

Prism

2026 First Half Outlook

Investing amid AI exuberance

By the &Partners Investment Team,
with perspectives from J.P.Morgan
Asset Management, PIMCO,
Constitution Capital, Carlyle,
and KKR



About Prism

Prism, released in June and December every year, offers the &Partners Investment Team's insights on positioning client portfolios for the months ahead. It includes:

- Our top three investment recommendations
- The macro analysis that informs our perspective
- Our outlook for U.S. equities, international equities, fixed income, and alternative investments
- Perspectives from our investment partners

By distilling the knowledge of our Investment Team and network, *Prism* gives financial advisors the unique, actionable insights they need to help clients thrive.



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Letter from the Investment Team

We see one question increasingly dominating investors' conversations: Are we in an AI-fueled bubble?

Aspects of today's markets remind us of previous bubbles — historically high valuations, growing debt, and a dismissive attitude toward risk. On the other hand, many AI leaders are powerful businesses (not the case during the dot-com bubble), and they really might change the world (unlike the subprime mortgages that fueled the 2008 financial crisis).

No one knows for sure if we're in a bubble. But for investors, the important question ultimately isn't *whether* we're in a bubble — it's how to invest *when we might be*. That's the focus of this issue of *Prism*. We think part of the answer is to try to win by not losing (see page 6).

Our top three recommendations for investing through a possible AI bubble (explained on page 5):

1. Evaluate your portfolio's exposure to AI risks
2. Consider reducing concentrated positions
3. Manage the tax impact of any changes

You may notice that this *Prism* looks a little different from past issues. We've revised the layout and design to make it simpler and clearer — part of our ongoing effort to be more helpful to advisors and their clients. We hope you like the new look.

And as you navigate the markets, remember that the &Partners Investment Team is here to help. Please reach out if you have any questions.

Warm regards,

Kristi, John, Fredrik, and Erik

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Top three recommendations

We recommend the following moves entering 2026:

1 Evaluate your portfolio's exposure to AI risks

2 Consider reducing concentrated positions

3 Manage the tax impact of any changes

1. Evaluate your portfolio's exposure to AI risks

You may have more exposure to AI than you realize. Investors commonly base their U.S. equity allocations on the S&P 500, but as of December 8, shares of the Magnificent Seven companies — all of which have staked their futures on AI — make up more than a third of the benchmark.

AI-powered stocks could keep up their momentum or fall back to Earth. Investors' job isn't to bet on one outcome or the other; it's to build a resilient portfolio that can help them reach their goals in a wide range of scenarios.

The first step to building a resilient portfolio today is to gauge how exposed a portfolio might be to the AI theme. We recommend advisors and clients review:

- The size of positions in individual AI-related stocks
- The Magnificent Seven's weight in the U.S. equity allocation and the overall portfolio
- The technology sector's weight in the U.S. equity allocation
- The size of U.S. equity allocation relative to the overall equity allocation

2. Consider reducing concentrated positions

You may want to trim oversized AI-focused positions and add to other allocations, possibly including:

- International equities, which have much lower valuations than U.S. stocks and may offer greater diversification benefits in a deglobalizing world
- Shares of high-quality companies, whose healthy balance sheets and strong competitive positions have made them more resilient than other shares, historically
- Dividend-focused stocks,* which offer regular payments that may grow over time, potentially reducing volatility and defending against inflation
- Mid-cap stocks, which often represent companies in their prime growth phase
- Small caps, particularly small-cap value stocks, which offer compelling earnings growth, relatively low exposure to tariffs, and diversification away from large caps
- Asset classes outside of equities, including long-term fixed income and alternative investments such as private credit

**Dividend payments are not guaranteed. The amount of a dividend payment, if any, can vary over time.*

3. Manage the tax impact of any changes

A range of strategies may help minimize the tax implications of rebalancing.

- Execute sales in tax-advantaged accounts such as IRAs when possible
- Use new money to diversify taxable accounts
- Harvest losses to help offset the tax impact of selling appreciated securities — consider direct indexing, which can harvest losses automatically and may provide efficient ways to manage concentrated positions
- Explore ways alternative investments such as Opportunity Zone investments or 1031 exchanges may help manage taxes

Win by not losing

Investing for growth is key to building wealth — but so is trying to minimize losses.

