

**PICTON**  
INVESTMENTS

# MACRO OUTLOOK

THE 2026 PICTON REPORT

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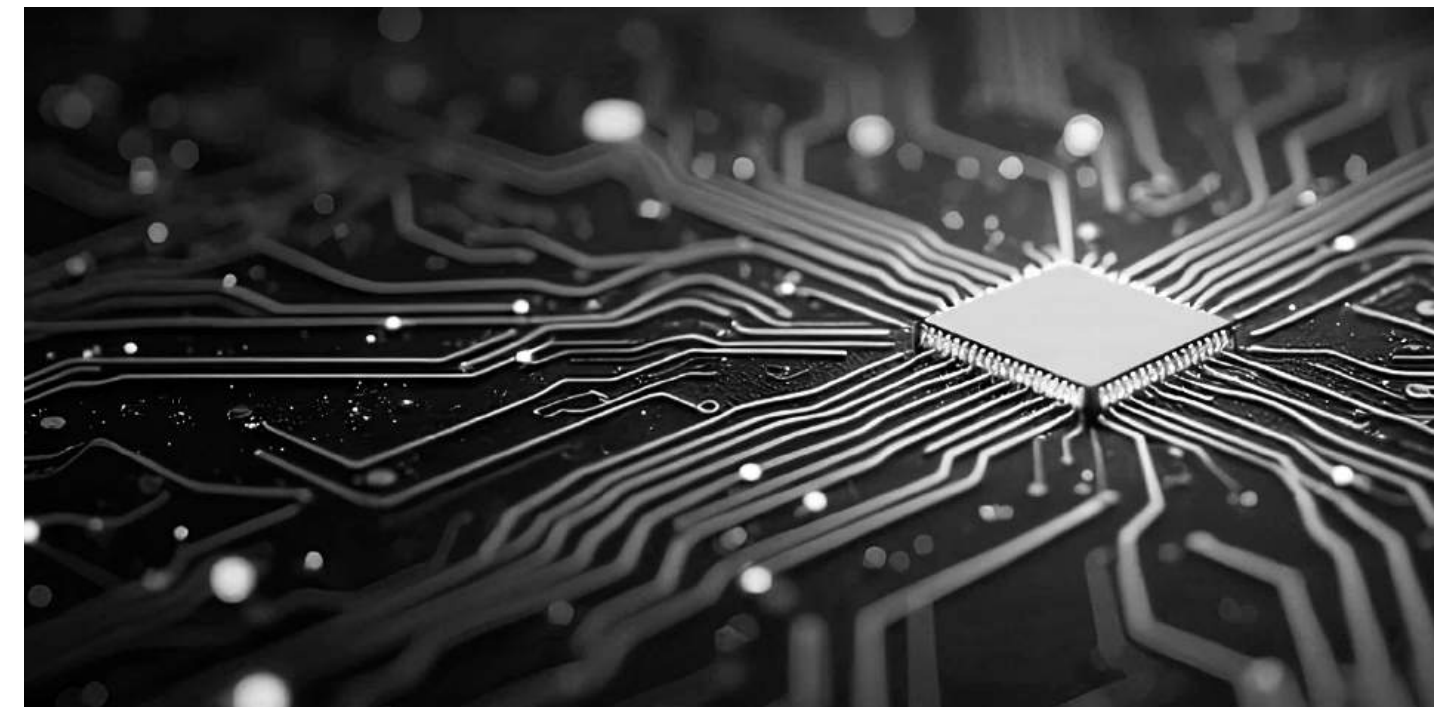




## WHERE HAVE WE BEEN

### How 2025 Tested Markets Without Breaking Them

- **Markets absorbed significant policy and political shock without breaking**, as tariff uncertainty, regulatory shifts, and geopolitical noise failed to derail growth or risk assets.
- **Resilience was real but uneven**, with AI-driven investment supporting markets while households faced rising costs and deteriorating affordability.
- **Volatility fell despite elevated uncertainty**, showing investors learned to live with disruption rather than demand resolution.



## WHERE ARE WE NOW

### Living With a K-Shaped Economy

- **The economy has settled into a pronounced K-shaped structure**, benefiting asset holders and large corporations, while lower-income households and younger workers face weaker labour market conditions.
- **AI is a double-edged driver**, boosting productivity and margins, while reducing hiring and widening labour-market divergence.
- **Policy has turned accommodative despite inflation above target**, reflecting fiscal dominance and a willingness to support employment growth at the expense of higher long-term inflation risk.



## WHERE ARE WE GOING

### Why 2026 Could Reward Rotation and Broadening

- **Recovery is emerging through rotation**, as extreme market concentration eases and earnings growth is poised to broaden beyond mega-cap leaders.
- **This shift need not be disorderly**, with history showing leadership can rotate through the passage of time and valuation compression rather than a market re-set.
- **Global conditions are turning more supportive**, expanding opportunities beyond U.S. large caps.
- **Bond markets will determine the recovery's durability**, making diversification and balance-sheet discipline essential.

**KEY RISKS WE ARE WATCHING****Conditions That Could Impact Recovery**

- **Positioning is extended and consensus is growing around the broadening recovery thesis.** Near term data disappointments around growth and/or inflation could trigger a market set-back, potentially providing a better entry point.
- **Bond markets are the gatekeeper,** with the 2026 recovery and rotation thesis depending on continued bond-market cooperation amid above-target inflation and rising fiscal dominance.
- **Policy credibility is being tested as an unconventional easing cycle,** growing political influence over central banking, and heavy debt issuance raise the risk of higher term premia and tighter financial conditions.
- **Global funding risks could narrow the window** with the risk of the Yen carry trade unwinding, elevated leverage tied to AI capex, and signals from precious metals suggesting the margin for policy error is thin.



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WHERE HAVE WE BEEN

# HOW 2025 TESTED MARKETS WITHOUT BREAKING THEM

## The Surprisingly Resilient U.S. Economy in 2025

Despite navigating one of the most policy-distorted and politically volatile environments in decades, the U.S. economy in 2025 demonstrated a degree of resilience that surprised many investors, including ourselves.

U.S. growth remained positive even as households faced rising prices and worsening employment prospects, firms absorbed tariff-driven cost pressures, and the Federal Reserve (Fed) operated under increasingly politicized policy constraints.

Notably, the U.S. consumer proved more resilient than expected. Despite elevated inflation, rising borrowing costs, and repeated policy shocks, consumer spending held up, supported by residual pandemic-era balance-

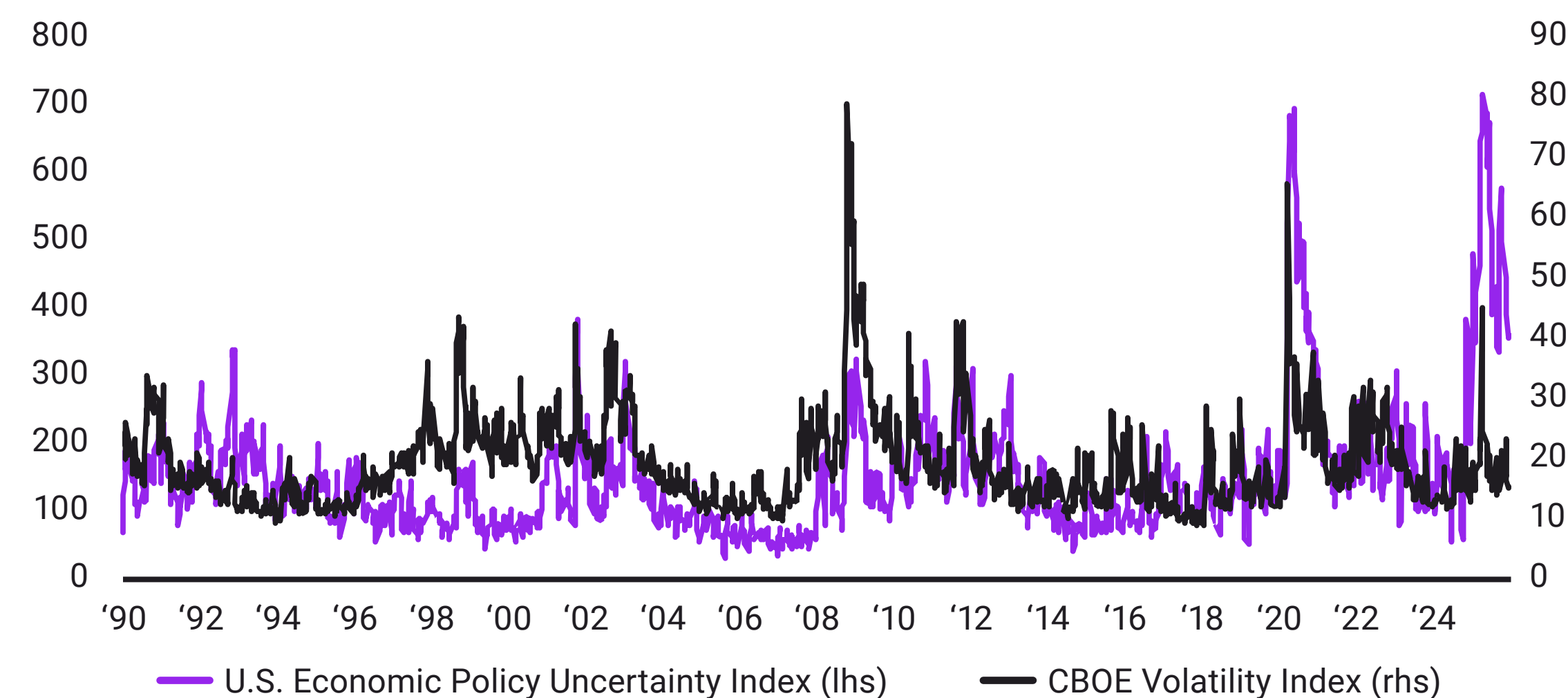
sheet strength and the wealth effects of rising asset prices. This resilience helped prevent a broader economic slowdown, even as underlying pressures intensified.

Equity markets, buoyed by extraordinary AI-driven capital investment, continued climbing even as the real economy displayed pockets of strain, especially among lower-income and lower-skill households. Tariff uncertainty and policy noise remained elevated throughout the year, yet markets grew increasingly indifferent. Investors learned to live with disruption rather than demand clarity.

This divergence between market strength and economic uncertainty became a defining feature of the year.

“  
*Investors learned to live with disruption rather than demand clarity.*  
 ”

**FIGURE 1**  
**Economic Policy Uncertainty Not Reflected In Volatility**



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1990 to Dec 2025.

Even as inflation stubbornly remained around 3%, the Fed embarked on further interest rate cuts in a nod to a deteriorating labour market backdrop. The result was an environment where policy was *loosening at the margin* but remained tight in real terms for most households. With mortgage rates still elevated, refinancing channels largely closed, and credit becoming more expensive, the transmission of Fed policy provided far less support to lower end consumers than desired.

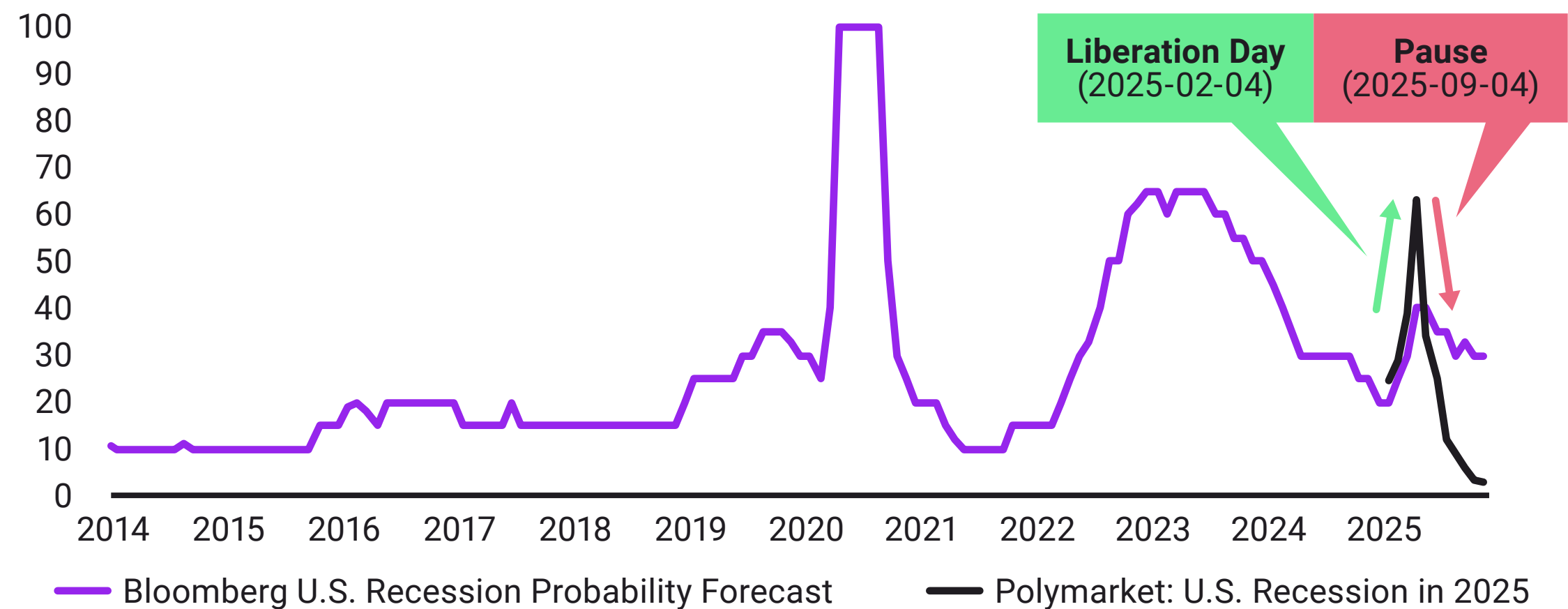
While policy shocks, particularly around trade, initially unsettled markets and briefly pushed recession probabilities higher, those fears proved short-lived.

U.S. GDP growth was solid but was increasingly being carried by corporate investment rather than household spending.

Strong corporate earnings (especially in most of the Magnificent 7 companies) buoyed equity markets in the U.S., while a recovery thesis took hold in the Rest of World (ROW) economies.

