

Q1 2026 OUTLOOK: SUNSHINE AND ROSES

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The 2025 stock rebound pushed U.S. equities to fresh highs, but it left the market's "usual suspects"—the Mag-7 and specifically mega-cap AI—with stretched valuations. Most major banks are optimistic about equities for 2026, forecasting positive returns for U.S. stocks. The S&P 500 is expected to see gains, with targets ranging from Bank of America's modest 7,100 to Deutsche Bank's bullish 8,000. The AI theme is a primary driver of this optimism, expected to fuel robust earnings growth.

Economic growth is expected to continue, albeit moderately. Goldman Sachs expects a global growth rate of 2.8% in 2026, with the U.S. likely to outperform other major economies due to pro-growth policies and easier financial conditions.

Inflation is expected to continue cooling, moving closer, but not all the way, to central bank targets. However, a potential slowdown in the labor market and uneven consumer spending, particularly impacting lower-income households (part of the K-shaped recovery we discuss below), are noted as key risks in bank predictions.

Globally, interest rates are expected to decline. Central banks, including the U.S. Federal Reserve and the Bank of England, are set to continue their rate-cutting cycles as inflation moderates. Japan is the main exception, however, having raised rates to a 30-year high, which is narrowing the yen carry-trade spread. The market is pricing in at least two Fed rate cuts through 2026, supporting borrowing and investment.

Overall, the outlook for 2026 is rosy. Below, we discuss the top three investing themes we are looking for in 2026. But first, a brief look back at 2025:

Markets*

	As of 12.31.2025	Q4 Return	2025 FY
S&P 500	6,845.50 pts	2.3%	16.4%
NASDAQ	23,241.99 pts	2.6%	20.4%
The Dow	48,063.29 pts	3.6%	13.0%
Global Equities		5.5%	25.7%
Emerging Markets		2.5%	30.8%
Energy		0.1%	4.4%
Gas	\$3.36/gal	-7.7%	-4.2%
Gold	\$4,319.37/oz	11.9%	64.6%
VIX	14.95 pts	-8.2%	-13.8%
10-Yr Treasury	4.167%	1.7 bps	-40.2 bps

*See endnotes.

Alternatives*

	Q4 Return	2025 FY
Direct Lending	-0.3%	-7.4%
CLOs	1.4%	7.5%
Private Equity	-2.1%	1.2%
Hedge Funds	1.2%	11.2%
Equity REITs	-2.6%	1.3%
Residential REITs	-1.9%	-10.6%
Industrial REITs	9.4%	14.6%
Wine & Cheese	0.9%	-24.7%
Crypto Market	-30.6%	-19.2%
SPACs	-0.4%	30.7%

*See endnotes.

U.S. and Global Market Summary

- **Gold and Stocks Climb on Rate-Cut Bets, Oil Dumps:** S&P 500 was up 18% in 2025, hitting a record high and a third straight year of double-digit returns. Gold briefly surpassed \$4,400/oz (+75%) as it broke through the \$4,000 per ounce level for the first time ever. Oil dropped 20%, its worst year since 2020.
- **Emerging Markets Shine:** Dollar weakness fueled emerging markets to strong gains in 2025, with local currency bonds up roughly 18% and equities up 30% (vs 7% in 2024). This is due to strong central bank monetary policy and increasing investment in local currency for EMs.
- **Infrastructure is the New Direct Lending:** Global private infrastructure deal volume rose 22% year over year to more than \$960 billion, driven by strong demand for renewables and digital infrastructure assets. McKinsey projects cumulative infrastructure investment to reach \$106 trillion by 2040.
- **Recent AI Investment Activity:** AI investment remained red hot in Q4 across capital spending, dealmaking, and infrastructure buildouts. VC deals of \$1 billion or more included Databricks (\$10 billion), OpenAI (\$6.6 billion), xAI (\$6 billion), Waymo (\$5.6 billion), and Anthropic (\$4 billion). Even Disney got in on the action with a \$1 billion investment in OpenAI. This surge in AI-related investment has already provided a meaningful boost to economic growth and is expected to continue doing so through 2026. Read more on AI's impact on infrastructure in the body below.