The chart below represents four hypothetical portfolios with different levels of volatility. Each starts at \$1 million and has the same simple average annual return (7.5%, our current long-term forecast for U.S. equities).

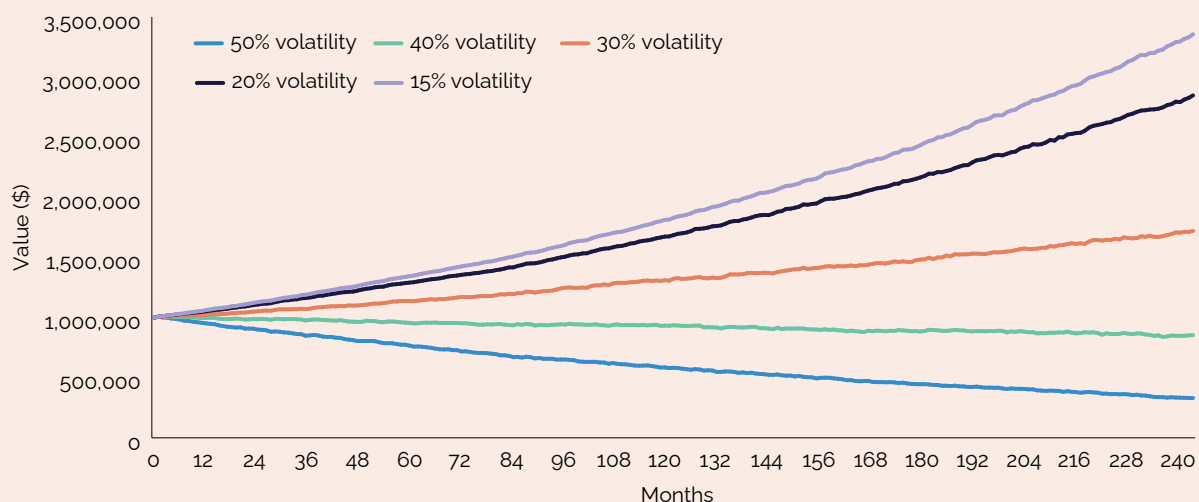
As you can see, the less volatile the portfolio, the more wealth it's projected to create. All else being equal, less-volatile portfolios can produce more wealth over time because they tend to preserve

more during downturns — potentially leaving more money to benefit from compounded growth.

This understanding informs our investment recommendations. We've seen client portfolios with large concentrations that can create volatility of 50% or more (the riskiest scenario in the chart below). We believe reducing those concentrations and transitioning toward a more-diversified, lower-risk portfolio can greatly improve the investor's odds of reaching their financial goals.

Volatility matters

Median expected compounded growth of \$1 million over 20 years with a 7.5% simple average annual return and different levels of volatility



The chart shows the median result from a Monte Carlo simulation with 10,000 return scenarios. Volatility measured by standard deviation. 15.4% volatility based on &Partners' long-term standard deviation forecast for U.S. equities. 7.5% average annual return based on &Partners' long-term return forecasts for U.S. equities. The examples provided are hypothetical and are provided for informational purposes only. They are not intended to represent any specific investment, nor are they indicative of future results.

Zoom out: Macro analysis

Our analysis of the macroeconomic environment provides the foundation of our investment outlook.

Economic growth

The U.S. economic picture is mixed. Growth in gross domestic product (GDP) has held up better than expected, rising to 3.8% in the second quarter¹ and possibly more than 4% in the third quarter.²

The solid GDP numbers may overstate the strength of the economy, however. One reason: Anomalies related to tariffs have inflated GDP growth. For example, many companies and households purchased durable goods early to avoid paying new tariffs.

Meanwhile, AI drove much of the economy's growth. AI-related capital expenditures — such as investments to build data centers — contributed more than a percentage point to U.S. GDP growth during the first half of the year, exceeding all consumer economic activity combined.³ But just nine companies made up 30% of the S&P 500's capital expenditures in 2025.⁴ Relying on a handful of companies to keep up massive spending is risky, because any interruption in AI-related investment could have outsized economic repercussions.