Volatility receded even as uncertainty persisted, reinforcing the market's willingness to look through disruption rather than price in deterioration. "Dip buying" from retail investors remained in full force as the year progressed.

**FIGURE 2**  
**Post-Liberation Day Recession Odds Spike Then Quickly Retreat**



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2014 to Dec 2025.



“  
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”

WHERE ARE WE NOW

# LIVING WITH A K-SHAPED ECONOMY

## Tariffs, Inflation, and the Consumer Squeeze

The contradiction between macro resilience and micro-level strain has become the defining feature of the current economic cycle. Households, especially those in the lower half of the income distribution, continue to struggle with elevated prices, rising debt burdens, and affordability challenges. Tariffs acted as a direct tax on consumers and businesses, pushing core goods inflation higher and eroding real purchasing power. This added to a cost-of-living squeeze, particularly for lower-income households who spend a larger share of income on goods. Even modest inflation compounded years of earlier price pressures, leaving essentials such as food, energy, and housing significantly more expensive than pre-pandemic norms.

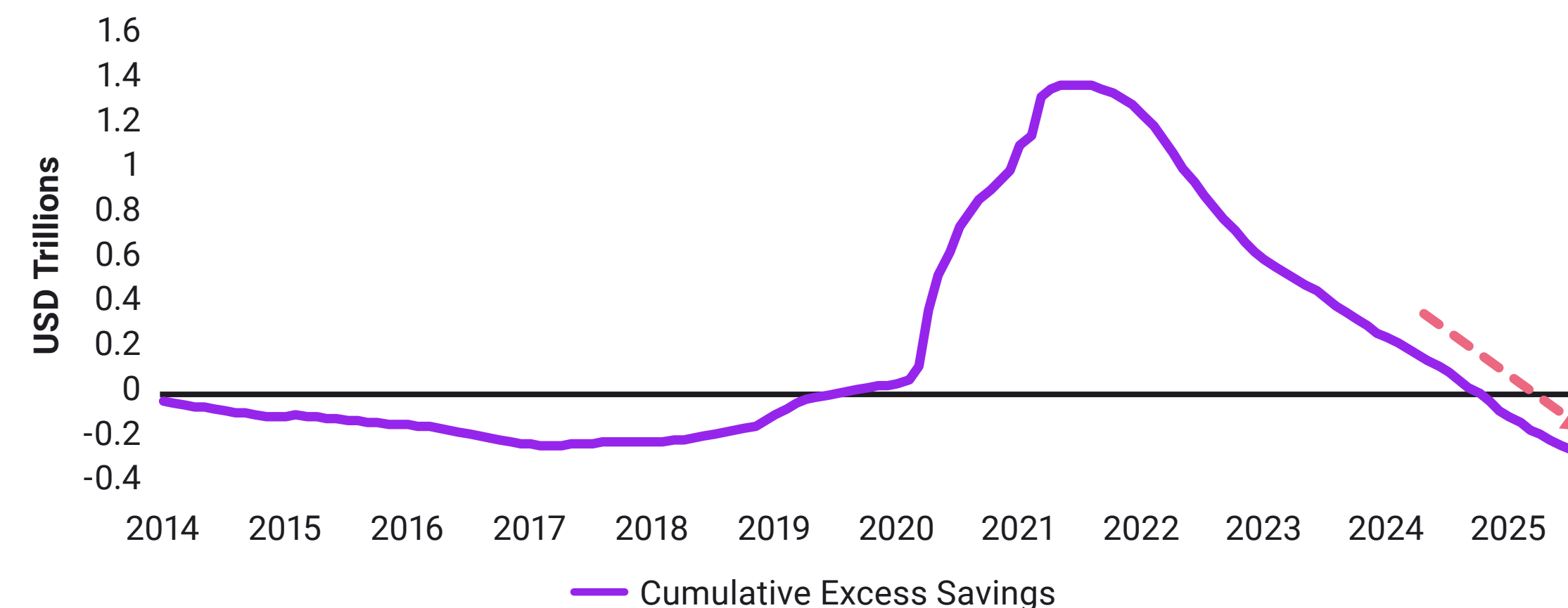
Indicators such as negative real disposable income growth, rising credit-card delinquencies, and the exhaustion of post-pandemic savings

showed that the consumer, traditionally the engine of U.S. growth, was increasingly strained beneath the surface.

## A K-Shaped Economy Takes Hold

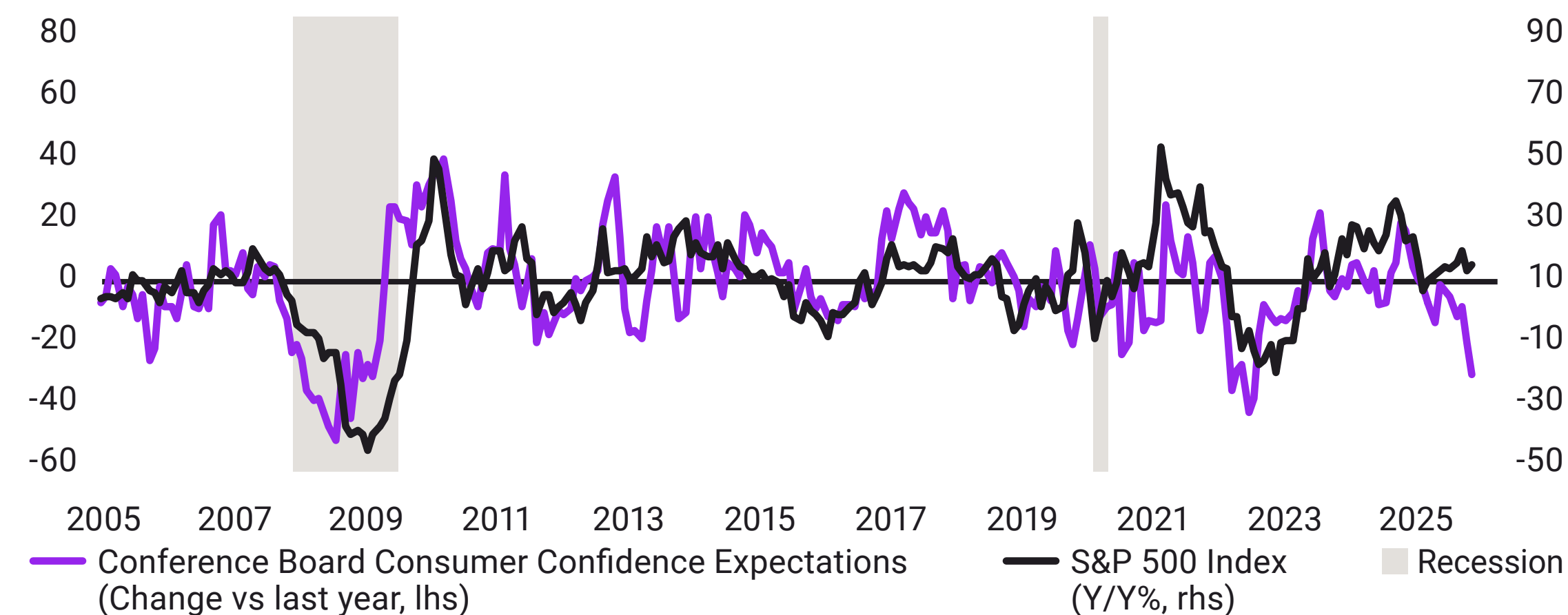
Despite deteriorating prospects for many lower-income households, the U.S. economy has avoided recession on the back of wealth effects buoying higher end consumption, strong corporate earnings and soaring AI capital spending. Asset owners continued to benefit from surging equity markets and significant new wealth has been created in AI related companies. A new form of K-shaped economy has taken hold, and its consequences are shaping policy, markets, and investor positioning as we move into 2026. The S&P500 Index continued to reach new highs throughout the year despite consumer sentiment plummeting lower, which helps to summarize this K-Shape phenomenon.

FIGURE 3  
Excess Savings Reach Decade Low



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2014 to Sep 2025.

FIGURE 4  
Divergence in Consumer Sentiment and Stock Market



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2005 to Dec 2025.

This divergence helps to explain why the Fed is easing monetary policy even as inflation remains above its 2% target.

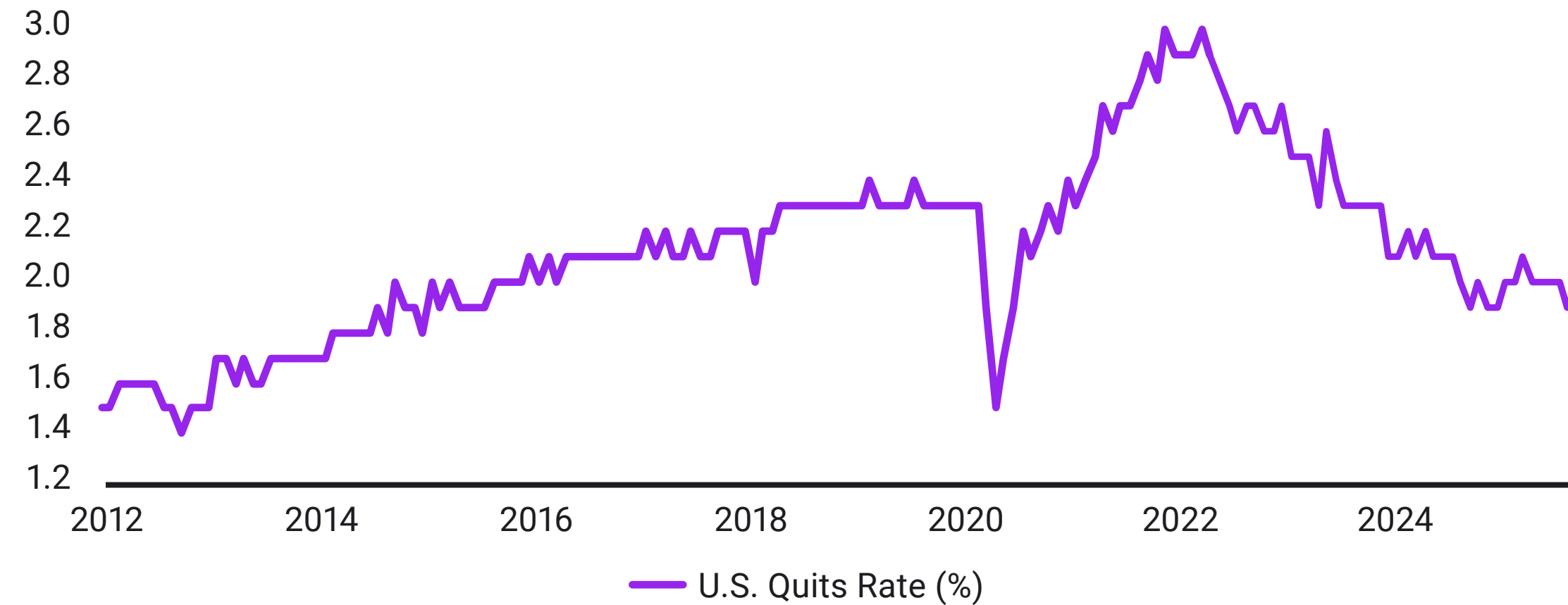
Over the past year, more than one million job cuts were announced, alongside limited hiring and growing difficulty finding replacement work.

Reduced job churn, fewer outside opportunities, and moderating wage pressure suggest the job-market dynamics that empowered workers during the COVID era have flipped.

These are symptoms historically associated with recessionary periods and the Fed is paying increased attention to this.

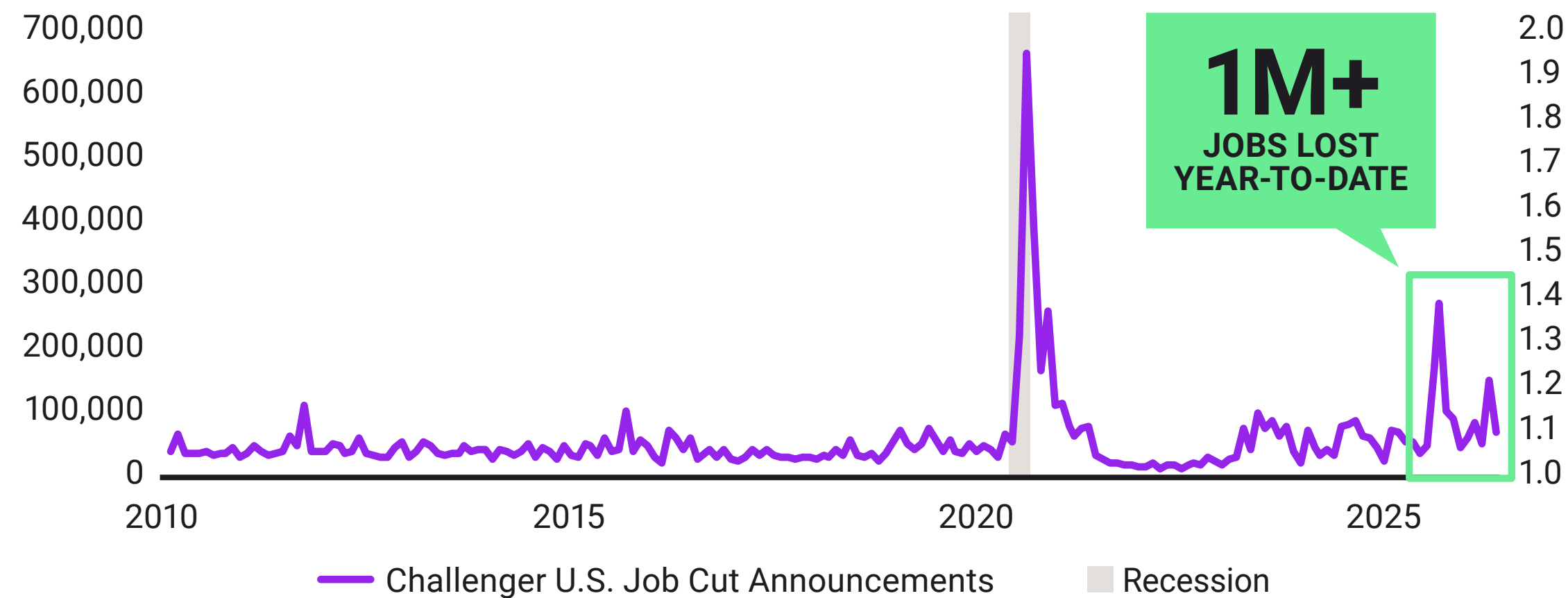
“  
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 ”

**FIGURE 5**  
**Fewer U.S. Workers Are Quitting as the Labour Market Shifts Gears**



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2012 to Oct 2025.