Economic Performance

- **U.S. Growth is Picking Up Into 2026:** The economy accelerated into year-end, with the Atlanta Fed estimating Q4 growth around 2.7%, and Vanguard projecting full-year GDP growth of about 2.25% in 2026. The growth is largely driven by a broad pickup in business investment and a meaningful fiscal boost from tax cuts taking effect in 2026.
- **S&P Earnings Momentum Continues:** The S&P 500 is expected to post 8.3% year-over-year earnings growth in Q4 2025, marking the tenth straight quarter of growth. Nine of eleven sectors are projected to grow, and analysts see a 13.1% expansion in earnings across the board in Q1 2026.
- **Hiring Momentum Softens:** December payrolls rose +50k after October's shutdown-driven losses and a 162k drop in federal jobs. Unemployment is now 4.4%, unchanged from the end of Q3 after rising to 4.5% in November, pointing to a softening but stable labor market. Hiring is led by health care, social assistance, and food services while more cyclical sectors continue to contract.
- **Consumers Remain Cautious in Q4:** The Conference Board's Consumer Confidence Index fell 3.8 points to 89.1 in December, marking a fifth straight monthly decline and well below 2025's peak confidence in January. Consumer Confidence has materially decoupled from stock market returns.

Monetary Policy

- **Fed Cuts Rates, Signals Caution:** The Fed cut rates 25 bps to 3.50% - 3.75% at its final 2025 meeting but signaled less urgency to keep easing. Updated projections point to just one cut in 2026, suggesting a slower pace of rate cuts heading into Q1 2026.
- **Rates Lean Toward More Cuts:** The 10-year Treasury yield is at ~4.1% and the 2-year is near 3.5%, showing that investors expect more rate cuts in 2026 than the Fed has projected. A divided FOMC has elevated uncertainty around the Fed's rate path.
- **The Fed is Quietly Adding Liquidity:** Alongside its 25 bp cut, the Fed has begun \$40B in Treasury bill purchases, boosting system liquidity and easing financial conditions.

Credit Market Performance

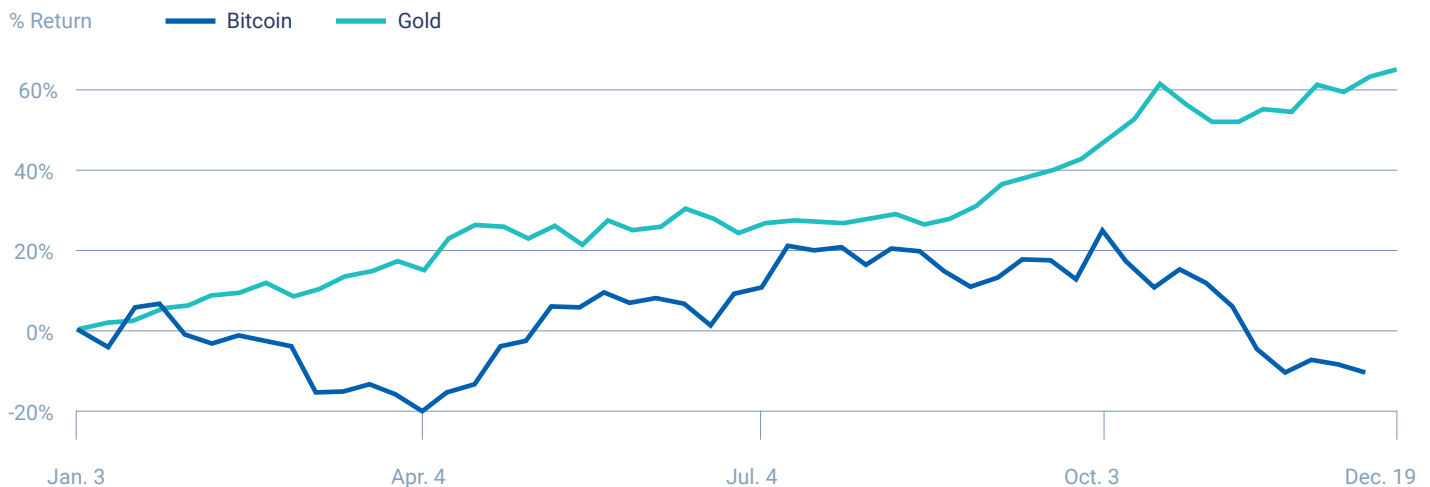
- **Credit Market Returns:** Performance for FY 2025: High yield (HY) +8.6%, investment grade (IG) +7.8%, and leveraged loans +5.9%, and direct lending (6.9%). Both leveraged loans and direct lending returns took hits as the Fed cut rates throughout the year.
- **Speculative-Grade Defaults Are Declining:** S&P Global expects the U.S. speculative-grade default rate to fall to ~4% by September 2026 from ~4.6%, with Europe improving to ~3.25% from 3.7%, supported by stronger earnings, ongoing refinancing activity, and lower interest rates.
- **Private Credit Activity Picked Up in Q4:** After a slow first half of 2025, private credit issuance rose to nearly \$70 billion across 201 deals in Q4, the highest level since Q2 2024. The rebound was driven by large M&A and refinancing transactions shifting from the syndicated loan market into private credit, with nearly 30% of year-to-date volume tied to M&A and leveraged buyouts.