Employment softened throughout much of 2025. The economy added only 40,000 jobs during the six months through October, according to workforce data tracker Revelio Labs,⁵ and companies announced more than 150,000 layoffs in October alone — the most October layoffs in 22 years.⁶

Business sentiment surveys were consistent with slow growth,⁷ and consumers felt pessimistic:

- Consumer sentiment dropped 29% over the 12 months through November⁸
- Consumers' expectations for their finances over the next five years fell to the lowest level since at least 2011⁹
- Consumers' expected change in the unemployment rate was the worst outside recessions since the question was introduced in 1978¹⁰

Amid all this negativity, strength from affluent households helped raise overall consumer spending,¹¹ while lower-income consumers struggled with growing debt and elevated delinquency rates.¹²

The 43-day government shutdown further complicated the economic picture. It shaved one to two percentage points off GDP growth in the fourth quarter, according to an estimate from the nonpartisan Congressional Budget Office,¹³ and the lack of government economic data made policymakers' jobs harder. "What do you do if you're driving in the fog? You slow down," Federal Reserve Chair Jerome Powell said recently.¹⁴

The Federal Reserve (the Fed) reduced its target short-term interest rate by 0.25 percentage point at its September, October, and December meetings. Fed members' expectations for future moves diverged sharply in December, however, casting uncertainty on the outlook for monetary policy in 2026.



Just nine companies made up 30% of the S&P 500's capital expenditures in 2025.

Entering 2026, both positive and negative economic scenarios seem plausible. A variety of potential tailwinds might boost the economy, including lower interest rates, strong capital investment, pro-growth regulatory policies, declines in energy prices, potential resolutions of trade conflicts, and more. However, the economy's momentum has slowed, and risks have increased.

Economies outside the United States look generally healthy, if not especially robust. Many developed economies are boosting defense spending, leading to increases in government investment and hiring. They include Germany, where growth is expected to improve significantly over the coming year. Economic fundamentals in Europe overall look solid: Business surveys are moderate, southern European countries such as Spain are showing relative strength, and reduced regulation may encourage growth.

Lower regulation also may help in Japan, where new leadership brings in a pro-growth agenda. Meanwhile, China's economy has been surprisingly resilient despite deflationary pressures. Goldman Sachs estimates that China's GDP grew 5% in 2025,¹⁵ and recent softening of trade tensions with the United States may support further expansion.

Inflation

Inflation this year has been high compared to recent history but surprisingly stable, especially compared to expectations earlier this year. That said, inflation has picked up in recent months, and September posted the largest increase in the Consumer Price Index (CPI) in almost a year and a half.¹⁶ We are now in an unusual situation in which the Fed is cutting interest rates as price gains accelerate.

The recent pickup in CPI probably reflects higher tariffs. Tariffs' impact may prove temporary, but they heighten uncertainty. The Trump administration's plans and proposals are unprecedented in their scope; their implementation has been unpredictable; and the Supreme Court may determine that the administration has overstepped its authority, potentially forcing reversals of tariff policies.

These factors complicate the Fed's decision-making. Powell has noted repeatedly that there is no risk-free path on interest rates: Lowering rates could boost inflation, but not lowering rates could further weaken the job market. Reflecting this conundrum, the Fed's October and December decisions to cut rates a quarter point featured rare "dual dissents." Fed Governor Stephen Miran voted for half-point reductions, while Kansas City Fed President Jeffrey Schmid voted to leave rates unchanged.

Given all these question marks, we believe investors should prepare for a wide range of potential inflation outcomes in the first half of 2026.



We are now in an unusual situation in which the Fed is cutting interest rates as price gains accelerate.

Zoom in: Asset class outlook

&Partners' investment outlook for major asset classes

	Unfavorable	Cautious	Neutral	Somewhat favorable	Favorable
U.S. equities		●			
International equities				●	
Fixed income				●	
Alternatives				●	

U.S. equities: **Cautious**

Huge gains by AI-related shares have buoyed market-weighted indexes in recent years. The Magnificent Seven was responsible for almost half the S&P 500's gain during the first three quarters of 2025.¹⁷

These stocks are expensive. With their outsized weights in broad-market indexes, they make market-weighted benchmarks expensive too.

