



# OPTIMUM<sup>®</sup>

## Global Asset Management

# Financial Outlook



## First Quarter 2026

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## At a Glance

- Equities have continued their strong performance for the third year in a row
- The US economy is expected to grow in the 2-2.5% range in 2026
- Labor shortages could slow GDP growth due to lower immigration
- Equity investors may be extrapolating recent performance too far into the future
- Risky assets are “priced for perfection” and subject to negative surprises

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# Point of View

Jan Erik Warneryd, CFA, Chief Investment Officer



As we start the new year, we can look back at another year of strong returns in both Equities and Fixed Income markets in the US. Judging by market performance, it would appear as if all was well in the economy as we enter 2026. The boom in Artificial Intelligence (AI) investments has boosted growth and powered the S&P 500 and Nasdaq to new highs in Q4.

The general optimism in financial markets has diverted investor attention away from other issues that may warrant concern regarding the economic outlook for the US. These issues include the White House's apparent loss of focus on bringing down the budget deficit to any meaningful extent. While tariffs have generated revenue for the budget, other initiatives such as DOGE, appear to have fizzled out. The net result is a projected budget deficit only slightly lower than in 2025, with the risk that revenue comes in lower than expected if growth undershoots the CBO's 2.2% forecast in 2026. President Trump has hinted at providing more stimulus to consumers in the form of "dividends" from the tariff income and other, more targeted, initiatives to compensate for high prices for food and other necessities. This risks further diminishing any progress towards a smaller budget deficit which is why it's hard to see a real commitment to fiscal soundness from the current administration. The longer-term consequences can already be seen in the steepness of the Treasury yield curve, where the 10-30 year Treasury spread has risen from 18 basis points to 67 basis points since President Trump was elected. The Bond market is now demanding an increased risk premium to lend to the US Government in longer maturities.

Another issue is the impact on medium-term growth from the size of the labor force, which after a period of strong growth is flattening out and possibly starting to contract in 2026, due to sharply lower immigration. An expanding labor force is a key driver of growth in the economy. A simple model of potential output in the US economy has growth as the product of change in the labor force times change in productivity. Without a growing labor force, all of the GDP growth will have to come from increased productivity. It may be up to AI to provide growth if immigration levels stay low in the US. A more benign consequence of lower immigration is that the slowdown in job creation that we are currently witnessing will have less of an impact on the unemployment rate than would otherwise be the case. The downshift in non-farm payrolls from the roughly 200,000 per month pace seen since the end of the COVID pandemic to the current roughly zero new jobs per month, would have had a much more noticeable effect on the unemployment rate, likely taking it from November's 4.6% to well over 5%.

A third issue is the widening gap between those who are benefitting from higher asset prices, such as homeowners and those with equity holdings, versus renters and consumers with credit card debt. Persistent inflation and the high level of prices in the aftermath of the pandemic have put significant economic pressure on many Americans. While the "Big Beautiful Bill" contained some tax relief for low- and middle-income earners, the impact of AI on the US job market may further serve to widen the gap while also starting to

encroach on middle-income "white collar" cohorts. We are already seeing delinquencies on subprime auto loans hit new records, with more than 6% of loans more than 60 days past due, according to Fitch Ratings. In credit cards, we are seeing delinquency rates rise faster among middle- and high-income borrowers, showing how financial health is enjoyed by an increasingly narrow segment of the population. As mentioned, high asset price appreciation has increased the spending power of many high earners who also own stocks and real estate, but the implication is that a market correction could remove this support. The housing market has been a significant contributor to the net worth of homeowners since the pandemic, with the S&P/Case-Shiller National Home Price Index showing an average price increase of 55% since 2020. The same index is now showing a slight weakening trend since June of this year.

While home price declines are still small, the trend appears to have turned negative. The addition of a correction in the Equity market could quickly turn sentiment among high-earning consumers from optimism to pessimism.