Theme #1 – In Times of Uncertainty, People Want Tested Stability: “Gold” Gold Soars; Digital Gold Whiffs

2025 was supposed to be a huge year for Bitcoin. It had regulatory support, a pro-crypto executive, normalization as an asset class, and buy-in from large banks. Bitcoin managed to ignore all those tailwinds and, after peaking at \$126,000 in October, dropped below \$90,000 by the end of the year. It ended up negative on the year.

Gold, that “barbarous relic,” soared in 2025. It hit a record high, surpassing \$4,000 an ounce. Central banks continue to scoop up gold and reduce their reliance on the U.S. dollar. Skepticism about the government’s fiscal discipline, inflation concerns, and general market anxiety have turned investors to the safety of gold.

Digital Gold vs. “Gold” Gold



Data: Bloomberg. Source: Financial Times.

Despite record highs, gold’s role is a temporary shelter from the storm and not a permanent residence. Over the long term, gold’s stability is its Achilles heel. The asset is stable, but its value quietly erodes over time. Meaningful growth only occurs during specific regimes. Outside of such regimes, equities have dominated over long horizons, rewarding investors who stayed invested and held through drawdowns rather than attempting to sidestep volatility.

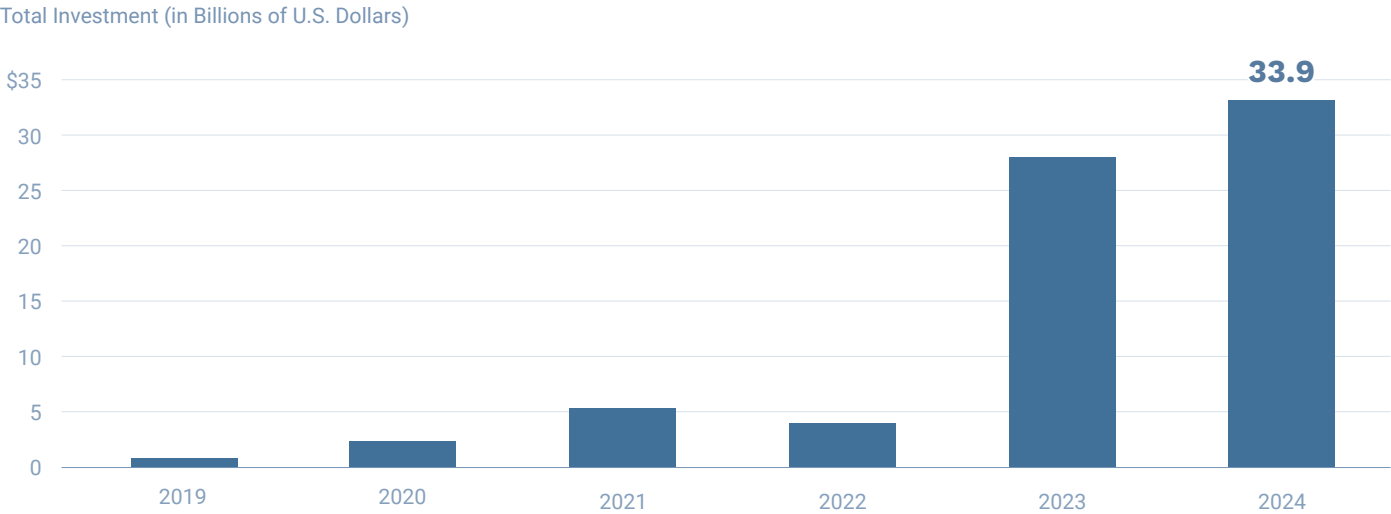
Gold is manic. Its returns arrive in violent bursts followed by extended stretches of stagnation. It is structurally incapable of compounding in the way productive capital does. Gold’s function is not to maximize wealth over time, but to preserve purchasing power when trust in financial and political systems erodes. Nevertheless, in 2026, gold may have more room to run.

