On the supply side, firms have adapted rapidly to disruptions, reconfiguring supply chains and absorbing cost pressures more effectively than expected.

This resilience is expected to persist into 2026. Forecasts for global growth generally cluster around the mid 2% range, comfortably above recessionary levels. Importantly, this expansion is not reliant on a single engine. While the United States remains a key contributor, growth is becoming more broadly distributed across sectors and regions. Even economies facing structural headwinds have delivered outcomes that are materially better than feared.

Purchasing managers' indicators reinforce this message. Both services and manufacturing PMIs are entering 2026 in the upper range of recent years, suggesting solid underlying momentum. Services continue to outperform manufacturing, reflecting the long-term shift in global demand, but manufacturing has stabilised rather than deteriorated further. The global economy enters the year on a firm footing.

EASING MONETARY AND FISCAL POLICY

Policy remains a crucial support for the outlook. Monetary conditions are easing globally, though cautiously. Central banks have shifted away from restrictive stances, with policy rates already past their peaks. The Federal Reserve has resumed gradual rate cuts, the European Central Bank remains accommodative given inflation close to target, and other major central banks including the Bank of England have adopted more dovish postures.

However, this easing cycle is fundamentally different from those of the past. Inflation, while lower than its post-pandemic peak, remains persistent. As a result, central banks are unlikely to cut rates as aggressively or as quickly as markets once hoped. Instead, interest rates are expected to drift modestly lower, providing support to growth and asset prices without returning to the ultra-low levels of the previous decade.

Fiscal policy is also playing a larger and more active role. Governments are increasingly directing capital toward strategic priorities such as infrastructure, defence, energy security and technology. This reflects a broader shift away from a purely market-led model towards one that prioritises resilience and national security. While high public debt limits fiscal flexibility, the overall stance remains mildly expansionary, reinforcing growth into 2026.

INFLATION, A HIGHER FLOOR NOT A RESURGENCE

Inflation has eased significantly from the highs reached earlier in the decade, but it has not returned to the ultra-low levels that characterised the pre-pandemic era. Instead, the world appears to have entered a regime of structurally higher and more volatile inflation.

For 2026, inflation is expected to settle broadly in the 2.25–3% range, varying across economies and over the course of the year. This outcome reflects several structural forces: tighter labour supply, higher fiscal spending, reduced efficiency from global fragmentation, and ongoing supply-side constraints in areas such as energy, food and housing.

Crucially, this level of inflation is not inherently negative. Stable, moderate inflation supports nominal GDP growth, pricing power and corporate earnings. It also gives central banks room to ease policy without undermining their credibility. The greater risk lies not in inflation being too high, but in its increased sensitivity to shocks. Supply disruptions, renewed labour shortages or geopolitical tensions could push inflation temporarily higher, complicating policy decisions. As a result, inflation remains one of the most important variables shaping both macro-outcomes and portfolio construction in 2026.

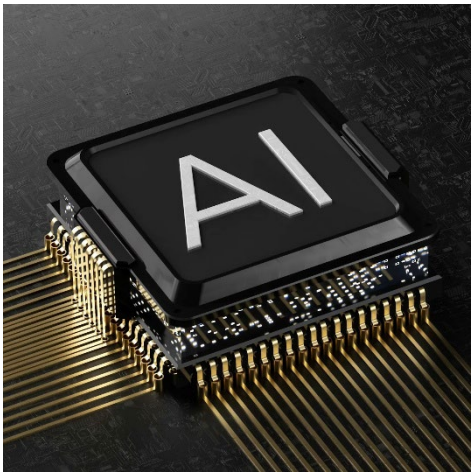
THE DOMINANCE OF ARTIFICIAL INTELLIGENCE

No force is shaping the 2026 outlook more than artificial intelligence. Since the emergence of generative AI earlier in the decade, its impact on both the real economy and financial markets has been extraordinary. The majority of equity market gains, earnings growth and capital expenditure expansion over the past few years can be traced directly or indirectly to AI-related activity.

AI investment has become a primary driver of economic growth, in some cases contributing more to expansion than consumer spending. This represents a profound shift in the growth model and underscores why it is no longer possible to form a meaningful market or economic view without an explicit stance on AI.

The technology is now entering a new phase. Adoption is accelerating across the economy, with a growing share of firms using AI not only to improve efficiency but also to generate new revenue streams and expand market share. This diffusion supports broader earnings growth and helps explain why equity leadership is beginning to widen beyond a narrow group of technology firms.

Concerns about an AI bubble are widespread, but the evidence points to excitement rather than euphoria. Unlike the late-1990s technology boom, today's AI investment is not characterised by massive overcapacity. Data centre vacancy rates are extremely low, most new capacity is pre-leased, and demand for computing power continues to outstrip supply. Moreover, today's leading AI firms are highly profitable, with strong balance sheets and substantial free cash flow.



Leverage is an area to monitor closely. While most AI investment to date has been funded from earnings, debt financing is playing a growing role. This increases interconnectedness within the AI ecosystem and raises the potential for higher volatility if investment slows. However, credit spreads remain contained, and profitability provides a substantial buffer against financial stress. From a valuation perspective, AI-related equities are expensive, but those valuations have been supported by exceptional earnings growth. In many cases, multiples have actually declined as earnings have risen faster than share prices. As long as this growth trajectory continues, valuations appear justifiable.