## Market Outlook

Financial markets in the US are essentially "priced for perfection" if viewed from afar. The price/earnings ratio on the S&P 500 is about 25 times 2025 estimated earnings. For 2026, the market expects earnings growth of 14.7% according to Thomson Financial Consensus EPS Estimates. This would represent an acceleration from the roughly 11% pace expected for 2025. While valuations this high have historically resulted in low or negative ex-ante returns, because of the relatively narrow market leadership in recent years, there may exist an opportunity for underperforming sectors to do better if the economy avoids a recession and continues to grow at a modest pace. Financials, Health Care and the Telecom sub-sector of Communication Services come to mind as potential outperformers. If interest rates continue to fall, Utilities may also perform well.

We think US Treasuries offer reasonably good value at these levels. Real rates on 30-year TIPS (Treasury Inflation-Protected Securities) are now among the highest since the 2008-2009 Financial Crisis, offering long term investors a real yield of about 2.6% while offering protection against rising inflation and credit risk. The Corporate Bond market, however, is trading at some of the narrowest spreads of the last several decades while experiencing significant new issuance, not the least to finance AI infrastructure investments. While demand has been solid so far, some market participants are starting to wonder if the current AI investment boom will ultimately result in enough new revenue to pay for the fast-depreciating technology being built today.

Our philosophy as investors is to take risk when the potential rewards warrant doing so, but in the current environment risk premia are overall very low which makes us lean towards being conservative for the time being.

# Bond Markets

Marvin Kouame, Investment Analyst



## Navigating Late-Cycle Crosscurrents

As markets wrap up the year and transition into 2026, the macro environment is firmly shaped by late-cycle characteristics as opposed to an imminent downturn. Economic growth deceleration, muted inflation, and a presumably peak level of monetary policy tightness are key factors influencing this scenario. Therefore, looking ahead to 2026, markets are less likely to be affected by macro shocks and are instead expected to be shaped by policy expectations, interest rate dynamics and issuer-specific fundamentals. In such a scenario, there are opportunities available for fixed income investors. U.S. rates provide attractive yields, with the risk-reward profile having gradually improved with the stabilization of the policy backdrop, the fundamentals for investment-grade credit are solid even if they are deeply valued, and structural themes such as artificial intelligence are having a growing impact on capital allocation and the credit markets. Together, these forces set the stage for a more selective, income-focused approach.

## U.S. Rates - From Peak Policy to Greater Optionality

The U.S. rates market is currently in an easing cycle prompted by the Federal Reserve that is defined by patience and optionality. Although it can be said that policy is still restrictive in real terms, the FED is reducing rates as inflation moderates and the risks associated with peak restrictiveness become more apparent. Policymakers have a greater level of flexibility to respond to evolving growth conditions.

At the same instant, the conditions in the labor market are weakening, even as the headline numbers for employment keep holding up. The forward-looking measures of the labor market, such as job openings, muted hiring plans communicated by companies (low hiring and firing), and wage growth, suggest a continued cooling of demand for labor. The unemployment rate in November ticked higher to 4.6% echoing the sentiment of gradual cooling. While this does not yet signal recession, it increases the likelihood that restrictive policy could weigh more meaningfully on growth if left unchanged.

The FED's easing path is best viewed as insurance against overtightening. In other words, policy action is preemptive rather than reactive and designed to reduce future downside risk, not a response to dire economic stress (ex: collapsing growth). Policy rates are expected to move slowly towards neutral levels over the coming periods, with the pace of rate cuts remaining highly dependent on the data at the time. However, the FED has been flying blind to a degree post-shutdown with major economic data still significantly affected.

As labor market softening becomes more evident, front-end rates appear mispriced for a policy path that remains sensitive to downside growth risks, suggesting a potential for further declines in front-end yields as the easing cycle progresses. This would be supportive of a continuation of the steepening of the yield curve, primarily driven by the decrease in the front-end yields. The 2s10s

curve (the spread resulting from selling the 2-year Treasury and buying the 10-year Treasury) is over 69 bps and continues to move in a strong uptrend that should persist as we navigate this easing cycle.