**FIGURE 6**  
**U.S. Job Cuts Highest Since the Pandemic**

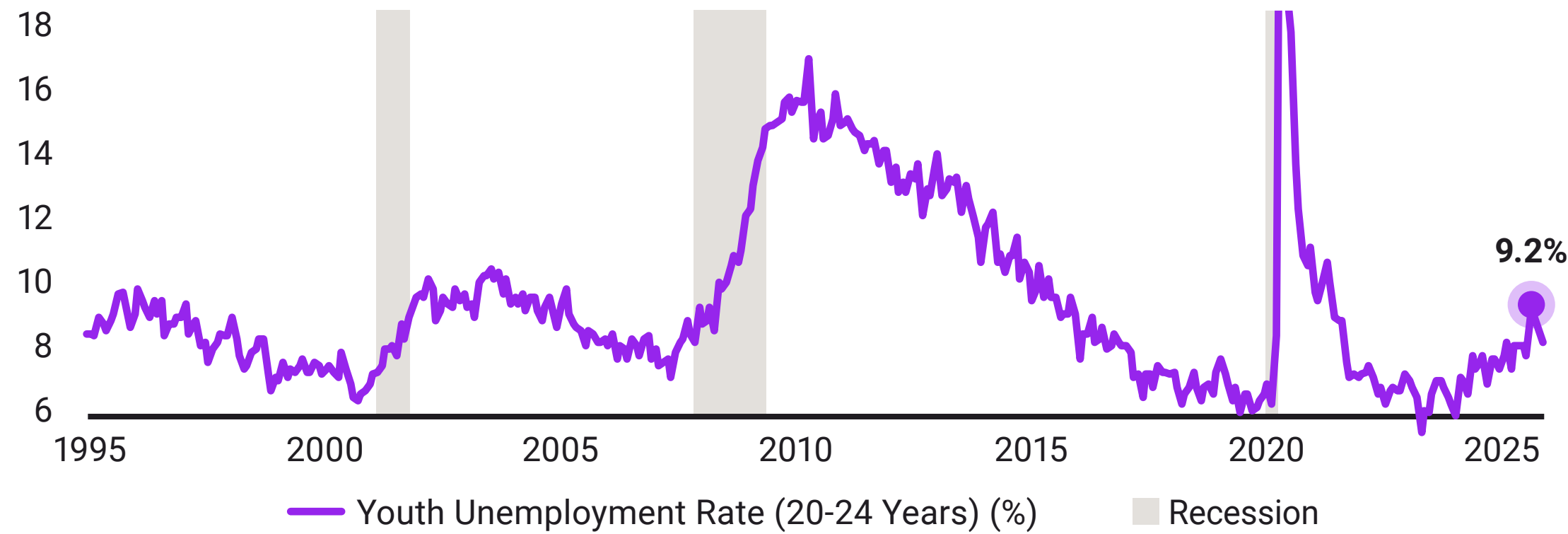


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2010 to Nov 2025.



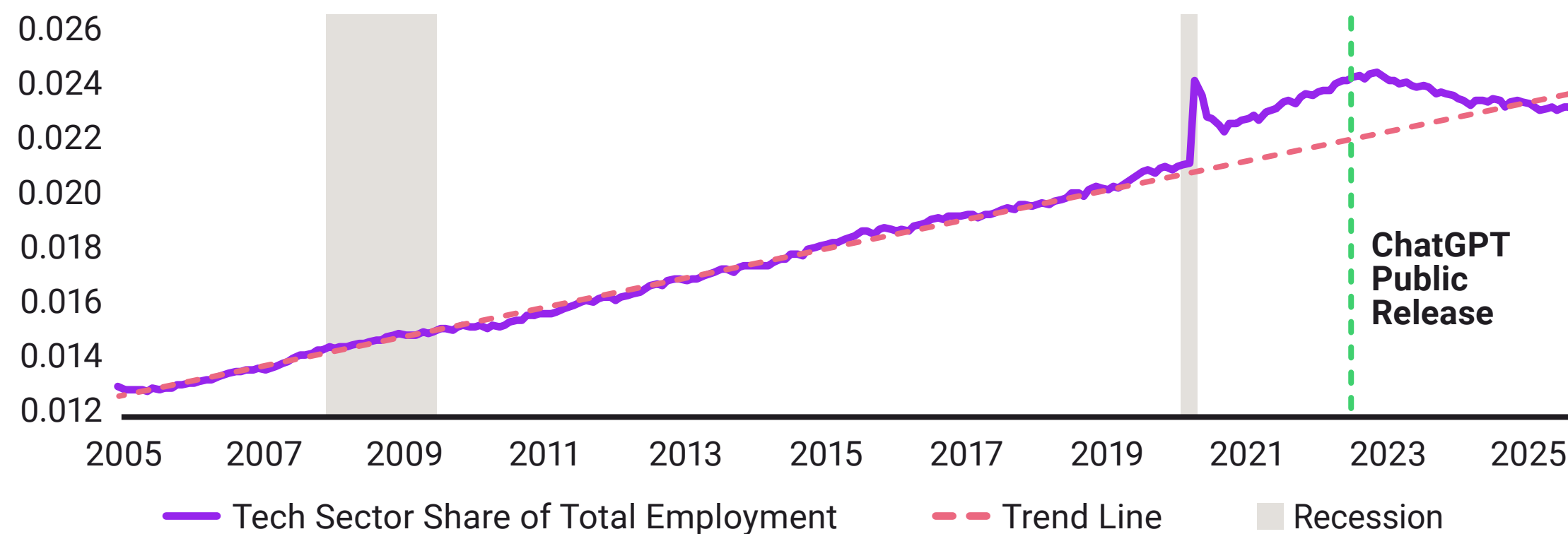
In a sign of the new AI era we live in, youth unemployment, particularly in tech and entry-level IT roles, rose to levels typically observed during economic downturns.

**FIGURE 7**  
**Youth Unemployment at the Highest Level in a Decade**



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1995 to Nov 2025.

**FIGURE 8**  
**Tech Sector Workers Are Not Immune to AI’s Impact**



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2005 to Nov 2025.

## The Longer-Term Employment Question

It can be difficult to assess how much of the disruption in the labour market today is directly attributable to AI rather than normalization following the Covid-era hiring spree, but it is worth considering how much AI could disrupt the existing job market.

As Howard Marks recently wrote:

“

*AI is likely to replace large numbers of entry-level workers, people who process paper without applying judgment, and junior lawyers who scour the lawbooks for precedents. Maybe even junior investment analysts who create spreadsheets and compile presentation materials. It’s said that AI can read an MRI better than the average doctor. Driving is one of the most populous professions in America, and driverless vehicles are already arriving; where will all the people who currently drive taxis, limos, buses, and trucks find jobs?<sup>1</sup>*

”

– Howard Marks, Co-chairman of Oaktree Capital Management

In either scenario the direct economic impact should be a sharp acceleration in GDP due to AI’s ability to increase productivity.

<sup>1</sup> Oaktree Capital, Is It A Bubble?, December 9, 2025.

The outcome of the AI revolution has two diverging outlooks. The more positive view, informed by previous large scale technological advancement, promises that the AI age will bring about many types of new jobs that we can’t imagine today. The more concerning view is that AI will fundamentally change the employment landscape by making many jobs redundant across a variety of industries.

Even this positive outcome still creates a conundrum: if that increase in productivity materializes can the employment market keep pace to ensure there is enough demand to meet this increase in supply?

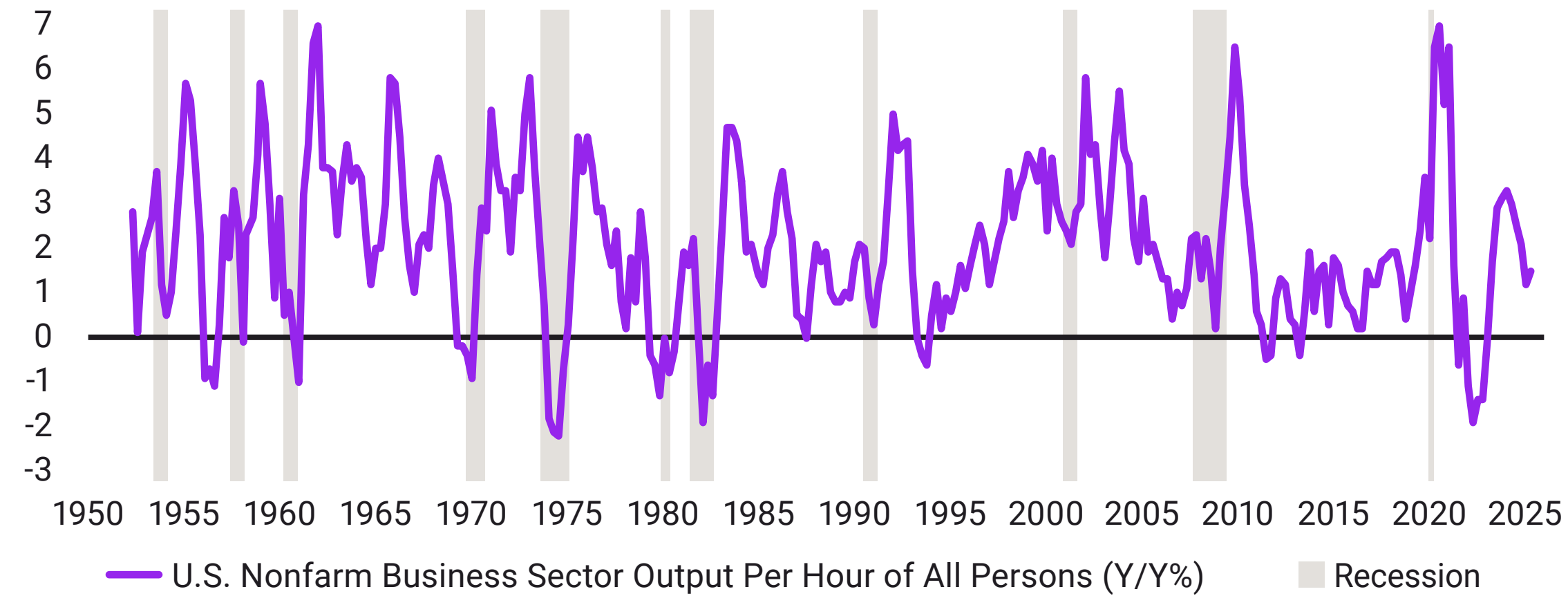
## Early Signs That Productivity Gains Are Impacting Hiring

Despite labour-market pressures weighing on sentiment and spending in the lower-income cohorts especially, there are early signs of improved productivity growth which might be contributing to continued earnings resilience and buoyant stock markets, especially in the U.S.

Productivity gains tend to accelerate when employment weakens, as companies streamline operations, deploy automation, and produce equal or greater output with fewer workers. Historically, these productivity spikes often occur around downturns, when firms prioritize efficiency. These dynamics have been amplified by AI-related technologies expanding beyond white-collar roles into warehousing, logistics, and manufacturing. A small but discernible increase has appeared recently in U.S. productivity measures.

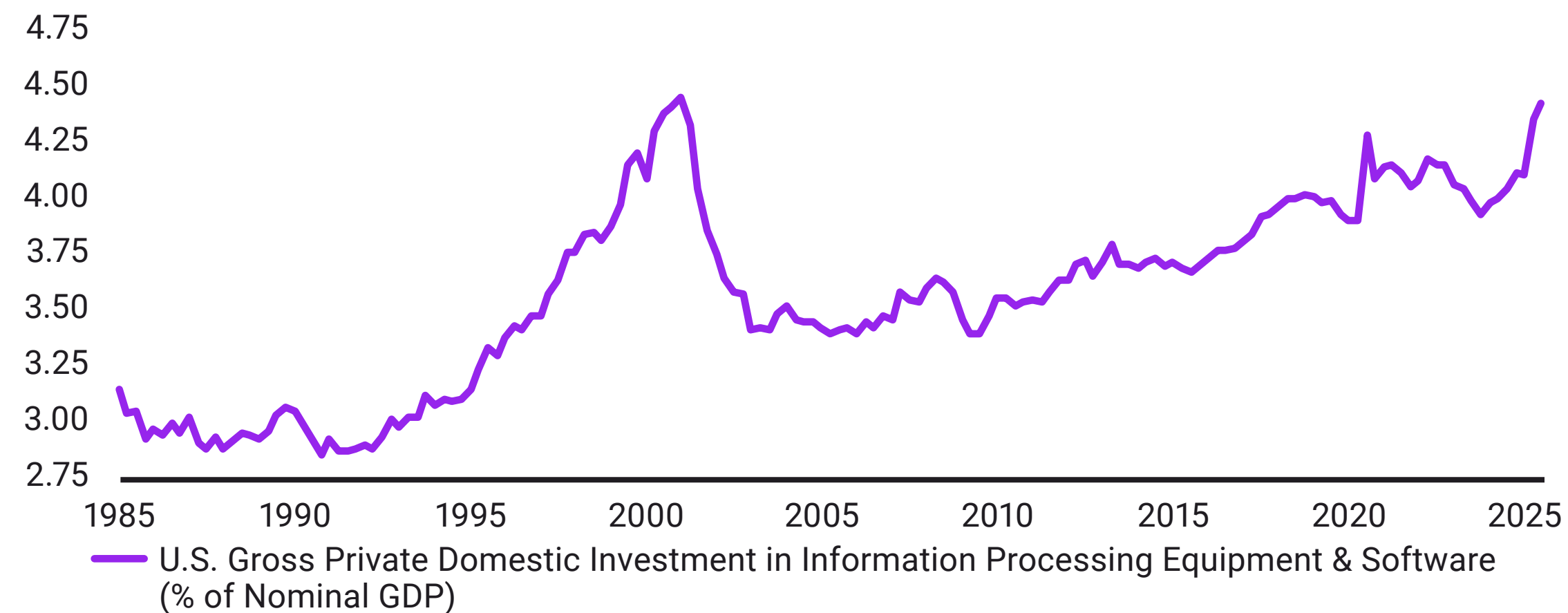
U.S. corporate earnings remained resilient, supported by margin expansion and early signs of productivity gains. One area where employment growth has remained strong is in large corporations, particularly those tied to AI and data-centre infrastructure. These companies have boosted investment capex considerably while continuing to deliver strong profits.

