

## Adapting to a Structurally Higher Nominal World

- **Primary equity message:** The market is transitioning from a macro-driven rally to an earnings-and-cash-flow market. That favors the US and Japan.
- **On rates:** Higher yields are not automatically bearish if they're being driven by nominal growth and resilient earnings rather than financial stress.
- **On portfolio positioning:** We're overweight US equities, overweight Japan, more cautious on Europe, and in fixed income we still prefer carry over duration.
- **Risk appetite:** This is not a recession market. This is a late-cycle nominal growth market.”

**Jim Caron:** Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Welcome to another edition of Caron's Corner, powered by The BEAT—our asset allocation framework across bonds, equities, alternatives and taxes.

The key question for 2026 is not whether growth collapses, but whether investors can adapt to a world in which nominal growth, inflation and interest rates all settle structurally higher than they did over the last decade.

Overall, we remain constructive on risk assets because the global economy continues to prove more resilient than consensus expected. Earnings remain healthy and liquidity is still supportive but this is no longer a zero-rate world, and selectivity matters much more across both equities and fixed income.

Let me start with the equity outlook. The market is transitioning from a macro-driven rally to an earnings-and-cash-flow market, and we believe that favors the U.S. and Japan. Higher yields are not automatically bearish if they are being driven by nominal growth and resilient earnings rather than financial stress.

In portfolio positioning, we remain overweight U.S. equities and overweight Japan, while staying more cautious on Europe. In fixed income, we still prefer carry over duration. Our risk appetite is this is not a recession market. This is a late-cycle nominal growth market.

So why do we continue to favor U.S. equities? In our view, the U.S. remains the highest-quality earnings market globally. Earnings resilience continues to surprise positively. AI-related capital spending is broadening beyond semiconductors into infrastructure, utilities, industrial automation, software and productivity enhancements. U.S. corporates still benefit from superior margins and stronger balance sheets. Consumer demand has slowed, but it has not cracked, and labor markets are moderating without collapsing.

Yes, the U.S. market is expensive (potentially), but expensive markets can remain expensive when earnings visibility is structurally better. That is a key point. We continue to see support from productivity gains tied to AI, an ongoing capital expenditure cycle, fiscal support still flowing through the system, and resilience in nominal GDP. The market keeps waiting for the consumer to break, and what we are seeing is normalization instead.

Japan is the other equity market where we remain particularly constructive. In our view, Japan is no longer just a cyclical trade—it is becoming a structural allocation. Corporate governance reform is real. Domestic inflation has returned. Wage growth is improving. Shareholder returns continue to improve. Japanese institutions are reallocating domestically, and valuations remain reasonable relative to U.S. growth stocks.

Japan finally has many of the ingredients investors have wanted for 20 years: inflation, wage growth, governance reform and greater shareholder discipline. It also stands to benefit from global capital spending and industrial reshoring. Yen weakness remains supportive for exporters, and Bank of Japan normalization still appears gradual rather than disruptive.

By contrast, we remain underweight Europe. We are cautious but not catastrophically bearish. Europe is more vulnerable to energy shocks, structural growth remains weaker than in the U.S., and the ECB's flexibility is constrained by persistent inflation. Manufacturing weakness also remains unresolved.

In other words, Europe appears caught between weaker growth and stickier inflation, which is a difficult backdrop for both margins and policymakers. Oil, energy sensitivity, industrial competitiveness, fiscal fragmentation and geopolitical exposure all continue to weigh on the region. For now, Europe looks more cyclical and policy-constrained than opportunity-rich.

Turning to fixed income, we remain slightly underweight duration. Deficits are high, and in some cases rising. Inflation is stickier than in the last cycle. Treasury supply remains large, the neutral rate is likely higher than pre-COVID assumptions suggested, and growth has slowed—but not enough to justify aggressive easing.

The bond market is repricing from a zero-rate anomaly back toward a more normal nominal growth regime. We think the floor for long-end yields is structurally higher in this cycle. Investors no longer need a recession to own bonds, because yields once again offer income. But we are not convinced that duration is the best way to express that view today.

Instead, we prefer higher-yielding credit as part of our bond allocation. This is a strong institutional position right now. Carry matters more than spread compression. Corporate fundamentals remain decent, the default cycle remains manageable, and income can help cushion volatility. Floating-rate and shorter-duration carry assets remain attractive, and U.S. high yield continues to benefit from stronger nominal growth.

That said, in fixed income today, carry is doing most of the work. We prefer getting paid for income rather than betting aggressively on falling rates. I'm not saying spreads are cheap though—especially in investment grade—so selectivity still matters. We are also more cautious on European fixed income, given slower growth, energy vulnerability, ECB constraints and political fragmentation. U.S. credit still benefits from stronger nominal growth dynamics than Europe.

Stepping back to the macro backdrop, our base case is that there is no recession this year. We expect slower, but still positive, growth, with inflation gradually moderating. The market is moving away from an obsession with a Fed pivot and toward a greater focus on growth durability. The economy has moved from exceptional to sustainable, and that looks more like normalization than recession cycle.

Inflation remains sticky, but it is not spiraling. Services inflation is still elevated, while much of the goods disinflation has already occurred. As for the Fed, policymakers have more flexibility than markets feared six months ago because growth has held up better than expected. The hurdle for aggressive rate cuts therefore remains relatively high. Recent market concerns around elevated treasury yields and sticker inflation support this framing.

The key data points to watch include PCE inflation, ISM manufacturing and services, payrolls, wage growth, Treasury auctions, consumer confidence and spending, oil prices and geopolitical developments. Markets remain highly sensitive to any data that challenges the soft-landing narrative.

Of course, risks remain. These include an oil shock, geopolitical escalation, a reacceleration in inflation, long-end Treasury yields moving disorderly above 5%, a sharper consumer slowdown and policy uncertainty tied to tariffs and other developments. In our view, the biggest risk to equities right now is probably not earnings—it is the level and volatility of long-end yields.

There are a few questions I continue to hear most often. Are stocks too expensive? Parts of the market are expensive, but earnings leadership, cash flow and quality justify some of that premium. What could surprise markets from here? Growth staying firmer for longer while inflation gradually cools would be a meaningful surprise—and it remains non-consensus.

What is the biggest market misunderstanding? In my view, it is the idea that higher rates automatically mean

recession. I do not think that is necessarily true in this environment. And what is my highest-conviction trade? It remains U.S. and Japanese equities over Europe, alongside carry over duration in fixed income.

Finally, what keeps me up at night? A disorderly rise in long-end yields tied to deficits rather than growth. That is the type of move that could unsettle markets more meaningfully.

The bottom line is this: we may be moving beyond the post-global financial crisis world of chronically low nominal growth and into a more inflationary, more capital-intensive regime. So again, the key investment question for 2026 is not whether growth collapses. It is whether investors can adapt to a world where nominal growth, inflation and interest rates all settle structurally higher than they did over the last decade.

Thank you for listening to this edition of Caron's Corner.

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