2s10s Yield Spread (bps)



Source: Optimum Quantvest and Bloomberg

The longer-term yields would most likely stay anchored by the factors of term premium effects, fiscal factors, and the associated risks of future inflation expectations. Such a scenario would be associated with the bull steepening state, as opposed to the post-pandemic era that saw the associated rise of the long-end yields and the heightened concerns associated with inflation risks.

An additional source of uncertainty could stem from the impending leadership change at the FED. Although the change itself is not sufficient to enable a drastic change in policies, it is likely to cause an increase in dissents among voting members and a disconnect in future FED communications, as the newly appointed chair will be highly influenced by President Trump's agenda for much lower rates. Some key risks and catalysts that could affect the U.S. rates market are persistent inflation that slows or pauses the easing cycle, a sharper than expected deterioration in the labor market, increased market sensitivity around the FED Chair transition, and possible term premium volatility. Overall, Treasuries continue to offer great value. As this easing cycle continues, positioning on high-quality duration as both an income generator and a portfolio stabilizer is favorable.

## IG Credit – Yield Remains the Anchor

Investment-grade credit finished 2025 with solid fundamentals supported by strong balance sheets and ample liquidity. While economic growth is slowing and labor market conditions are cooling, the adjustment has been gradual, allowing issuers to maintain stable earnings and manageable leverage. As growth moderates, the environment is shifting away from one that supports broad spread compression toward one that rewards credit discipline and issuer selectivity. Valuations remain tight by historical standards, making spreads more sensitive to supply and changes in risk appetite.

Recent spread volatility has been driven primarily by issuance rather than a deterioration in credit quality. Elevated all-in yields help explain continued demand for investment-grade credit, even as spreads grind tighter and supply increases. As a result, carry

# Bond Markets (cont'd)

Marvin Kouame, Investment Analyst



and roll-down are expected to remain the primary drivers of total return, even as modest spread widening becomes more likely over time.

## U.S. Investment Grade Yields Remain Elevated



Source: Optimum Quantvest and FRED

Looking ahead, rising capital expenditures particularly related to artificial intelligence, alongside a pickup in M&A activity, could lead to modest balance sheet expansion for select issuers. As financial conditions ease, balance sheet management and capital allocation decisions will play a larger role in determining performance across the IG universe.

Overall, the outlook for investment-grade credit remains constructive but less forgiving. Strong fundamentals and demand should continue to anchor spreads, while issuer-level differentiation is likely to increase. In this environment, maintaining exposure to high-quality income with an emphasis on selectivity remains key.

## Artificial Intelligence – Financing the Next Phase

Artificial intelligence remains a powerful structural theme, but the market's treatment of the AI trade has evolved as we saw a repricing in 2025. Investor focus has shifted away from headline growth potential toward profitability, capital efficiency, and execution, reflecting a more mature phase of the cycle and a higher cost of capital environment.

A key development has been the increasing role of credit markets in financing AI-related investment. Large technology and cloud infrastructure providers are turning to debt issuance to fund capital-intensive infrastructure buildouts, signaling confidence in long-term cash flow generation while preserving equity flexibility. As a result, AI-driven investment is becoming a structural contributor to investment-grade supply, even as demand for high-quality issuers remains strong.

Credit markets are beginning to differentiate more clearly among AI beneficiaries. Recent widening in Oracle's five-year CDS highlights growing investor focus on leverage, balance sheet capacity, and the timeline for monetizing AI investments. While this is not indicative of systemic stress, this repricing underscores that AI exposure alone is no longer sufficient to support valuations but instead how the investment is financed and executed increasingly matters.