Theme #2 – Infrastructure Everywhere: AI Has Generated Insatiable Demand...and Investment Opportunity

AI has people worried. 2025 saw a significant rise in the valuations of many AI-connected companies, massive investments in AI-related infrastructure, and ouroboros-like circularity of the AI investment/partnership ecosystem. Yet, investment momentum continues.

AI accounted for more than 30% of GDP growth in Q2 2025, and spending is expected to continue through 2026. Goldman Sachs estimates that AI could add more than \$7 trillion to global GDP over the next decade, with even more conservative forecasts still pointing to substantial growth. There are now six major models competing for dominance (ChatGPT, Gemini, Anthropic’s Claude, Microsoft’s Phi, Mistral’s models, and xAI’s Grok), and all of them are willing to go to the mattresses to win the AI race.

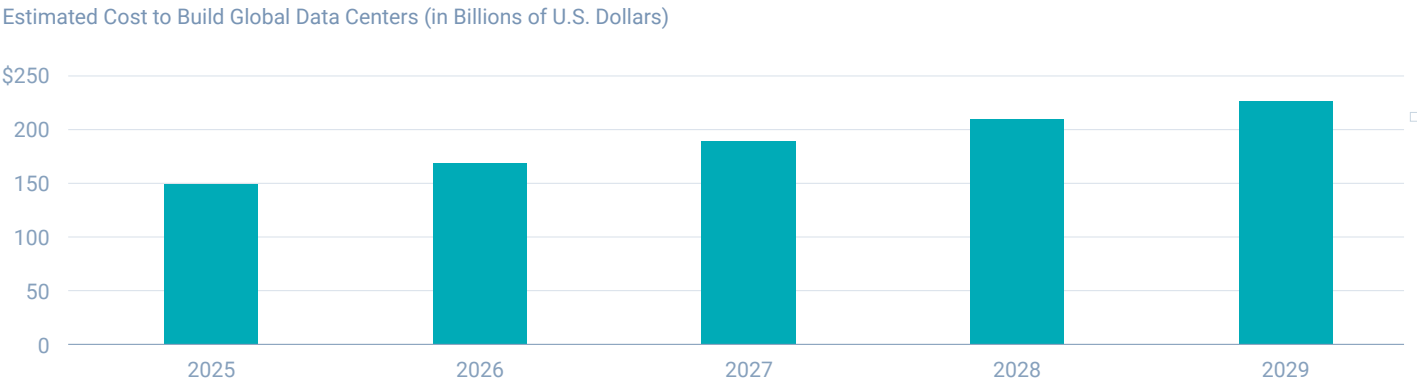
Global Private Investment in Generative AI, 2019–24



Data: Quid, 2024. Chart Source: 2025 AI Index Report. Source: Stanford University Human-Centered Artificial Intelligence.

The result is an expected \$400 billion boom in 2026, an amount that makes the moon landing look small (\$250 million in current USD). By the end of 2026, more than 150 new hyperscale data facilities will be completed worldwide, which is the biggest buildout since cloud computing began. The specialized nature of these facilities means the industry can’t rely on retrofits; new AI facilities have power and cooling systems engineered from the ground up.