AI's impact on labour markets is likely to be profound, but also uneven. In the near term, automation will put pressure on certain roles, particularly in areas such as customer support and coding. At the same time, AI is driving job creation in critical infrastructure, energy, cybersecurity and data management. Over the longer term, productivity gains from AI have the potential to support higher growth with less reliance on labour input. However, these gains may not be evenly distributed, raising important questions about income inequality and the balance between capital and labour. Increasingly, economic value is flowing toward owners of capital rather than labour - a trend with significant social and political implications.

GLOBAL FRAGMENTATION, PRIORITISING SECURITY OVER EFFICIENCY

The second major trend shaping 2026 is global fragmentation. The era of frictionless globalisation is giving way to a world where countries prioritise self-sufficiency, security and resilience. This shift is evident across trade, technology, energy, supply chains and immigration policy.

Tariffs have played a prominent role in this transition. While they have reshaped trade flows and contributed to inflationary pressures, their overall economic impact has been more contained than had been feared. Firms and consumers have adapted, and global trade has continued to grow, albeit along more regional and fragmented lines.

More broadly, fragmentation has prompted a more assertive role for governments in directing capital. Infrastructure investment, defence spending and industrial policy are accelerating across many economies. Corporations are responding by investing in resilience and redundancy, even at the cost of some efficiency. This environment supports sustained capital expenditure and spreads growth more evenly, while also reinforcing the trend toward higher baseline inflation.

Fragmentation also has implications for currencies. The US dollar has already adjusted from previously overvalued levels as markets priced in fiscal concerns and institutional risks. Looking ahead, the consensus among economists is that the US dollar will continue to soften moderately through the course of 2026.

SUPPORTIVE YET DEMANDING FINANCIAL MARKETS

Against this macro backdrop, financial markets enter 2026 with a supportive tailwind. Equities are expected to remain underpinned by easing monetary policy, steady growth and strong earnings dynamics. A fourth consecutive year of positive returns is plausible, though returns are likely to be more selective and volatile than in the recent past.

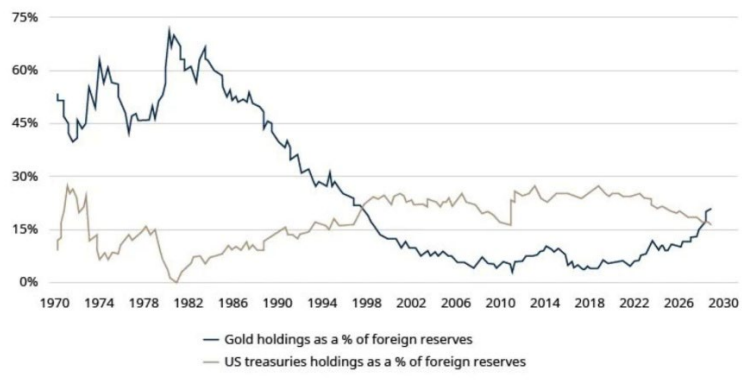
A key theme for 2026 is broadening. While large-cap technology remains a critical driver of earnings, other sectors linked to AI infrastructure, energy, security and industrial investment are increasingly contributing. This broadening reduces concentration risk and supports a more durable market performance.

Fixed income presents a more nuanced picture. Yields are attractive relative to much of the past decade, but persistent inflation and large fiscal deficits limit the scope for strong capital gains, particularly at longer maturities. Bond returns are therefore likely to be driven primarily by income rather than duration. Credit markets benefit from healthy corporate balance sheets and contained default risk, though valuations are tight. Selectivity remains essential here.

THE IMPORTANCE OF ALTERNATIVES AND REAL ASSETS

Persistent inflation, elevated fiscal risks and geopolitical uncertainty are reshaping portfolio construction. Traditional equity-bond portfolios remain a solid foundation, but the case for including alternatives is even stronger. In a world where inflation risk is higher and correlations can rise, additional sources of diversification are increasingly important.

Central bank buying and fiscal concerns remain positives for gold



Schroders, LSEG Datastream, ICE Data Indices. As on 31/10/25.

Alternatives are therefore regaining prominence. Real assets, infrastructure, commodities and absolute-return strategies offer diversification, inflation protection and differentiated return streams. Within commodities, gold plays a particularly important role. Despite a strong multi-

year rally, the structural case for gold remains compelling, supported by central bank demand, high public debt, concerns over currency debasement and geopolitical risk. While short-term volatility is likely, gold's role as a strategic diversifier remains intact.

RISKS LOOKING AHEAD

Despite the constructive outlook, there are some risks that warrant close attention:

- A larger-than-expected drag from tariffs, particularly if delayed inflation pass-through squeezes consumers.
- A sharper deterioration in labour markets, which historically tends to accelerate once it begins.
- A slowdown or reassessment of AI investment, which could trigger a pullback in business spending and equity markets.
- Weaker private demand in China, with implications for global trade and commodity markets.
- High public debt levels, which constrain policy flexibility and could undermine confidence if financing conditions tighten.