**FIGURE 9**  
**Productivity Growth Remains Positive**

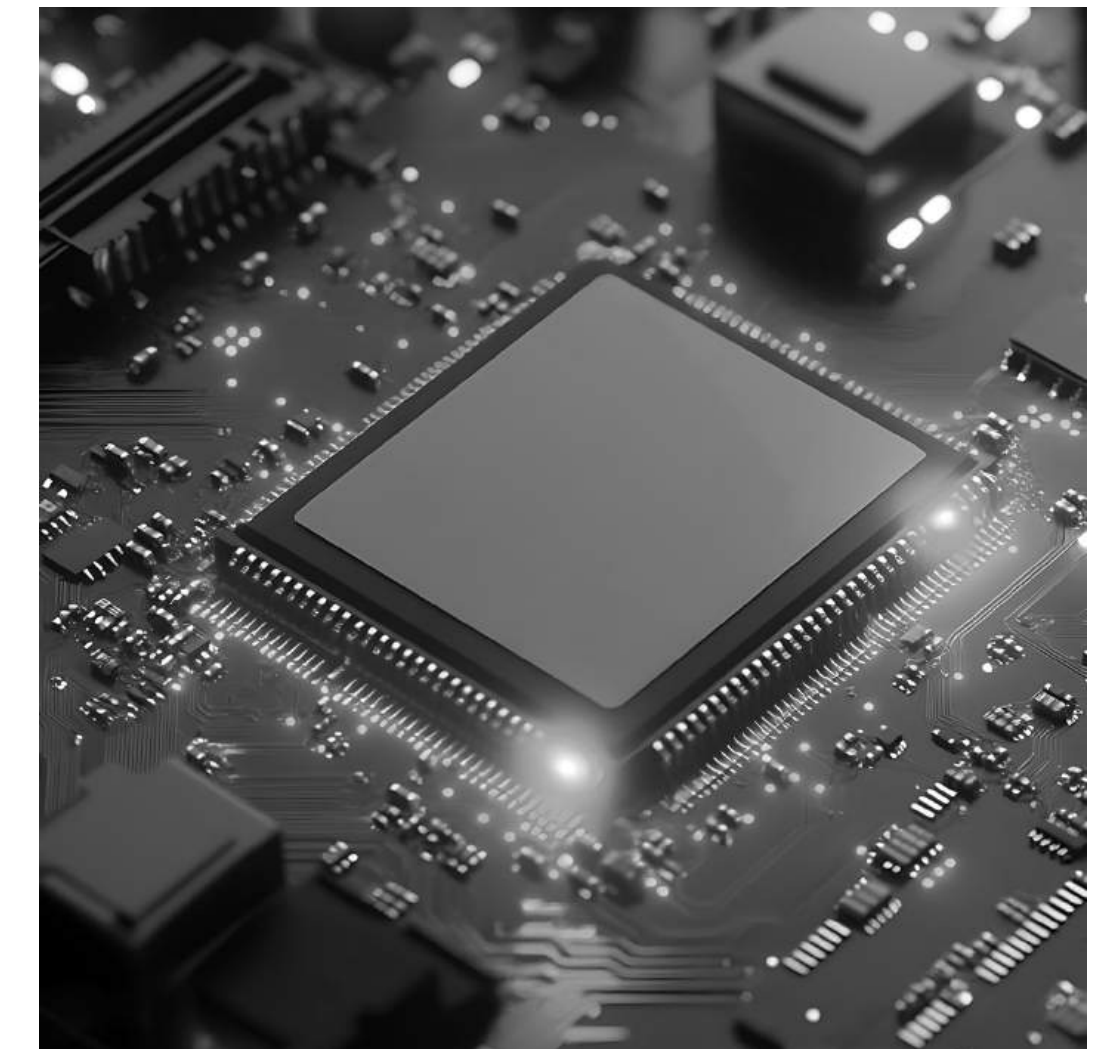


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Q1 1950 to Q2 2025.

**FIGURE 10**  
**U.S. Companies Increase Spending**



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Q1 1985 to Q2 2025.



“  
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WHERE ARE WE GOING

# WHY 2026 SHOULD REWARD ROTATION AND BROADENING

## The Cyclical Rotation Base Case for 2026: A Shift in the Macro Backdrop

The Federal Reserve’s increasingly accommodative stance reflects the reality of the K-shaped economy. Policymakers are cutting rates even though inflation remains above target because labour-market pressures are worsening and are concentrated among more vulnerable segments of the workforce.

AI adoption introduces new job-displacement risks the Fed may also be seeking to cushion, while political pressure to support employment ahead of an election year continues to rise.

At the same time, the global economy is showing signs of broadening recovery. Major central banks have been easing.

Public investment remains robust across the U.S., Europe, and Asia. Emerging markets with favourable demographics are gaining momentum. AI, automation, and clean-energy technologies are pushing a global investment cycle. And fiscal stimulus—particularly the U.S. “One Big Beautiful Bill Act”—is poised to inject substantial liquidity beginning in 2026.

Layered on top of these dynamics is fiscal dominance, the growing need to maintain supportive financial conditions to sustain excessive government borrowing while stabilizing household finances.

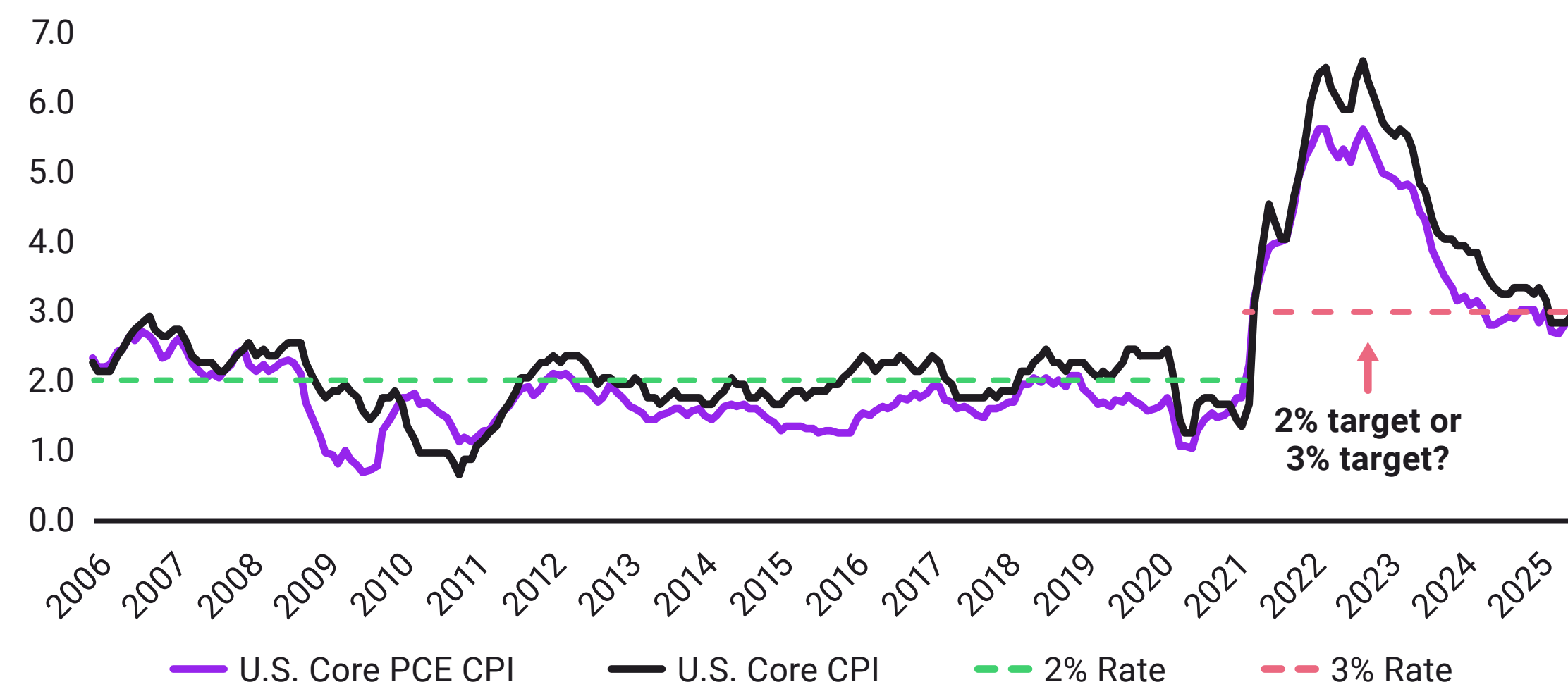
As a result, bond market vigilantes, not the Fed, may determine how long the policy mix of excessive fiscal stimulus and increasing monetary stimulus can persist.

“  
...the global economy is showing signs of *broadening recovery*.  
”

## A More Accommodative Fed Sets the Stage for Growth to Accelerate

We were surprised by the Federal Reserve’s pivot toward accommodation in the second half of 2025 despite inflation remaining stubbornly above 3%. In prior cycles, following the Volker Fed of the early 1980s, policy support would not have arrived until inflation was more clearly under control.

FIGURE 11  
Sticky Inflation Remains Well Above the 2% Target



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1, 2006 to Sep 30, 2025. Personal Consumption Expenditures (PCE). Consumer Price Index (CPI).

The decision to cut rates under these conditions marks a clear departure from past frameworks where controlling inflation was of paramount concern. Instead, labour market stress, debt servicing ability and perhaps even political realities seem to be increasingly shaping policy.

This accommodative tilt is expected to provide near-term support to the real economy in 2026 in a number of ways:

**Households**

Receive modest relief on debt-servicing costs and incremental support for housing affordability.

**Businesses**

Benefit from a lower cost of capital just as AI-related and industrial-rebuilding investment cycles accelerate.

**Markets**

Reduced recession risk at the margin, reinforcing confidence even as real policy remains restrictive for many consumers.

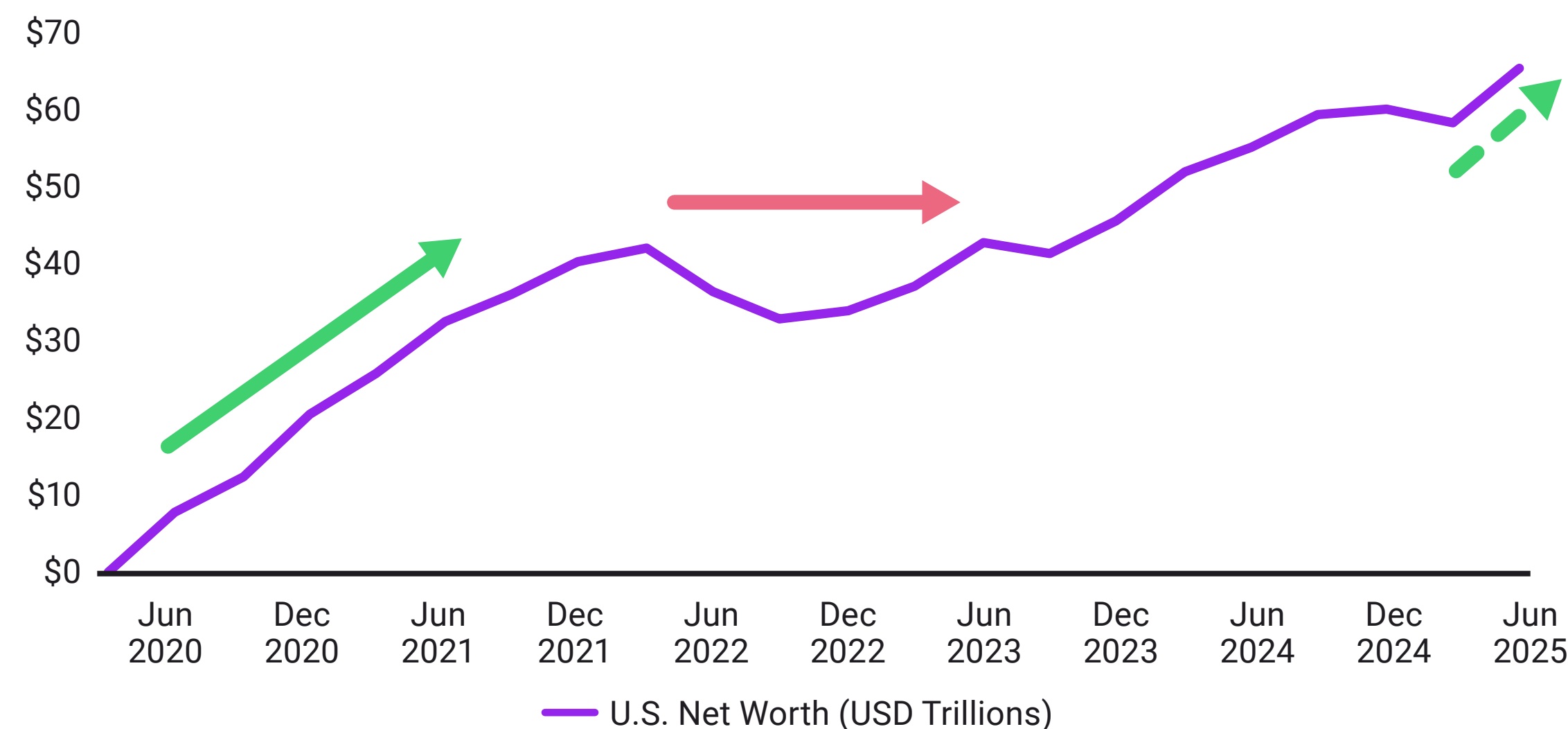
**Fiscal Policy: Stimulus Without Recession**

Fiscal policy is reinforcing this accommodative backdrop. The “One Big Beautiful Bill Act” (OBBBA) represents a large-scale, multi-year stimulus package expected to materially impact the real economy, particularly once tax refunds begin flowing in the second quarter of 2026.