## Oracle 5-year CDS Widening (bps)



Source: Optimum Quantvest and Bloomberg

For fixed income investors, this shift reinforces the importance of selectivity. AI remains supportive of longer-term growth and productivity, but it also introduces execution and balance-sheet risk for issuers pursuing aggressive, debt-funded expansion. As AI-related supply increases, modest spread widening may be required to absorb issuance, further contributing to dispersion within the investment-grade universe.

## STRATEGY

As the FED progresses through an easing cycle amid softening labor conditions, U.S. rates appear biased toward a gradual bull steepening rather than a sharp directional move. In credit, elevated all-in yields and resilient fundamentals continue to support carry-driven returns, even as rich valuations leave less room for error. Meanwhile, the evolution of the AI trade highlights a broader market shift toward capital discipline, reinforcing the importance of selectivity as supply rises and dispersion increases heading into 2026. We look to maintain our long duration positioning above the index along with a moderate underweight in credit.

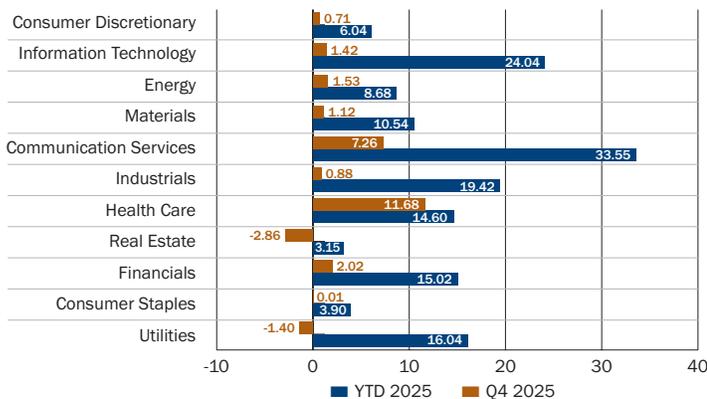
# U.S. Equities

Jan Erik Warneryd, CFA, Chief Investment Officer



In 2025, the S&P 500 equity index posted its third year in a row of double-digit returns. The total return for the S&P 500 was 2.66% for Q4 and 17.88% for all of 2025. Communications Services, which includes such stocks as Meta, Alphabet and Netflix, was the best performing sector for the year with a total return of 33.55%. Information Technology, with Nvidia, Apple and Microsoft as the largest names, took second place with a total return of 24.04%. The worst performer for 2025 was Real Estate with a 3.25% return. No sectors had negative returns for the full year (see below).

## S&P 500 Index Total Return (%) by Sector



Source: Optimum Quantvest and S&P Global

Most Wall Street forecasters appear to expect the bull market to continue, and consensus estimates are for Earnings Per Share (EPS) to increase by over 15% in 2026. This rate of change would represent an **acceleration** from the expected 11% EPS growth rate in 2025, even as corporations face increased input costs due to tariffs and potentially higher labor costs as changing immigration policies impact labor supply. To meet these expectations the AI investment boom would have to continue or even accelerate, consumers would have to increase spending, and corporations would have to make good use of the new accelerated depreciation rules in the “Big Beautiful Bill.”

The pattern we appear to be seeing is that the momentum of the market’s advance is increasing expectations for the future. Financial market history shows that while momentum can carry the market for periods of a year or two, mean-reversion ultimately dominates over longer periods. When we take into account the current low risk premium in the US Equity market, it seems reasonable that at some point the current rally will end and medium-term returns will be lower than currently expected. Below is a chart of the Equity Risk Premium (ERP) as defined as the spread in percentage points

between the inverted CAPE (Cyclically Adjusted Price/Earnings, also known as the Shiller P/E) ratio and the real yield on 10-year TIPS (Treasury Inflation-Protected Securities). The chart shows that, while the ERP currently is higher than at the lows of the “NASDAQ Bubble” in the late 1990s, we are at levels not seen since 2002. The level of ERP is not a predictor of short-term returns, but it does give an asset allocator a good understanding of the relative yield offered in Bonds versus Equities.