Can the stocks keep it up? **AI bulls** point to signs like Goldman Sachs' projection that generative AI will create \$20 trillion in global economic value,¹⁸ ultimately validating companies' massive investments. They also note that the large growth companies driving the market deserve higher valuations than other stocks. These firms are generating massive profits and free cash flow; they are buying back stocks; and some pay growing dividends. Earnings for the overall S&P 500 tech sector grew 30.8% in the 12 months through the third quarter of 2025, and they're projected to grow more than 24% over the next 12 months.¹⁹

What's more, high valuations alone are not necessarily bearish. Stocks can stay expensive for a long time. We noted in a previous issue of *Prism* that the S&P 500 more than doubled over the four years after Alan Greenspan noted "irrational exuberance" in the stock market.

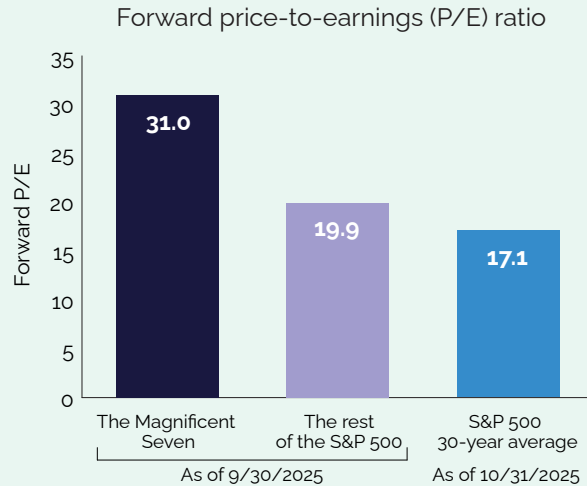
On the other side of the debate are **AI bears**. They point to parallels to the late-stage dot-com era, including:

- Disappointing results so far: 95% of organizations piloting generative AI produced zero return on investment, according to MIT²⁰
- Growing debt: Three leading AI-related firms recently sold \$73 billion in bonds²¹
- Circular relationships between providers and customers, involving links such as investments in each other and revenue-sharing agreements²²

While the largest tech firms are powerful companies, most generate their financial results from legacy operations like search and advertising, not from AI initiatives. For now, AI is a large, growing cost. Whether their eventual results justify their investments will remain unclear for years.

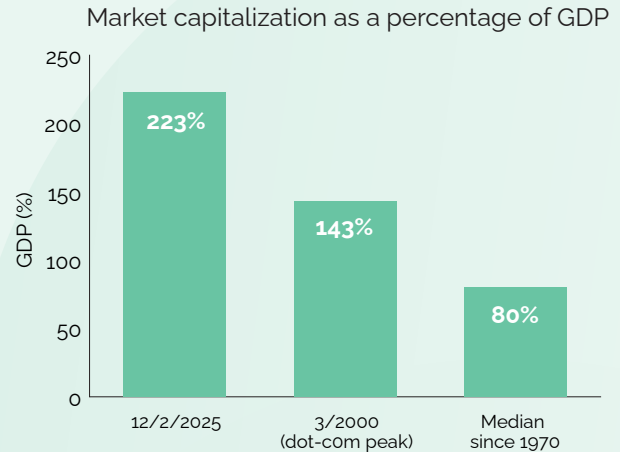
There are persuasive voices on both sides of this debate (see page 13). At &Partners, we believe there is a significant risk that we are currently in an AI bubble — but we think it's unwise to wager too much on one outcome or the other.

Valuations are historically high



Sources: Capital Group, October 15, 2025²³

J.P.Morgan Asset Management, October 31, 2025²⁴



Source: GuruFocus, December 3, 2025²⁵

Unfortunately, investors whose equity allocations track the S&P 500 are going almost all-in on AI. Ten stocks account for 40% of U.S. market capitalization, the highest concentration on record, and seven of them are highly leveraged to AI.²⁶ These largest stocks' influence in market-weighted indexes is hard to overstate. The Magnificent Seven alone now have a larger market capitalization than the entire MSCI EAFE Index,²⁷ which represents 21 of the largest international equity markets.