While the upper end of the K-shaped economy is likely to benefit disproportionately, the combination of fiscal expansion and monetary accommodation gives the U.S. economy powerful policy tailwinds that markets are increasingly pricing into earnings and valuation multiples in 2026.

Equity markets have continued to set new highs, driven by AI-related capex and confidence in policy support. Rising asset values have bolstered household net worth and spending, even as real incomes remain constrained, a dynamic that again favours middle and higher income households.

**FIGURE 12**  
**Rising U.S. Net Worth Fuels the Wealth Effect**



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Q2 2020 to Q2 2025.

“**Rising asset values have bolstered household net worth and spending, even as real incomes remain constrained, a dynamic that again favours middle and higher income households.**”

## An Early-Cycle Recovery?

It seems reasonable to ask why the U.S. should be continuing with such elevated levels of fiscal stimulus outside of a traditional recession? Historically, this type of policy response has followed broad economic contractions.

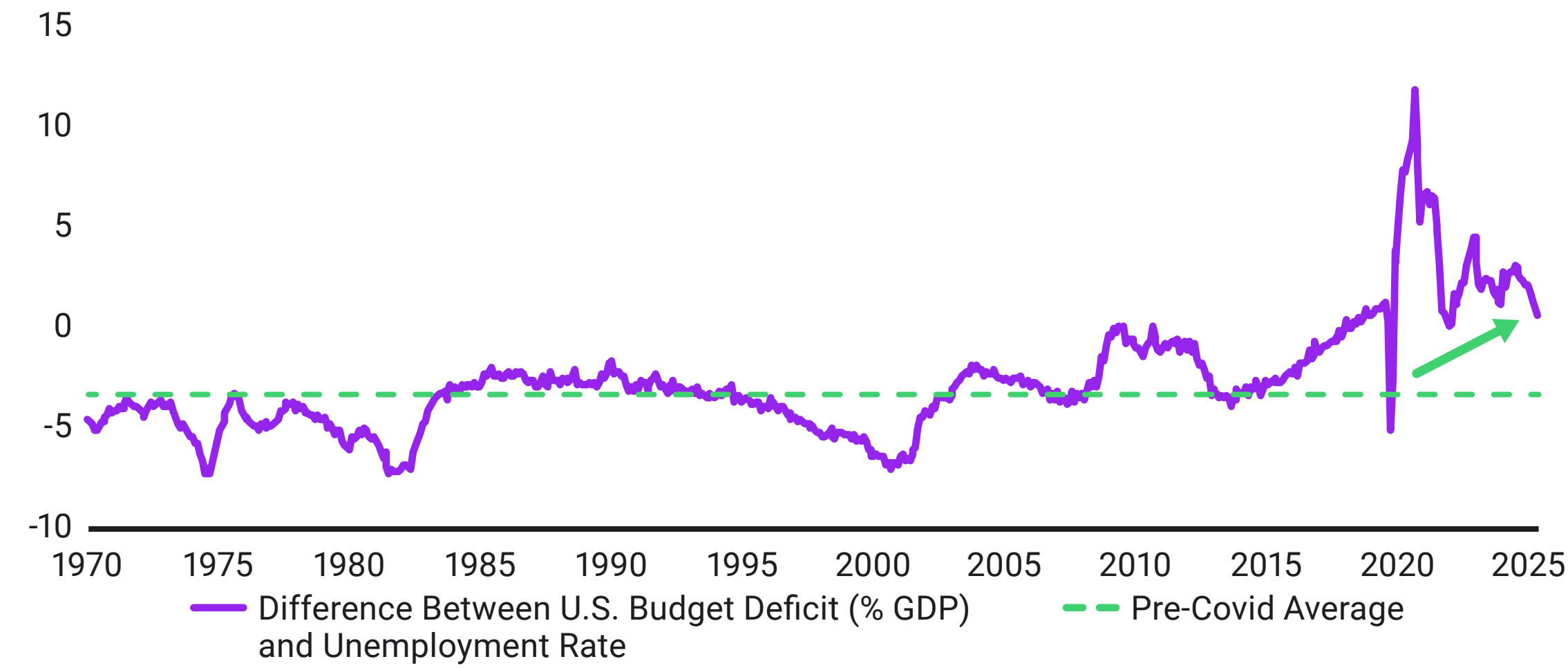
While the U.S. avoided an official recession after the Covid recovery, many parts of the economy did experience recession-like conditions over the past several years.

Morgan Stanley's CIO and Chief U.S. Equity Strategist, Mike Wilson, provides a unique perspective on this with his "early cycle" thesis<sup>2</sup>.

In his view, the U.S. economy has already experienced a "rolling recession" that began in 2022, moving through different sectors like technology, housing, and manufacturing at various times. This "rolling recession" is now nearing its end, with the economy now transitioning into a new early-stage growth cycle (a "rolling recovery").

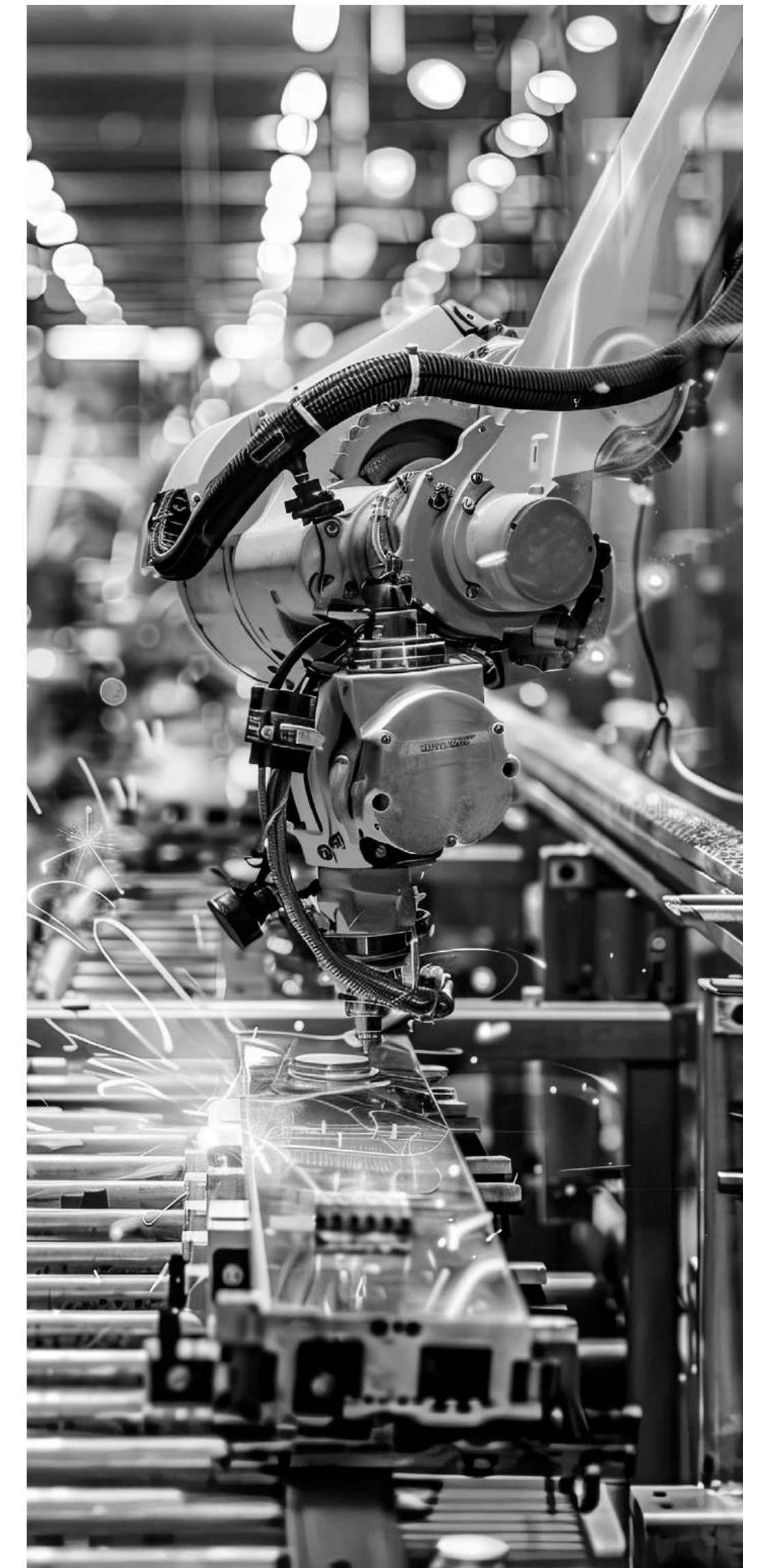
This new phase, in his view, not only justifies current stock valuations but also sets the stage for a new bull market, particularly benefiting previously lagging sectors.

FIGURE 13  
U.S. Deficit Spending Has Increased Despite Low Unemployment



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1970 to Nov 2025.

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*We are inclined to support this thesis given the amount of stimulus that is about to hit the U.S. economy and the opportunity for cyclically lagging industries to recover from their recent doldrums.*  
”



<sup>2</sup> Mike Wilson, 2026 U.S. Outlook: The Bull Market's Underappreciated Narrative, November 19, 2025.

# A MORE SUPPORTIVE GLOBAL ENVIRONMENT: OPPORTUNITIES FOR CONTINUED GROWTH OUTSIDE U.S.

While the U.S. has dominated the global growth narrative in recent years, driven heavily by AI-related investment and strong corporate profitability, non-U.S. developed markets and select emerging markets are gaining relative momentum, with 2026 shaping up to be a more balanced global opportunity set than in recent years. Inflation is gradually normalizing across advanced economies. Public-investment programs remain active in the U.S., Europe, and parts of Asia. Emerging markets, particularly in South and Southeast Asia, continue to benefit from favourable demographics and resilient domestic demand.

Overlaying these trends is accelerating investment in AI, automation, clean energy, and supply-chain reconfiguration, which are contributing to a new global growth cycle. Countries with competitive manufacturing bases—particularly those linked to semi-conductors, batteries, and industrial automation—are seeing rising foreign investment and strengthening export demand.

Commodity-linked economies are benefiting from structural demand driven by the energy transition and data-center buildout, supporting markets such as copper and nickel.

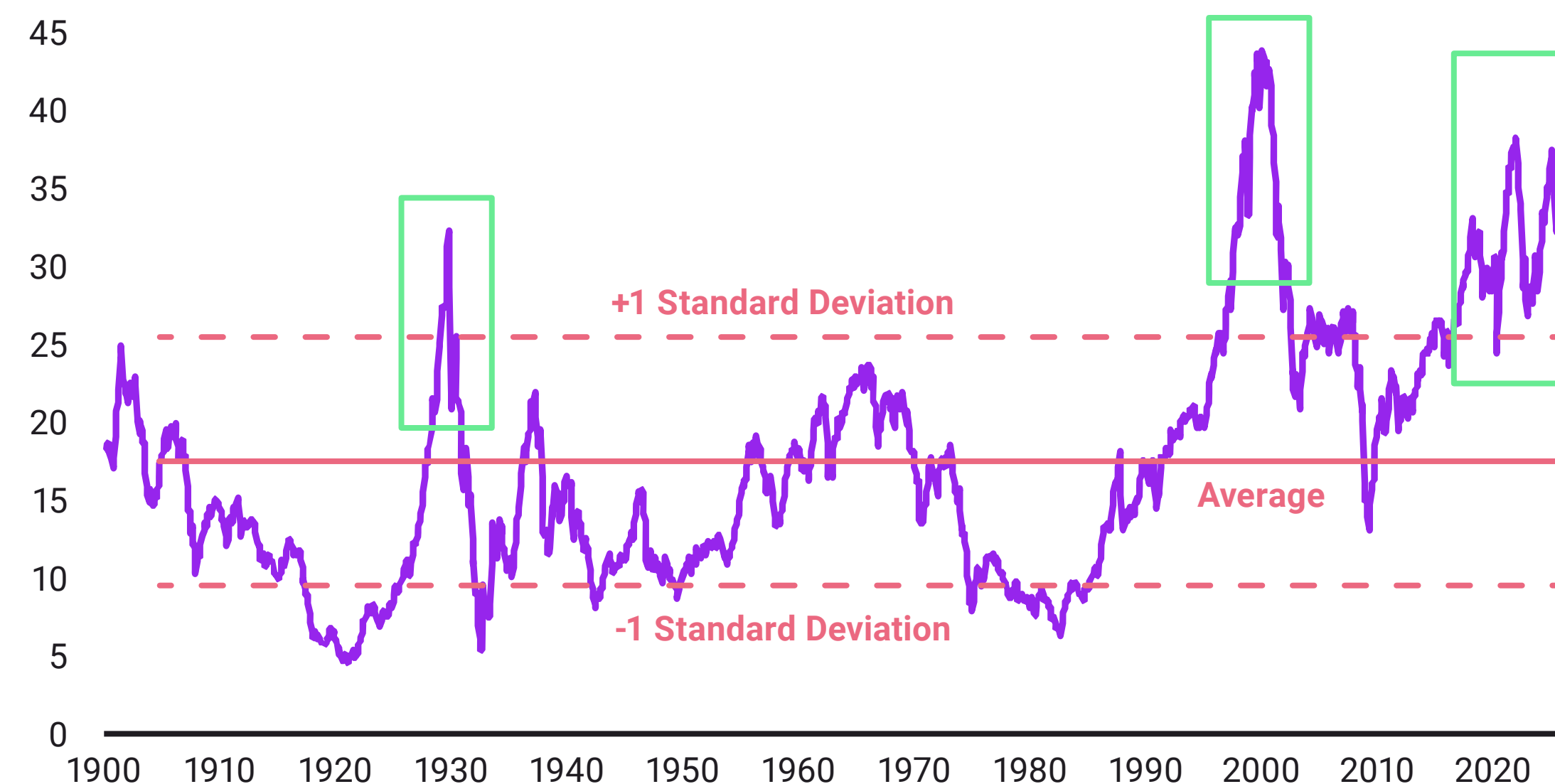
## Market Structure: From Concentration to Rotation

While stock markets around the world were strong in 2025, they also showed signs of internal broadening in strength. This is a welcome development given how narrow market leadership had become, especially as the AI bubble accelerated. In the U.S., valuations across the full index appear elevated, yet this overvaluation is heavily concentrated in the top decile of market-cap leaders.