More Than \$900 Billion is Needed for Global Data Centers Through 2029

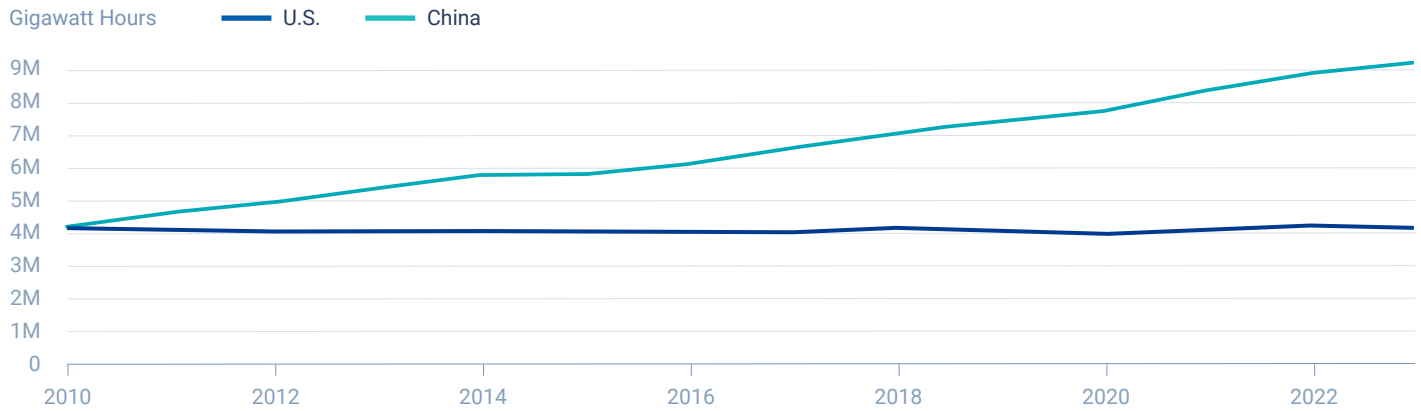


Data: 451 Research's Datacenter Services & Infrastructure Market Monitor & Forecast, March 2025. Source: S&P Global.

Each gigawatt of AI-optimized capacity now costs \$45 to \$55 billion to construct, nearly triple the price of a standard facility. Facilities will require nationwide power grid expansion and a huge increase in grid capacity. As AI demand explodes, "ready-to-use" power becomes more valuable than the chips themselves.

Capacity is an area in which the U.S. has been lagging. The U.S. has relied on efficiency gains to support economic growth while China took a great leap forward by building out generation capacity of all types—they are a world leader in solar energy production and in coal power plants. The U.S. may have the advantage in chips and models, but our AI is being held back by power capacity, an area we are scrambling to catch up in.

Electricity Generation Growth



Data: IEA. Source: Foreign Policy at Brookings.

Electrical infrastructure has now become the primary constraint on AI data center deployment. This creates exceptional opportunities for infrastructure, manufacturing, and power. Private credit and other alternative investment vehicles have filled the funding gap and continue to profit from the AI space.