## Equity Risk Premium



Source: Bloomberg and Optimum Quantvest

While Bond investors tend to use current market yields as a first approximation of future total returns, Equity investors often look at recent returns as a guide to the future.

Looking at the relative value in Equities through the yield lens may therefore seem foreign to many Equity investors. Indeed, research by Antti Ilmanen of AQR<sup>1</sup> suggests that, “Equity investors tend to extrapolate recent trends in returns and earnings growth, while Bond investors tend to expect mean reversion in rates.” Another way of saying this is that Equity investors look in the rear-view mirror, while Bond investors look forward. Ilmanen points out that Bond investors may be wrong to expect mean-reversion; research suggests that Bond yields trend over long periods whereas Equities exhibit more pronounced mean-reversion. This should not be confused with the observed long-term higher returns in Equities as an asset class, which is due to the risk premium over less volatile assets such as Government Bonds. While Equities have returned more than Bonds over long periods of time, the issue now is whether we are at a point where the optimistic extrapolation of returns has gone too far.

<sup>1</sup> Ilmanen, A., 2025, “Why Are Bond Investors Contrarian While Equity Investors Extrapolate?” AQR Capital Management

# U.S. Equities (cont'd)

Jan Erik Warneryd, CFA, Chief Investment Officer



## STRATEGY

After a wobble in Q1 2025 due to tariff uncertainty leading to a surge in imports, US GDP has expanded at a decent clip. Growth for all of 2025 looks to be at least 2%, which is a slowdown from 2024's growth rate of 2.8% but nonetheless better than many forecasters had feared after the "Liberation Day" tariff announcements on April 2. While there has been much talk about the "K-shaped economy", where low- and middle-income Americans are facing economic headwinds in the form of a high cost of living and a difficult labor market while high income earners, homeowners and those with Equity investments are benefitting, overall, the US economy is still generating growth.

As mentioned above, EPS growth expectations for 2026 look for an acceleration from the already-high pace seen in 2025. Given the high valuation (low ERP) in the US Equity market currently, the market appears "priced for perfection" with little room for anything to disrupt the bullish outlook without causing a painful market decline. It is of course possible that 2026 continues the trend of

strong Equity market performance; after all, the FED is likely to continue to ease rates and with 2026 being a year of mid-term elections, we may see more fiscal stimulus as well.

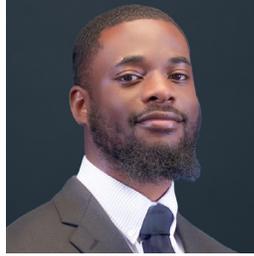
The current strong momentum would likely need a catalyst to change direction; potential ones include inflation staying stickier than expected thereby causing the FED to stay on hold or even contemplating rate hikes. Another potential catalyst could be job creation turning negative as a combined effect of AI replacing workers and a shrinking labor force due to lower immigration. The latter scenario would have a negative impact on GDP growth and, most likely, top-line revenue for corporations.

We believe that irrespective of the overall direction of the market, a rotation into sectors that have lagged the Equity market advance in recent years such as Health Care, Financials, Utilities and the Telecom subsector may surprise investors who are focused on the dominant AI theme.

# Contact Us



**Jan Erik Warneryd, CFA**  
Chief Investment Officer  
[jwarneryd@optimumquantvest.com](mailto:jwarneryd@optimumquantvest.com)



**Marvin Kouame**  
Investment Analyst  
[mkouame@optimumquantvest.com](mailto:mkouame@optimumquantvest.com)

## OPTIMUM QUANTVEST CORPORATION

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### OPTIMUM QUANTVEST CORPORATION

📍 1345 River Bend Drive, bureau 100  
Dallas, TX 75247, U.S.A.  
☎ +1 263 381-5677  
✉ [info@optimumquantvest.com](mailto:info@optimumquantvest.com)

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