FIGURE 14

### Valuations Remain Above Historical Norms

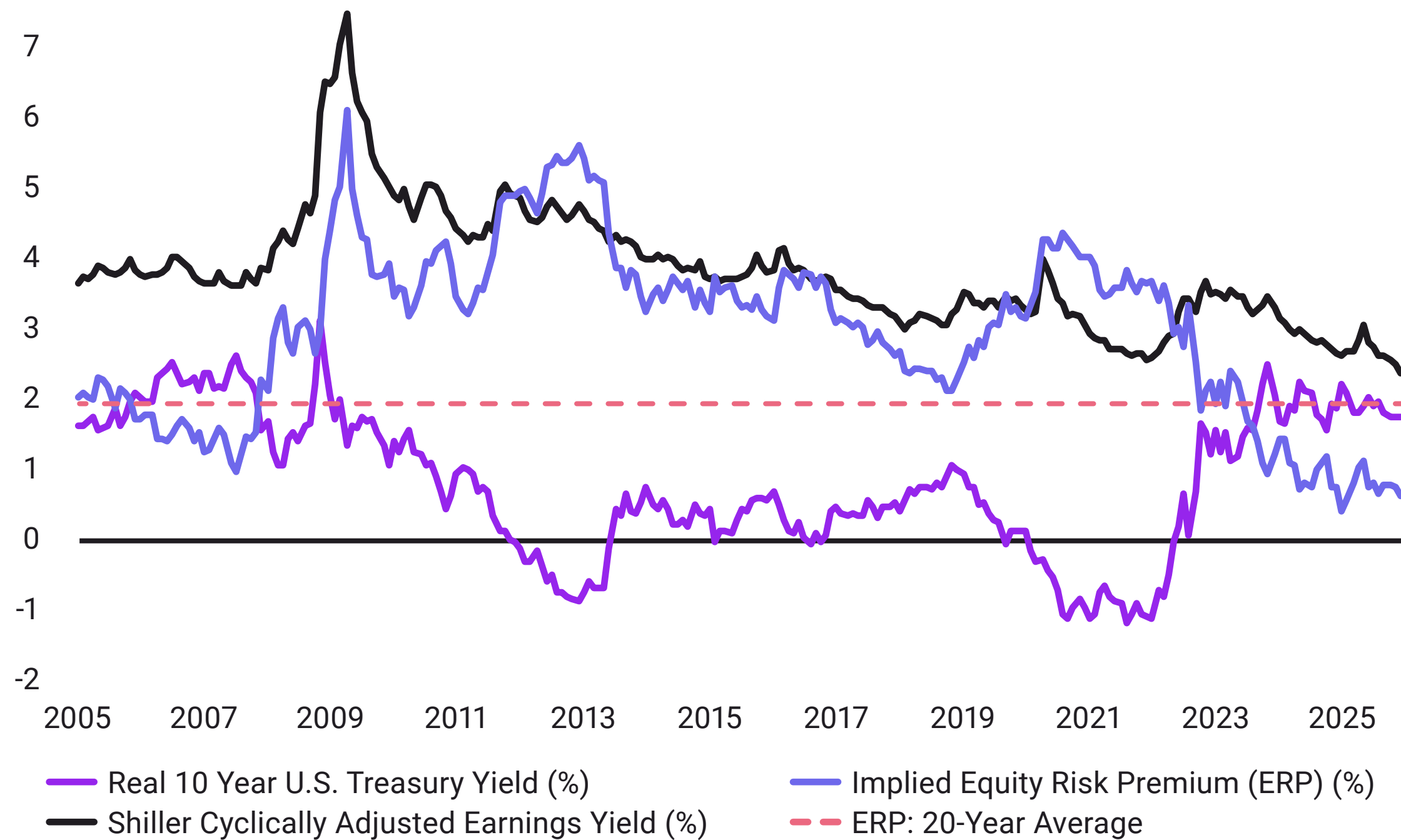
Shiller Cyclically Adjusted Price/Earnings



Source: Robert Shiller, Picton Mahoney Asset Management Research. Jan 1900 to Nov 2025.

When comparing these valuations with bond yields, equity risk premiums remain near multi-decade lows:

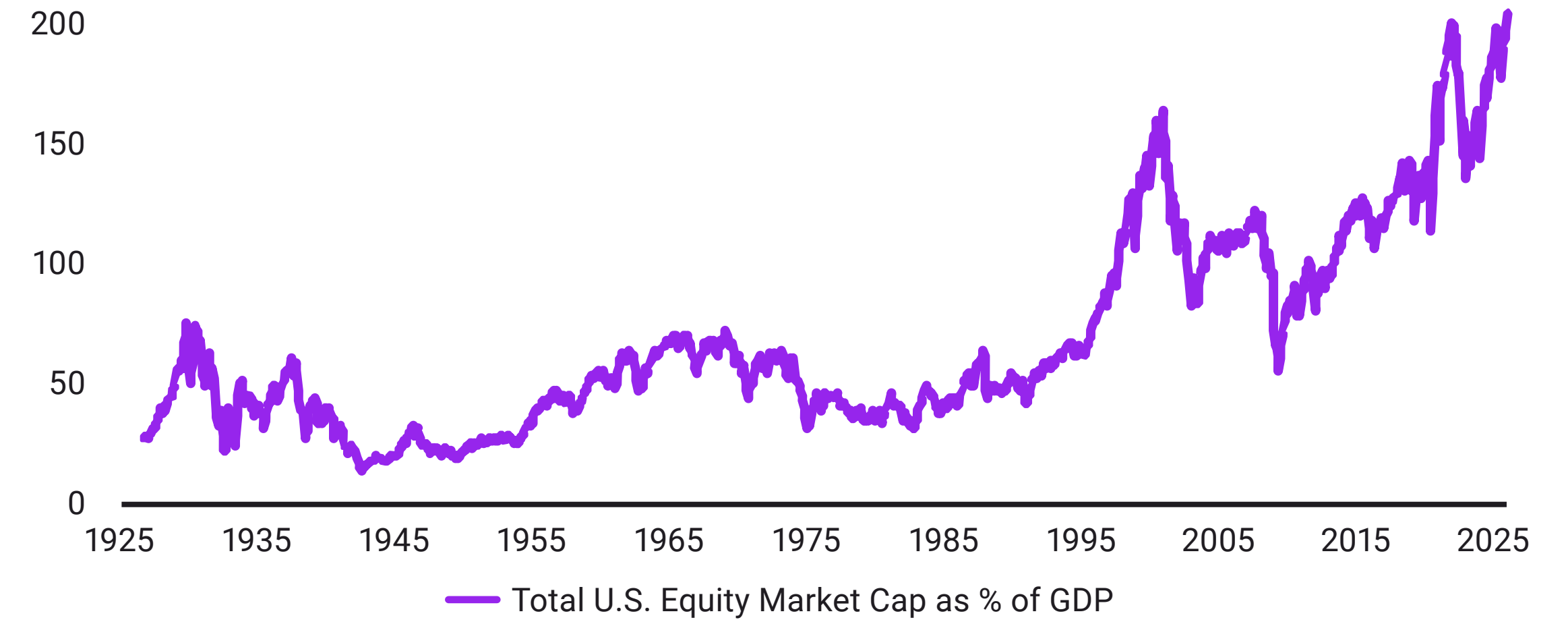
**FIGURE 15**  
**Equity Risk Premium Low Relative to Treasury Yields**



Source: Robert Shiller, Picton Mahoney Asset Management Research. Jan 2005 to Nov 2025.

Another way of showing how elevated the U.S. stock market is to compare its total market capitalization to the size of the overall U.S. economy. This measure is now at a new extreme as well.

**FIGURE 16**  
**Total U.S. Equity Market Cap as % of GDP is at All-Time Highs**

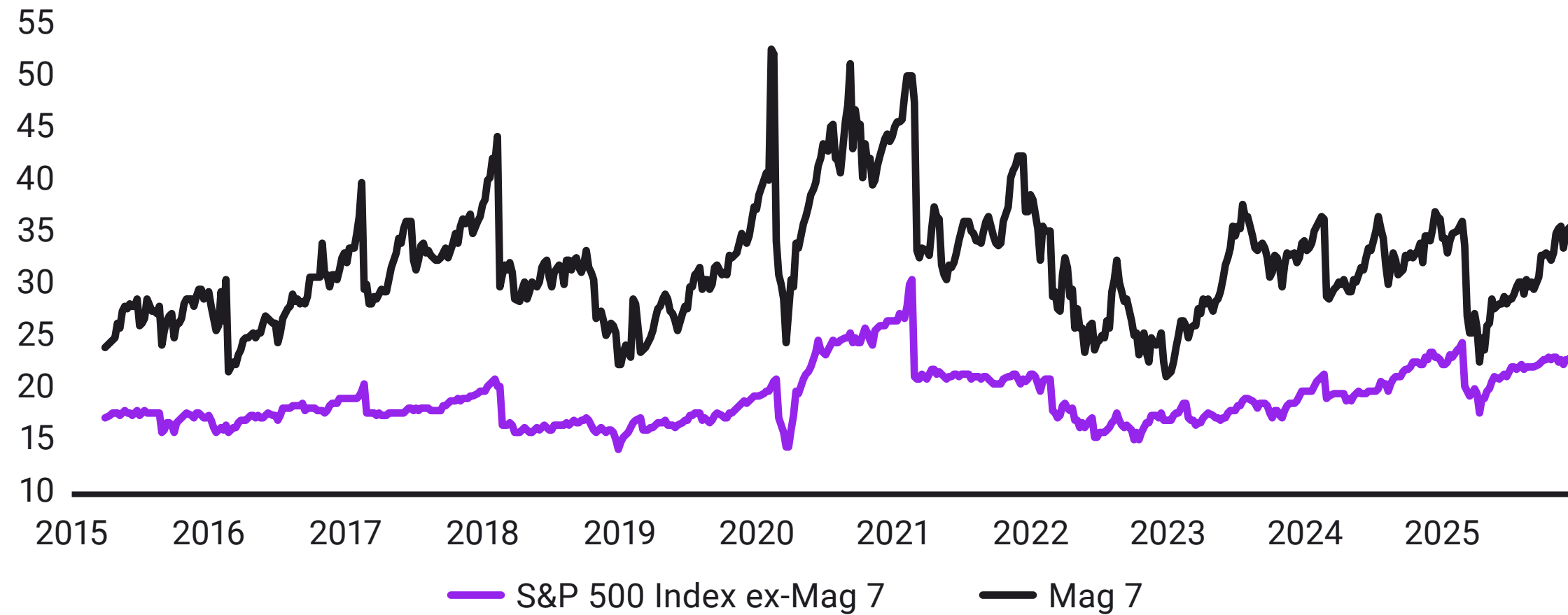


Source: Fama/French Data Library, Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1925 to Oct 2025.

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...non-U.S. developed markets and select emerging markets are gaining relative momentum, with **2026 shaping up to be a more balanced global opportunity set** than in recent years.  
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However, when the high flying “Mag-7” are stripped out, valuations for the rest of the index appear elevated but much more reasonable.

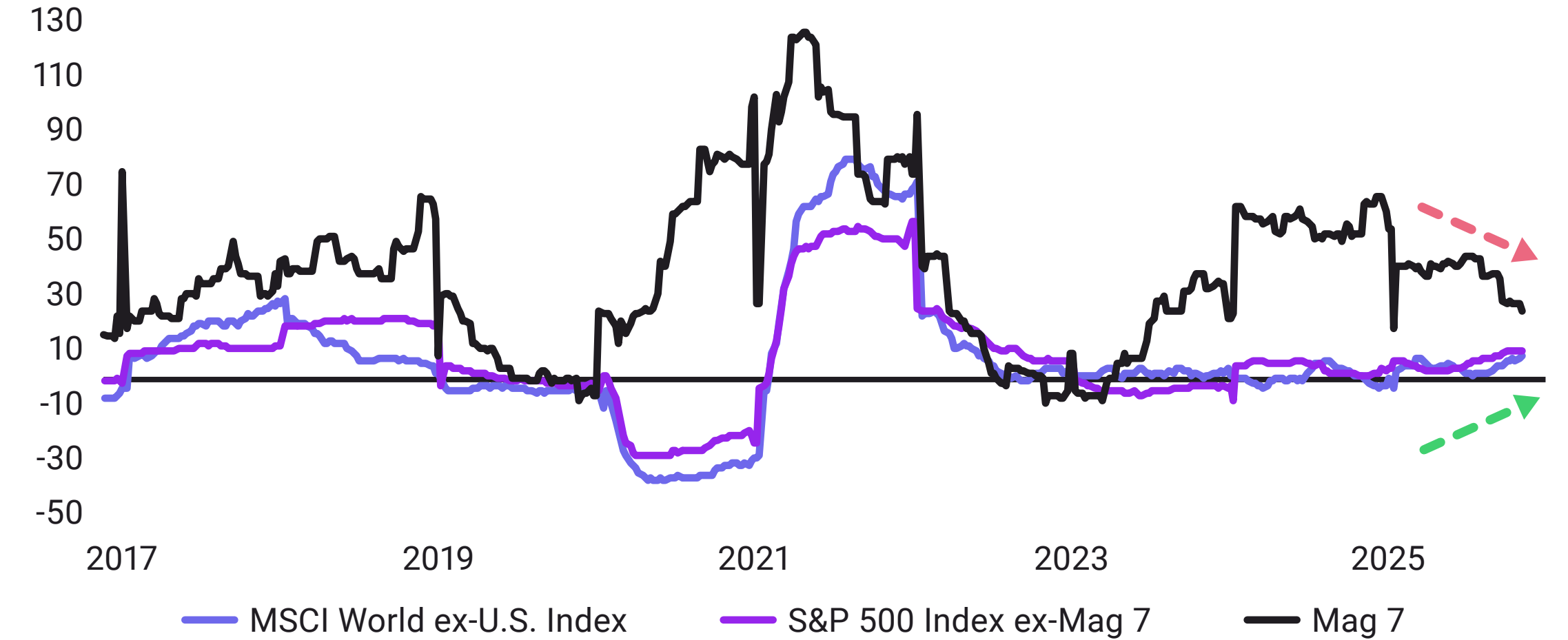
**FIGURE 17**  
**S&P 500 Index Valuations Excluding the Magnificent 7**  
 P/E Ratio (12m Fwd EPS)



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2015 to Dec 2025.  
 The Magnificent Seven (Mag 7) stocks are Apple, Microsoft, Amazon, Alphabet, Meta Platforms, Nvidia, and Tesla.