Theme #3 – The Economy is K-Shaped and So is Everything Else

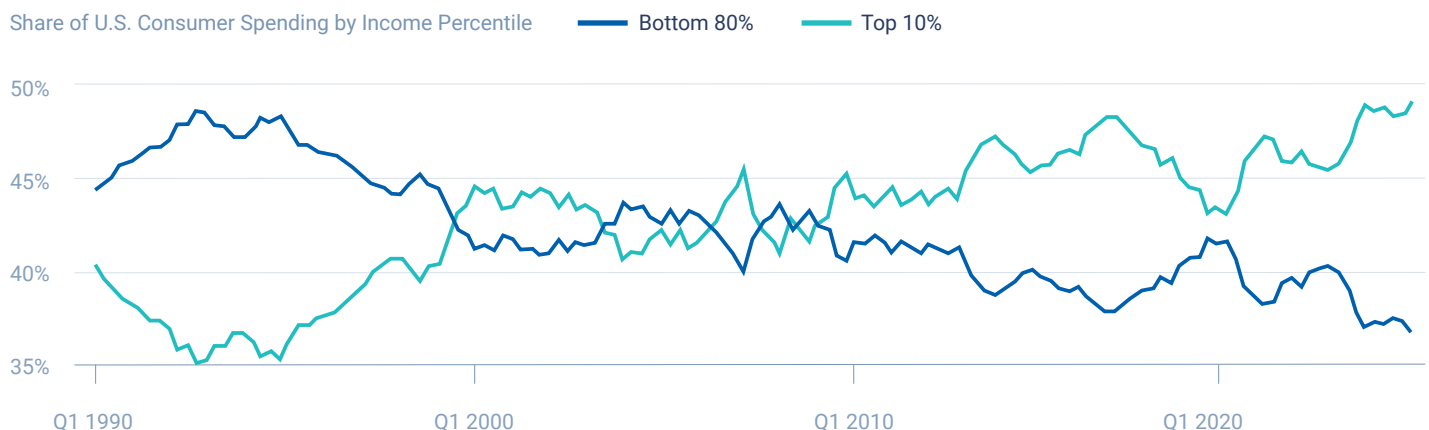
With GDP and the stock market at record highs, and employment still relatively low, why do so many people feel severe economic stress? A K-shaped recovery is part of the reason. The term describes an uneven economic rebound where some sectors and income groups thrive (the upward part of the 'K'), while others decline or stagnate (the downward stroke).

Young people have been hit hard. Job postings for entry-level roles have declined about 35% since January 2023, says labor research firm Revelio Labs, with AI playing a big role. According to the New York Fed, unemployment for new college graduates is up 30% (vs. 18% for all workers) since 2020.

The situation has been exacerbated by AI. Companies can grow with fewer workers. Existing workers must do more with less. The expected college grad career ladder is not as steady as it used to be.

Judging by the numbers, the economy is stronger than ever; judging by the vibes, we are on the cusp of an AI-fueled dystopian technological nightmare society. The societal parallax will continue to polarize. Top earners feel better than ever, while the downward stroke of the K feels angst, anger, and uncertainty.

The Top 10% of U.S. Earners Account for Nearly Half of All Consumer Spending



Data: Moody's Analytics review of Federal Reserve data. Source: Financial Times.

As we look toward the remainder of 2026, the financial market is in a striking paradox. On one hand, the "sunshine and roses" narrative is supported by a relentless AI-driven equity bull market, with the S&P 500 eyeing targets as high as 8,000 and global GDP growth projected at a sturdy 2.8%. On the other hand, the "K-shaped" reality is tightening its grip. The "rosy" outlook for 2026 is real, but it is not universal. Fortunately, investors have more options than ever to diversify their portfolios, reduce volatility, and weather whatever happens.

Endnotes

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"Crypto Market" represented by the Bloomberg Galaxy Crypto Index. "NASDAQ 100" represented by the NASDAQ 100 Index. "S&P 500" represented by the S&P 500 index. "Private Equity" represented by the Invesco Global Listed Private Equity ETF. "Direct Lending" represented by the DLX Direct Lending Index. "US Residential REITs" represented by the MSCI US Residential REIT Index. "CLOs" represented by the Palmer Square CLO Debt Index. "Leveraged Loans" represented by the S&P/LSTA Leveraged Loan Total Return Index. "High Yield Bonds" represented by the Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged. "Gold" represented by the SPDR Gold Shares. "Emerging Markets" represented by the iShares MSCI Emerging markets ETF. "Investment Grade Bonds" represented by the Bloomberg US Corporate Bond Index. "Hedge Funds" represented by the Bloomberg All Hedge Fund Index. "Equity REITs" represented by the MSCI World Equity REIT Index. "Financials" represented by the Financial Select Sector SPDR Fund. "Telecom" represented by the iShares US Telecommunications ETF. "Utilities" represented by the Utilities Select Sector SPDR Fund. "Commodities" represented by the Invesco DB Commodity Index Tracking Fund. "Oil" represented by the United States Oil Fund LP. "VIX" represented by the Chicago Board Options Exchange's CBOE Volatility Index. "Natural Gas" represented by the United States Natural Gas Fund LP.

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