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Reflections and Insights*

*'Surrounded by losers, misfits and boozers.
Hanging by your fingernails.
You made one mistake, you got burned
at the stake.
You're finished, you're foolish, you failed.'*

- THEME FROM 'SLOW HORSES', MICK JAGGER

This is the time of year when prognostications bloom. The reality is that nobody has any idea what will happen in the year ahead. Forecasts tend to reflect the ideological or emotional views of the forecaster, and the strongest correlation of any forecast is with what happened in the past year.

What that means is that the consensus broadly expects 2026 to look pretty much like 2025. The main features are supposed to be continuing reasonable strength in the U.S. economy, but not so much as to spark fears of inflation; rates are supposed to trend gently downwards; corporate earnings are to be strong; and equity markets are set to carry on upwards, generating a fourth consecutive year of double-digit returns. Indeed, this is a picture of how things stand currently, so it is not surprising that the 'Goldilocks' economy implicit in this menu offers the path of least resistance for a forecaster.

The gloomy variant of this is not that it's wrong, but that valuations in equity markets are so high that on a five-to-ten-year view, returns are likely to be lower than has been the case in the recent past, but no need to panic, as the speed bumps are somewhere in the foggy future.

The alternative to the rather benign case set out here is to posit something that is either apocalyptic or Panglossian. These are atypical outcomes, but not impossible, and anybody taking such a position will be right once in a while.

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This all raises the question of what the point is of making forecasts? This review marinated over the festive period, only to be undone by events in Venezuela, of all places, not somewhere on the radar at all. It is not Venezuela, per se, which upset the apple cart (although, to date, there is no regime change, and it could be its own special quagmire), but it is the implications for what has become known as the ‘rules-based order’ of the world. Essentially, this is now consigned to the dustbin of history. The U.S. administration, having pointed in this direction since the inauguration, now embraces ‘strength, force and power,’ arguing that ‘these are the iron laws of the world.’

Our past reviews have not spent a lot of time fretting about geopolitics, on the grounds that, generally, markets are not that bothered by politicians strutting about. This is such a significant change, though, that some thoughts on the topic seem warranted. What follows is put forward with a larger-than-average health warning.

These changes seem to imply that in a world where rules don’t matter, those with the biggest sticks get to call the shots. Whether they have good judgment, integrity and decency is less important than the size of the stick. This is the world of Putin, who is already attempting (not all that successfully) to wield his stick, and Xi, who is raising the temperature over Taiwan. Separately, the U.S. has followed its decidedly incomplete actions in Venezuela with threats against Mexico, Colombia, Cuba, Iran and Greenland.

THE REASONS FOR SUCH BEHAVIOUR?

What are the reasons behind such behaviours? The Russian view of Ukraine is purely imperialist, as is the Chinese view of Taiwan. The U.S. position vis-à-vis its hit list is imperialist, mercantile, but above all, a distraction from domestic political pressures and high-profile controversies.

Seen from a European angle, this set of developments is troubling because the E.U. (plus the U.K.) are too fragmented to acquire a suitably sized stick. Furthermore, the potential damage to NATO implicit in the U.S. threats over Greenland, the one-sided peace deal being pushed at Ukraine, and U.S.

support for populist right-wing E.U. politicians, should leave Europe in no doubt that it needs to get its house in order quickly. Because it is a collection of liberal democracies with highly developed welfare states, however, change is inevitably slow and incremental, unless a crisis intervenes.

Although Europe is often unfairly caricatured as being sclerotic and undynamic, like many developed economies, it has an aging and shrinking population and (unlike the U.S.) a tendency to ‘gild the [regulatory] lily’. Whether gradually or suddenly, the transfer of wealth from the young to the old, from the worker to the rentiers, and from individuals to government must be better balanced. We have reached peak ‘welfare state,’ and a reset is necessary. The question is whether this can all be achieved without destroying existing institutions. If this shift does not happen, Europe could easily become a set of divided vassal states, some with allegiance to the U.S., some to Russia.

WHAT DOES IT MATTER?

Does any of this matter to markets?