High valuations could intensify volatility and losses in the event of economic or financial-market problems. At the same time, the complex economic and political environment makes such stumbles more likely.

Even without an external shock, we think the broad market may struggle to grow earnings enough to justify today's stock prices. There are two main ways companies can increase their earnings: boost revenues and/or improve profit margins. We believe the near-term macro outlook doesn't look great for either. Weakening economic growth and higher trade barriers could restrain revenue growth, and companies may struggle to push historically high margins even higher.

We recommend considering ways to manage today's risks without disrupting long-term investment strategies. In U.S. large-cap allocations, we suggest seeking greater resilience by emphasizing high-

quality stocks. Investors who trim concentrated positions in large growth stocks might redirect some of those assets into a diversified mix of companies with strong balance sheets, strong competitive positions, relatively high profit margins, and in some cases histories of paying growing dividends. Dividend-focused stocks may also help boost portfolio resilience: Their payments may provide a cushion if the market declines, and stocks that pay growing dividends can help provide a hedge against inflation.

Allocations to shares of smaller companies may help enhance an equity portfolio's diversification. Investors can consider tactically overweighting mid caps, which we believe offer attractive earnings growth with greater stability than small caps. We also recommend considering a modest overweight to small-cap value stocks. Small-cap value shares offer lower valuations than large caps, many have strong growth prospects, and they are less exposed than large caps to shifts in trade policy and other geopolitical developments. The small-cap universe includes many unprofitable and otherwise questionable companies, so we recommend investing with select active managers.

International equities: **Somewhat favorable**

American investors may question the wisdom of international equity allocations following U.S. equities' 17.6% annual gain over the five years through October 31.²⁸ They might be surprised to learn that the MSCI EAFE Enhanced Value Index, which weights international stocks based on value characteristics, gained more than 19% per year over that time.²⁹

The takeaway: International value allocations can be valuable even when U.S. growth returns are exceptional.

International equities offer much lower valuations than U.S. stocks. The MSCI EAFE Index of developed international markets recently had a forward price-to-earnings ratio of about 16, only about three-quarters as high as the S&P 500. U.S. bulls tend to note that American companies offer stronger profit growth, but almost all the difference comes from the Magnificent Seven (see the chart below).

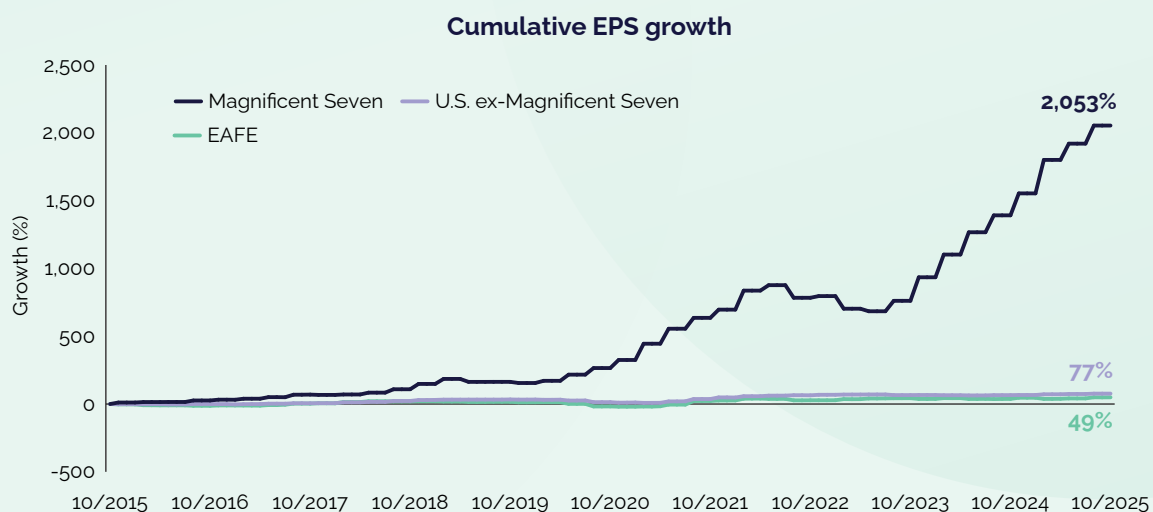
We believe the outlook for European equities has improved. A commitment to greater fiscal spending could help boost growth and earnings, particularly in Germany, and may support higher equity valuations. European companies have increased share buybacks as well.