At the same time, earnings growth forecasts are beginning to improve among previously lagging market segments, while AI-dominated leaders are showing early signs of deceleration.

**FIGURE 18**  
**Room for EPS Growth Outside the Magnificent 7**  
 12m Fwd EPS Growth (Y/Y%)



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2017 to Dec 2025.

“  
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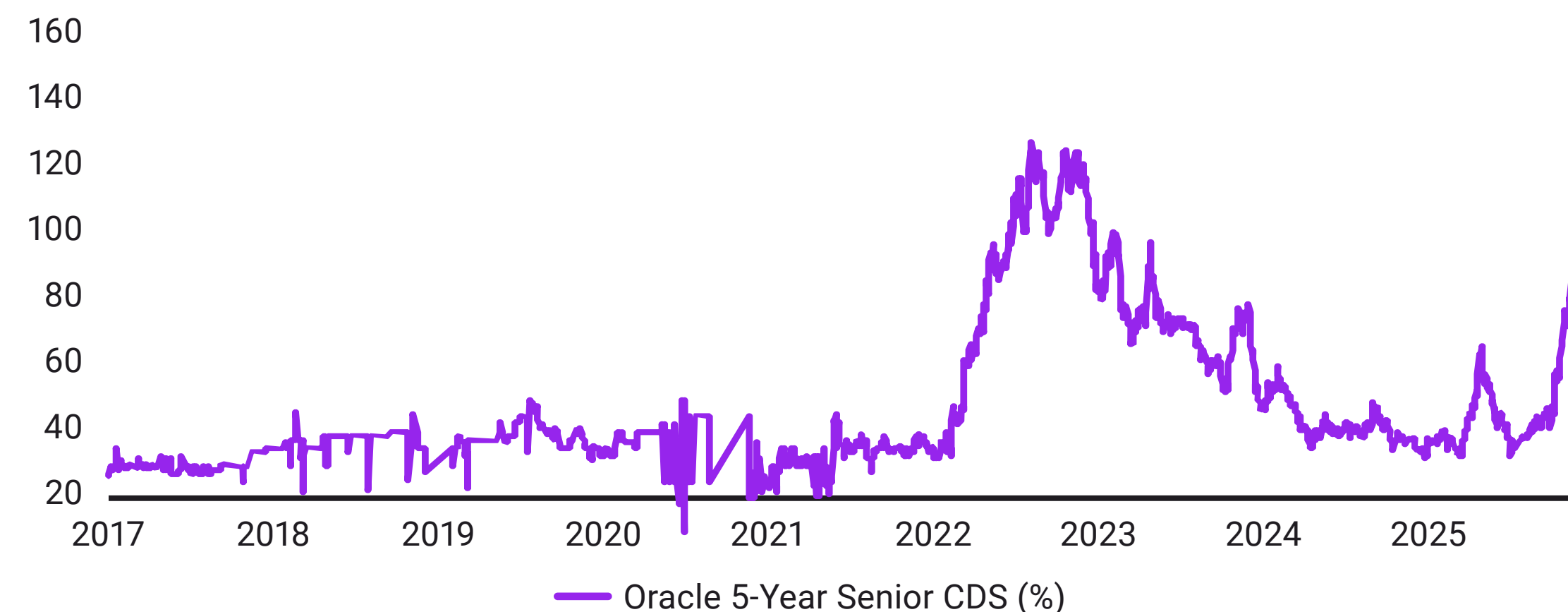
## AI: From Capex Boom to Capital Discipline

One of the most important dynamics shaping the 2026 outlook is the growing potential for rotation away from AI-linked “bubble” areas and toward more traditional cyclical sectors. While AI is likely to be transformational over the long term, the bubble in broad-based AI sentiment appears to have reached a peak in the near term.

New generations of Large Language models (LLMs) are using exponentially more data, compute and power, but are not showing exponential changes in efficacy. It has also become more apparent to the market that the race for AI superiority in the LLM space requires funding by some of the key participants that is larger and more aggressive than markets might be able to absorb. There is now a possibility that the vast amounts of debt required by companies such as OpenAI and other infrastructure related companies could be the Achilles heel for the sector. Hyperscalers and data-centre operators are increasingly tapping credit markets, with spreads widening and signs of investor fatigue emerging.

The recent surge in price for Oracle Credit Default Swaps (CDS) that can be used to insure against a default provides a unique view into this stress.

**FIGURE 19**  
Credit Default Swaps Signal Growing Stress in the AI Trade



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2017 to Dec 2025.

## Credit Markets: Calm, for Now

Credit markets remain largely complacent, with spreads tight outside select high-yield issuers. However, the debt burden required to sustain the AI capex boom (i.e. Oracle’s massive issuance, CoreWeave’s financing pressures, data-center operators stretching balance sheets) poses a structural risk to credit markets.

If the AI build-out fails to deliver timely productivity gains or if revenues lag capex burn rates, credit markets could reprice sharply.

History shows that highly leveraged investment booms tend to end more violently when tightening coincides with elevated debt.

As capital becomes more constrained and selective, the equity investment regime should shift from “growth at any price” to “earnings visibility, capital discipline and balance-sheet sustainability”, an environment that is distinctly less bubble-like than that witnessed over that past couple of years. Within the AI space there is now a greater attempt by investors to discern which companies may be clear winners with questions emerging about the viability of certain business models versus others.



“  
The debt burden required to sustain the AI capex boom **poses a structural risk to credit markets.**

”

We expect that flows could bifurcate significantly, driving some AI related stocks higher at the same time as overall exposure to the broader AI theme begins to fall.

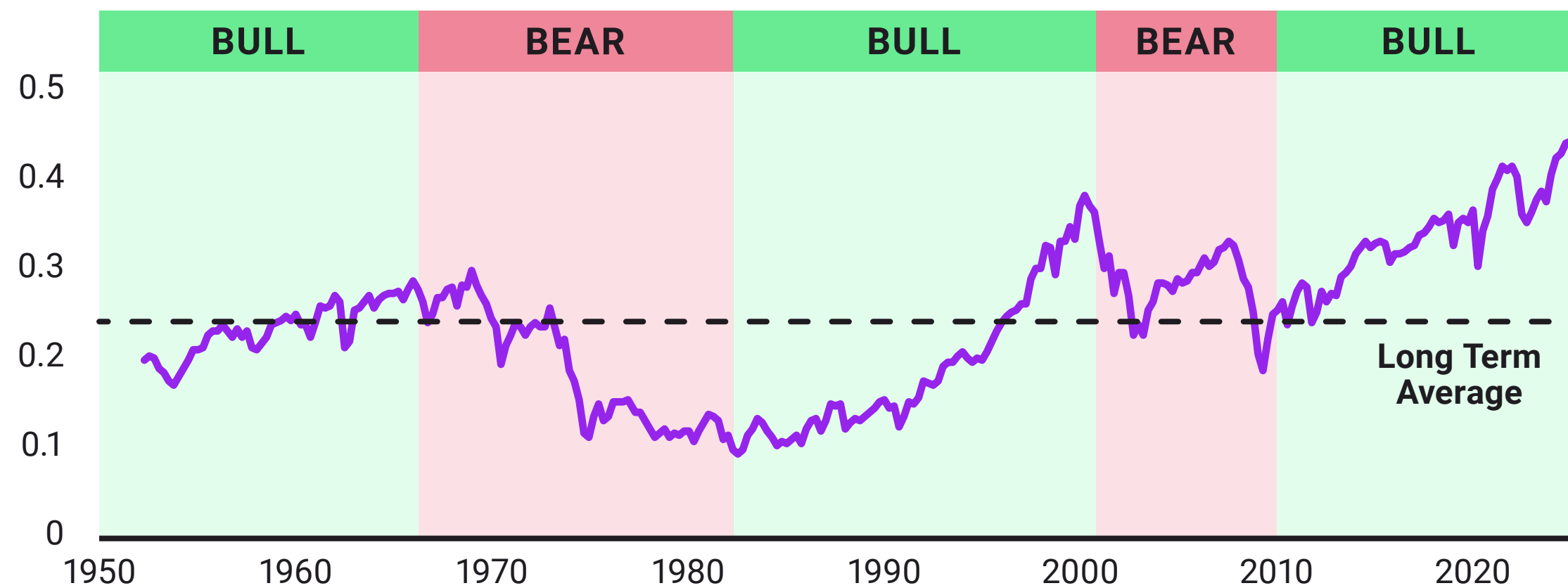
The AI narrative also sent stocks soaring across a number of sectors like semi-conductors, data centers, power generators and even engineering

and construction firms. If investors also rotate out of some of these trades the impact on flows could be even more widespread.

A disorderly market sell-off would be very difficult for U.S. households, who have a record 45% of their financial assets tied up in the equity market, double the long-term average.

**FIGURE 20**  
**U.S. Households Hold an Unprecedented Share of Financial Assets**

U.S. Household Equity Ownership as % of Financial Assets



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Q1 1950 to Q2 2025.

## A Rotation Could Have Exaggerated Impact on Early Cyclical

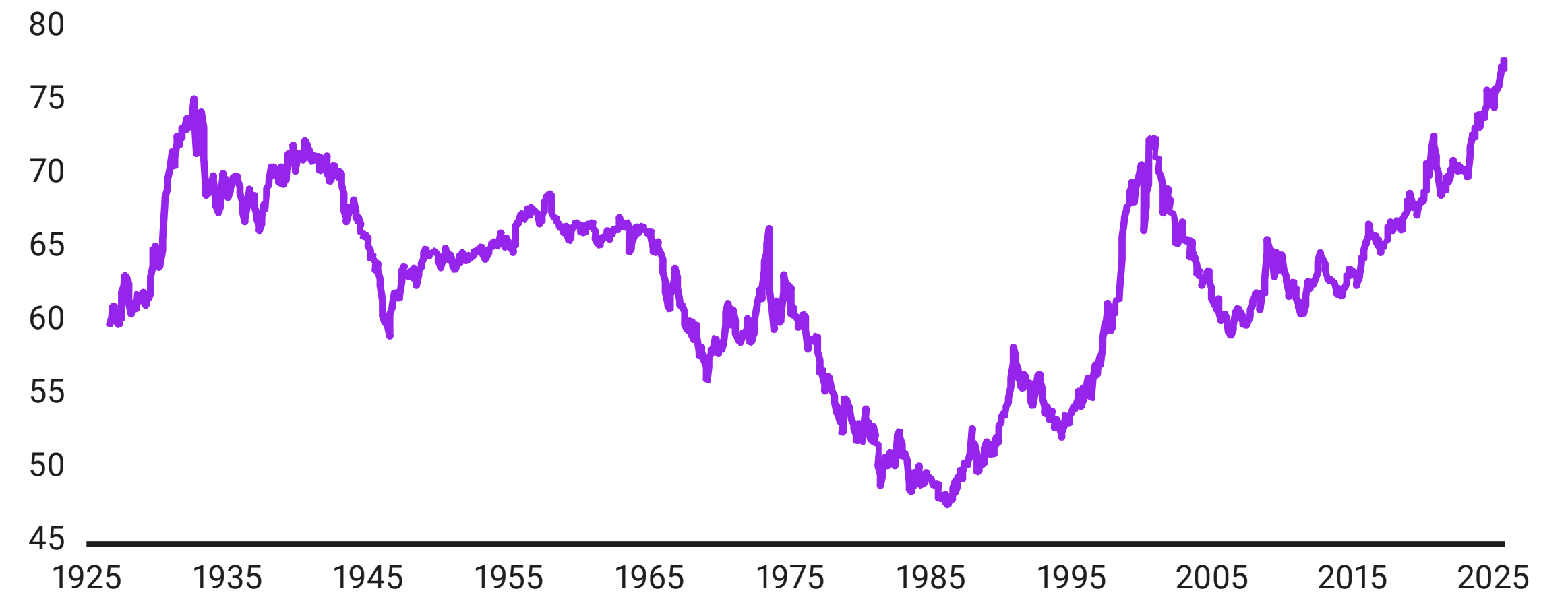
The confluence of improving economic growth combined with a potential deflating AI Bubble creates the conditions for what could be

a very significant rotation from expensive, overcrowded AI beneficiaries toward more attractively valued cyclical names and sectors.

The companies in the top decile of market capitalization are very extended relative to the rest of the stock market.

**FIGURE 21**  
**Extreme Concentration in the Top Decile of Market Capitalization**

Fama-French Size Factor - Top Decile Market Cap as % of Total



Source: Fama/French Data Library, Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1925 to Oct 2025.