There are a lot of negative scenarios one could build around the geopolitical axis: the U.S. may not have a plan for Venezuela; its comments on the oil industry there are hopelessly optimistic; would it really attempt to annex Greenland – a NATO member? Is Europe in danger of civilizational erasure, and so on.

Markets could probably deal with a large number of geo-debacles. More concerning could be the translation of a muscular administration into the domestic sphere. Here, the first major concern would be interference with U.S. Federal Reserve (Fed) policy – we know that Trump thinks interest rates should be much lower than they are. Of course, this is inconsistent with his insistence that the economy is brilliant (it’s OK) and that prices are falling, which they aren’t. The change in Fed Chair and a legal ruling on his ability to fire Fed governors during their terms without cause will indicate the direction of travel.

The second worry is interference in the electoral process. The Republicans are on course to lose their majority in Congress at the mid-term elections in

November, but there are several seemingly trivial procedural changes underway which tilt the playing field in Trump's favour, and there is also the prospect of continual challenges to electoral outcomes. If the Democrats regain control of Congress, a lot of the momentum behind the rewiring of the U.S. will be stymied, but a reversion to the status quo ante in foreign affairs seems very unlikely. Nevertheless, markets won't fall just because Donald Trump is a lame duck à l'orange.

THE MARKET BACKDROP

All this is unfolding against a market backdrop where valuations are very high, and growth expectations are also elevated. As has been said before in these reviews, valuations on their own don't mean anything. Markets do not decline just because they are expensive. They can stay expensive for long periods and, given earnings expectations, could still give good returns without getting more expensive. Of course, corrections can occur for any number of reasons. The realization that expected returns from artificial intelligence (AI) investments may be lower than the most optimistic forecasts, for example, could trigger something, but it is unlikely to derail the juggernaut, which depends on AI, for sure, but as much on plentiful liquidity and on so called 'animal spirits' – jargon which broadly means that things go up because people expect them to and so are prepared to 'buy the dip'.

The U.S. market is now about 72% of the world market capitalization, despite having underperformed Europe in the past year (almost entirely down to weakness in the dollar). Although participants have been focused on the so-called 'Magnificent 7'¹, in fact, only two of them outperformed the broad S&P 500 Index² – Alphabet and Nvidia, the latter now, on its own, more valuable than the entire Japanese market, itself the second largest global market after the U.S. Reveling in such absurdity is amusing but ultimately only useful at a very dull dinner party.

THREE TRIGGERING FACTORS

There are three factors which could trigger a more serious setback. The first is a recession. Here, the indicators are set to fair. Despite some wobbles in

the labour market, the probability of a significant economic decline is about 25%, and the changes to the global trading system have, so far, not had the consequences expected by the Cassandra class.

The second issue would be a significant rise in inflation. Again, here, the runes seem to imply things are OK, but could worsen. Tariffs have been milder than originally planned, and the one-off impact of related price increases is about to run off. It is worth noting that the upending of the old world order mandates greater resilience and preparedness, moving from a 'just in time' world to a 'just in case' one. This is already leading to commodity inflation, and this asset class, ignorable for many years, has a place in a diversified portfolio.

The third issue would be a rise in interest rates, which would drain liquidity from the system. While this could be twinned with a rise in inflation, it could also come about because of problems in credit markets or crypto or a host of other things. The other factor, which is an elephant in the room, is the size of the fiscal problem. For now, markets skirt around it, but an increase in rates and inflation could cause this factor to puncture the optimism. Apart from this, no catalyst is on the horizon, but that is exactly the point – there never is. It's the shock that causes the upset.

To be clear, this is not a forecast. This review has views about what might happen, but the increasing complexity of the world confuses the picture. What's more, the interface between geopolitics and the corporate world has become less distinct and, thus, less predictable. In this context, most investment advice is useless. *This is not to doubt the sincerity of the adviser or the intellectual rigour of the advice*, but because it usually focuses on which horse to back. It is a sounder proposition to own the racetrack, even if it is less obviously valuable than the favoured nag.

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Endnotes

1 Apple, Microsoft, Amazon, Alphabet, Meta, Nvidia, and Tesla

2 The S&P 500 is an index of 500 stocks designed to reflect the risk/return characteristics of the large-cap U.S. equity universe.

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