Japan's market has become more shareholder-friendly over the past several years, and recent

For the five years through October 2025, the MSCI EAFE Enhanced Value Index (+19.1%, annualized) beat the S&P 500 (+17.6%).



developments look likely to continue that trend. Companies have boosted stock buybacks, corporate profit margins have improved, and reforms are making companies more transparent and responsive. Citing these factors, among others, J.P.Morgan Asset Management expects Japanese stocks to outperform U.S. and global equities over the next 10 to 15 years.³⁰



Earnings per share (EPS) is the monetary value of earnings per outstanding share of common stock for a company during a defined period of time, often a year. It is a key measure of corporate profitability, focusing on the interests of the company's owners (shareholders), and is commonly used to price stocks.

Fixed income: Somewhat favorable

We recommend considering Treasuries for core fixed-income allocations rather than chasing marginally higher yields in credit. The 10-year U.S. Treasury note recently paid a real (after-inflation) yield of 1.55%. Positive real yields make Treasuries relatively attractive, because they suggest investors may receive a positive return, after inflation, from assets with effectively no credit risk.

Investors also might consider extending the duration of their Treasury holdings. Longer-term Treasuries typically pay higher yields than shorter-term securities and historically have hedged equity risk more effectively. If Fed rate cuts lead to higher bond prices, longer-term securities may benefit more than shorter-term securities.

We suggest considering lower allocations to public credit markets, which currently offer little reward for the additional risk they represent. Investment-grade corporate bonds yield only about 0.79 percentage point more than Treasury bonds, on average.³¹ That's near the lowest spread since 1998. Any cracks in the outlook for corporate finances or the credit markets could cause spreads to increase quickly, leading to substantial price declines.

International fixed-income markets offer opportunities for diversification. Some international bonds also may provide higher yield than U.S. fixed income, particularly for investors who hedge foreign currency exposures, as we recommend. We suggest allocating about a quarter of overall fixed-income exposure to non-U.S. markets.

Investors who want to generate greater income may choose to complement their high-quality fixed-income allocations with private credit (see Alternatives below).

Alternatives: Somewhat favorable

We have strong conviction that well-positioned, well-governed alternative portfolios can provide significant opportunities for growth potential and diversification.

Private equity historically has offered greater returns than the public stock market.³² Private equity managers can help improve their portfolio companies' capital structures or business processes, typically resulting in more efficiently managed companies with stronger growth and/or profitability.



Public credit markets offer little reward for the risk they represent.

We currently are cautious about secondary private equity investments, but we believe primary funds run by respected managers should continue to be attractive.

We also recommend considering carefully selected private credit opportunities. Yields in U.S. direct lending recently averaged between 9% and 11%,³³ compared to 7.1% for U.S. high-yield bonds and 5% for investment-grade U.S. credit.³⁴ Private credit also has low correlations to public markets, historically, so it may help enhance overall portfolio diversification.

That said, the quality of providers is paramount. We have concerns about the possibility of contagion among lower-quality borrowers. We take great care in curating our alternative investment providers, selecting only those we believe have strong diligence and investment practices.

In private credit, we currently see greater opportunities among non-sponsored deals (debt not backed by a private equity firm) than in sponsored private debt. To help diversify and avoid oversized effects from potential negative credit events, we recommend allocating to managers that target different size and market segments and being mindful of the potential for different managers to participate in overlapping deals.

Real assets like infrastructure can help protect a portfolio against inflation. Many infrastructure investments have inflation adjustments built into the agreements that determine their cash flows. When selecting managers, we prefer those that own infrastructure assets over those that just manage them. Investors looking for ways to reduce their portfolios' AI exposure may want to focus on essential needs infrastructure such as water or roads rather than data centers or AI-focused segments.