None of these risks appears imminent or overwhelming, but together they underscore the need for vigilance. And of course, significant geopolitical risks continue to lurk in the shadows and their escalation has the potential to derail economic forecasts.

CONCLUSION: NAVIGATING A NEW REALITY

The global economy enters 2026 in a position of strength, but also at an inflection point. Growth is steady, inflation is moderating but persistent, and policy remains supportive without being unconstrained. Artificial intelligence offers extraordinary promise, global fragmentation is reshaping economic relationships, and inflation is redefining portfolio construction.

The defining challenge of 2026 is not avoiding crisis but navigating a world where old assumptions no longer hold. The world economy has repeatedly demonstrated its ability to adapt, and there is little evidence that this capacity has been exhausted. At the same time, elevated valuations, geopolitical uncertainty, and structural challenges mean that risks are asymmetric and require careful monitoring. Success will depend on diversification, flexibility and an appreciation of the structural forces reshaping the global economy. In this environment, patience, discipline and a willingness to adapt remain the most valuable assets of all.

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ASSET CLASS RETURNS OVER THE LAST 10 YEARS

2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	Annualised
High yield 14.3%	China equities 54.3%	Cash 1.9%	U.S. equities 31.6%	China equities 29.7%	Commodities 38.5%	Commodities 22%	U.S. equities 27.1%	U.S. equities 25.1%	China equities 33%	U.S. equities 14.5%
Infrastructure 12.4%	EM equities 37.8%	DM gov. debt -0.4%	Infrastructure 27%	U.S. equities 21.4%	REITs 32.5%	Cash 1.3%	Japan equities 20.8%	China equities 19.7%	Europe equities 31.1%	Infrastructure 9.2%
U.S. equities 11.6%	Europe equities 26.2%	IG credit -3.5%	Europe equities 24.6%	EM equities 18.7%	U.S. equities 27%	Infrastructure -0.2%	Europe equities 20.7%	Commodities 18.4%	EM equities 30.4%	Europe equities 8.5%
EM equities 11.6%	Japan equities 24.4%	High yield -4.1%	REITs 24.5%	Japan equities 14.9%	Europe equities 17%	High yield -12.7%	High yield 14%	Infrastructure 15.1%	Japan equities 24.4%	EM equities 8.1%
Emerging debt 10.2%	U.S. equities 21.9%	U.S. equities -4.5%	China equities 23.7%	IG credit 10.1%	Infrastructure 11.9%	Europe equities -14.5%	REITs 11.5%	High yield 9.2%	Infrastructure 23.4%	Japan equities 7.8%
Commodities 9.7%	Infrastructure 20.1%	Emerging debt -4.6%	Japan equities 20.1%	DM gov. debt 9.5%	Japan equities 2%	IG credit -16.1%	Emerging debt 10.5%	Japan equities 8.7%	U.S. equities 17.7%	Commodities 7.4%
REITs 6.9%	High yield 10.4%	REITs -4.8%	EM equities 18.9%	High yield 7%	High yield 1%	Japan equities -16.3%	EM equities 10.3%	EM equities 8.1%	Emerging debt 12.9%	High yield 5.7%
IG credit 6%	Emerging debt 9.3%	Infrastructure -9.5%	Emerging debt 14.4%	Europe equities 5.9%	Cash 0%	Emerging debt -16.5%	IG credit 10.2%	Emerging debt 5.7%	High yield 11%	China equities 5.7%
Japan equities 2.7%	IG credit 9.3%	Commodities -10.7%	High yield 12.6%	Emerging debt 5.9%	Emerging debt -1.5%	DM gov. debt -17.5%	Infrastructure 6.8%	Cash 5.3%	REITs 10.1%	REITs 5.1%
DM gov. debt 1.7%	REITs 8.6%	Japan equities -12.6%	IG credit 11.8%	Cash 0.7%	IG credit -2.1%	U.S. equities -19.5%	Cash 5.1%	REITs 3.9%	IG credit 10%	Emerging debt 4%
China equities 1.1%	DM gov. debt 7.3%	EM equities -14.2%	Commodities 11.8%	Infrastructure -5.8%	EM equities -2.2%	EM equities -19.7%	DM gov. debt 4.2%	Europe equities 2.4%	DM gov. debt 6.7%	IG credit 3.3%
Cash 0.4%	Commodities 1.7%	Europe equities -14.3%	DM gov. debt 5.6%	REITs -8.1%	DM gov. debt -6.6%	China equities -21.8%	Commodities 0%	IG credit 1.9%	Commodities 5.6%	Cash 2.2%
Europe equities 0.2%	Cash 0.8%	China equities -18.7%	Cash 2.3%	Commodities -9.3%	China equities -21.6%	REITs -23.6%	China equities -11%	DM gov. debt -3.6%	Cash 3.9%	DM gov. debt 0.4%

Key: Lowest return ---------- highest return

Source: BlackRock Investment Institute with data from LSEG Datastream

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Approved by Best Practice IFA Group Limited on 5th January 2026.

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