Before investing in any alternative asset, advisors and clients should ensure the portfolio has ample liquidity to meet the investor's needs.

Partners' perspectives

We asked investment partners in several asset classes if they think we're in an AI bubble and where they are seeing opportunities. Here's what they had to say.

J.P.Morgan Asset Management

Asset class: U.S. growth equity

We believe we're not in a bubble. The capex investments being made are primarily funded with free cash flow from the biggest companies. All this capital is chasing real demand, unlike the fiber optic cable build-out in the '90s.

You get what you pay for. Leading companies have higher profitability than the rest of the market. These companies' benchmark weights have generally followed their contributions to the broad market's overall earnings and free cash flow.

We're **seeing innovation accelerate across sectors and industries.** We are leaning into fintech names, tech-forward consumer names, established consumer brands making big tech investments, innovative health care companies, and industrial companies benefiting from demand for more power generation capacity.

PIMCO

Asset class: Fixed income

Equity valuations remain stretched. Similar levels have preceded major corrections.

By contrast, fixed-income valuations are attractive. We advocate **high-quality fixed income**, where investors are being paid to build resilient portfolios. Global diversification is key.

We focus on liquid, high-quality assets and see strong return potential in asset-based finance. We favor **investment themes with secular tailwinds**, including aviation finance and data infrastructure.

Constitution Capital

Asset class: Alternatives (private equity)

We do not believe the market has the characteristics of a bubble. Unlike prior periods of speculative excess (e.g., the dot-com era), we have seen measurable productivity gains.

We invest in middle-market businesses in the consumer, health care, and industrial business services sectors. We have already seen a modest pullback in valuations over the last 18 to 24 months, creating what we believe are attractive entry points.

We believe the most compelling areas to focus on now are **companies that can be empowered by tech** in sectors like industrial services, health care, and consumer products. Most middle-market companies have not yet rolled out sophisticated technology platforms to support efficiency and drive productivity.

Carlyle

Asset class: Alternatives (private equity)

Public equity **valuations look frothy** compared to buyouts, where valuations are in line with the 10-year average. Broadly, private equity underwriting remains anchored in cash flow and profitability discipline.

We've been investing in **defense technology**, where the geopolitical environment has created a structural step-up in global defense spending, and **health care innovation**, where we continue to see attractive growth in biotech and next-generation therapeutics.

We are leaning into Carlyle's historical strengths in **large global corporate carve-outs**. Our approach allows us to acquire what we believe to be high-quality businesses at attractive entry valuations, particularly where organizational complexity or market dislocation creates opportunity.

KKR*

Asset class: Alternatives (infrastructure)

In our view, **the AI build-out isn't a bubble**; it's the backbone of the next industrial revolution. In the longer term, we think demand should justify much of today's data center build-out.

Those who own the tangible resources (such as power, land, grid connections, and permits) and master the intangibles (such as customer relationships and operational expertise) are in a better position to win. **We only take on projects with both sufficient electricity and entitlements**, including all the various permits, permissions, and agreements required to build a functional data center.

*Comments adapted with permission from "Beyond the Bubble: Why We Think AI Infrastructure Will Compound Long after the Hype."

About &Partners



&Partners was founded by a team of experienced executives dedicated to building a wealth management firm where advisors and their clients can thrive.

Our passion for putting advisors and their clients first defines &Partners. It fuels our commitment to exacting service standards, innovative technology, and a robust, flexible investment platform.

The founders of &Partners are leveraging their knowledge and experience to create a firm that is aligned around a single goal: to change lives for the better by empowering financial advisors to deliver effective advice and planning.

— &Partners Investment Team

&Partners Investment Team

The &Partners Investment Team brings extensive experience, deep market knowledge, and a disciplined approach to managing capital.

In keeping with our mission to bring institutional-quality research, analysis, and strategies to financial advisors and their clients, we make ourselves readily available to &Partners' advisors. Our concierge orientation results in highly personalized investment advice that allows clients to better achieve their financial goals.



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*Fredrik is a third-party consultant affiliated with &Partners.

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