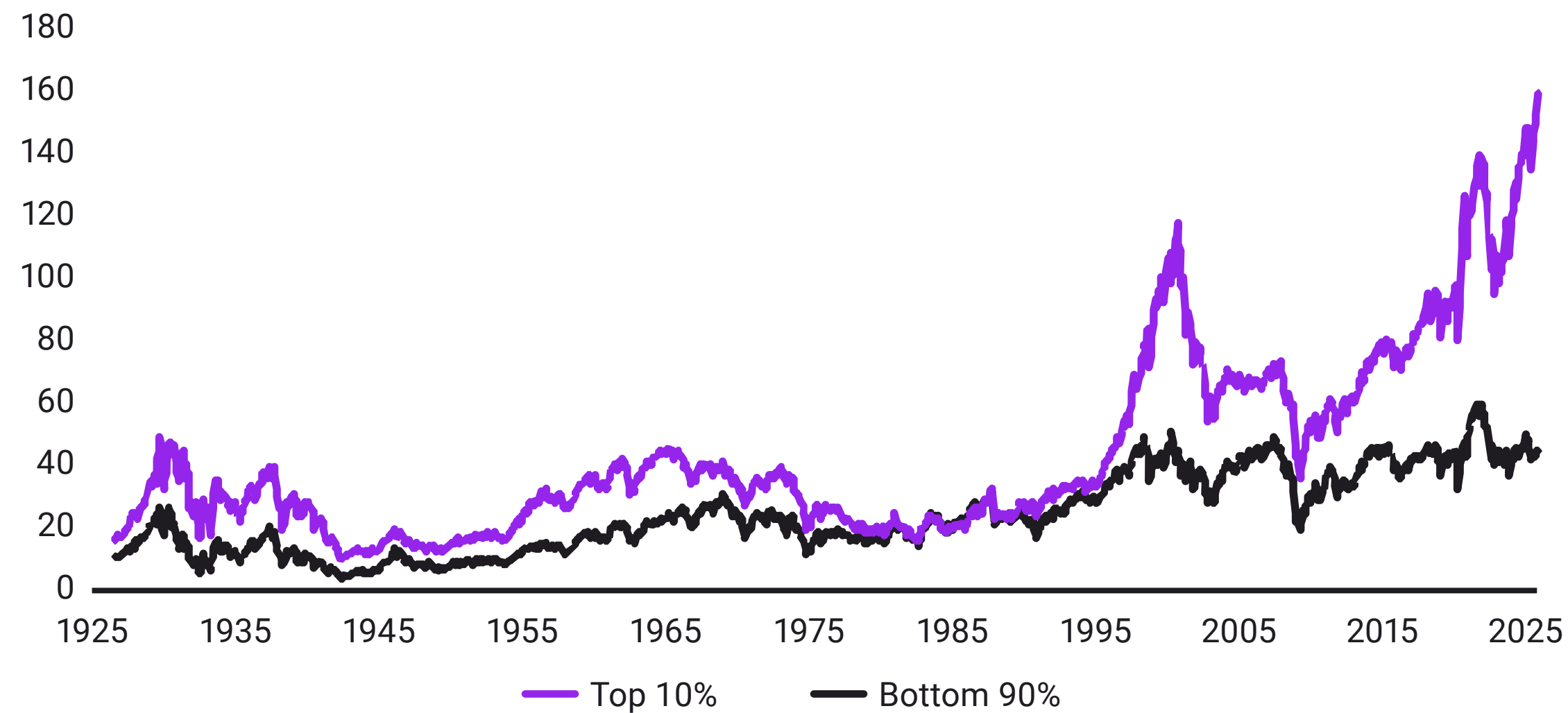
Many of these companies are large cap U.S. technology stocks, many of which have shown amazing ability to grow their earnings and cashflows at double digit rates at a massive scale. Some of the very largest are also at the forefront of the AI race for superiority.

If this AI mega-cap cohort sees any disappointment, whether from slowing AI related capital spending, rising debt costs, or even regulatory barriers, the potential flows moving away from this group in search of a new home could be substantial.

This setup is precisely the kind of environment in which cheaper cyclicals with smaller market caps can dramatically outperform, as investors move away from super-concentrated positioning in the top 10% of market cap stocks, while broadening out into the other 90%.

In other words, deflating of the current AI bubble could breathe life into the rest of the market just as its earnings growth is set to improve, especially given the extreme difference in current market caps.

**FIGURE 22**  
**The Gap Between the Top 10% and Bottom 90% Has Never Been Wider**  
 Fama-French Size Factor - Market Cap as % of GDP



Source: Fama/French Data Library, Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1925 to Oct 2025.



“  
**Deflating of the current AI bubble could breathe life into the rest of the market** just as its earnings growth is set to improve, especially given the extreme difference in of current market caps.  
 ”

KEY RISKS WE ARE WATCHING

# CONDITIONS THAT COULD IMPACT RECOVERY

## Positioning is Extended and Consensus is Growing Around the Broadening Recovery Thesis

Investor flows have become an important driver of markets and individual securities over the past decade. Many of these flows are systematic, meaning that they don't react so much to the value or improvement in an individual company, but rather they are driven by rules such as changes in market volatility or the closing out of hedge fund strategies that have gone through too large a drawdown within one of the large multi-pod hedge funds.

We monitor various sources of flow to try and get a feel for when individual securities or broader markets might be overbought or oversold.

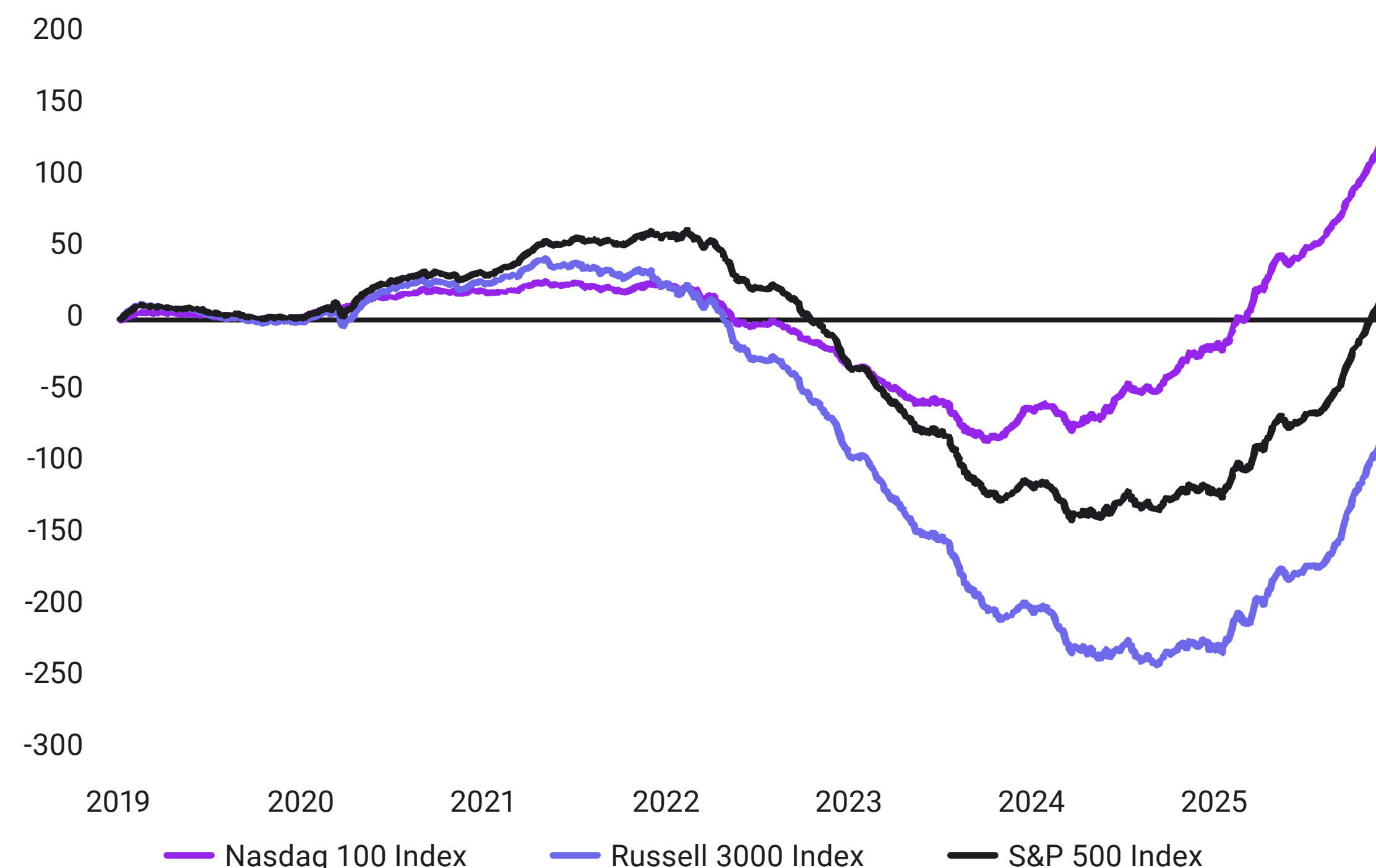
At this point in time many of the sources of flow that we track suggest that markets are overbought and vulnerable to a set-back in the near term. For example, the adjacent chart shows estimated retail investor flows into the S&P500, Nasdaq 100 and Russell 3000 Indices in the U.S.

This shows the significant recovery in flow into stocks (particularly tech stocks) post the Trump Liberation Day tariff announcements. These same positive flow dynamics have occurred within other investor cohorts and systematic strategies, with some positioning measures now at extremes.

At the same time, the broader strategist community is also embracing the economic recovery story to a certain extent. However, if near term economic data come in softer than expected or AI related financing strains develop faster than expected or even inflation readings come in higher than expected, there is the

FIGURE 23

Cumulative Retail Net Buying: U.S. Indices (USD Billions)



Source: Goldman Sachs, Picton Mahoney Asset Management Research. Jan 2019 to Dec 2025.

potential for large selling pressure to develop in fairly short order, as positioning extremes are alleviated. In other words, the cushion for error is small here, even if the probabilities of an economic recovery are increasing. Better entry points in the near term may await those willing to be more patient.

## Bond Markets and Inflation: An Important Risk Factor for 2026

Notwithstanding the case for cyclical recovery and market rotation, a critical risk to the 2026 outlook may lie in the reaction of the bond market to many of the economic tailwinds and forces discussed earlier.

The current policy mix rests on an important assumption: that investors will continue to finance large and persistent deficits at reasonably low interest rates even as inflation remains above target.

That assumption may be tested. The Federal Reserve is easing policy despite the absence of a classic, broad-based recession and with inflation still at stubbornly high levels of 3%.

This seems like a departure from past cycles and raises the risk of an adverse bond-market response. Especially given the excess supply of debt to finance from excessive deficit spending.

## An Unusual Rate-Cutting Cycle

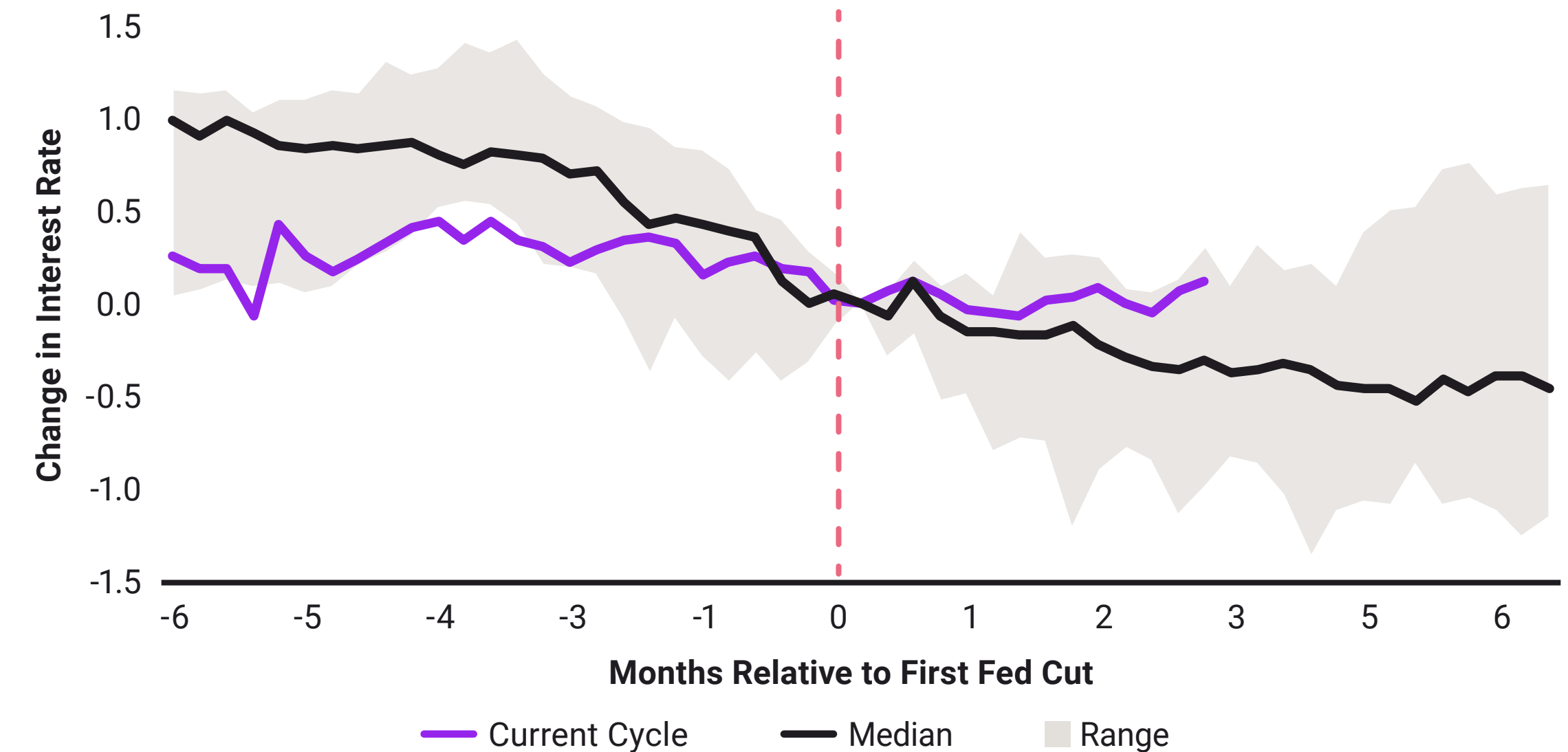
Over recent years, the Federal Reserve has emphasized that policy decisions would remain “data dependent.” Yet the renewed easing cycle began even as economic growth remained intact and inflation stayed above trend. **Historically, rate cuts fall into two broad categories:**

- Mid-Cycle Adjustments**  
 Modest cuts implemented when inflation is benign and growth levels fall below trend.
- Recessionary Cuts**  
 Aggressive easing undertaken after restrictive policy or a large exogenous shock (i.e. pandemic) triggers a sharp downturn and rising unemployment.

The current cutting cycle does not fit easily into either category. Outside of labour-market softness, particularly among youth and lower-skill workers, the economy does not display the kind of broad deterioration that typically precedes rate cuts. Meanwhile, inflation remains well above the Fed’s 2% target.

This creates a recipe for bond-market unease and bond yields have responded by acting firmer than is typically the case when the Fed begins to ease.

**FIGURE 24**  
**10 Year Rates Well Above Historic Norms in Current Cutting Cycle**  
 Change in U.S. 10-Year Rate After First Fed Cut



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1980 to Dec 2025.

“*The Federal Reserve is easing policy despite the absence of a classic, broad-based recession and with inflation still at stubbornly high levels of 3%.*”

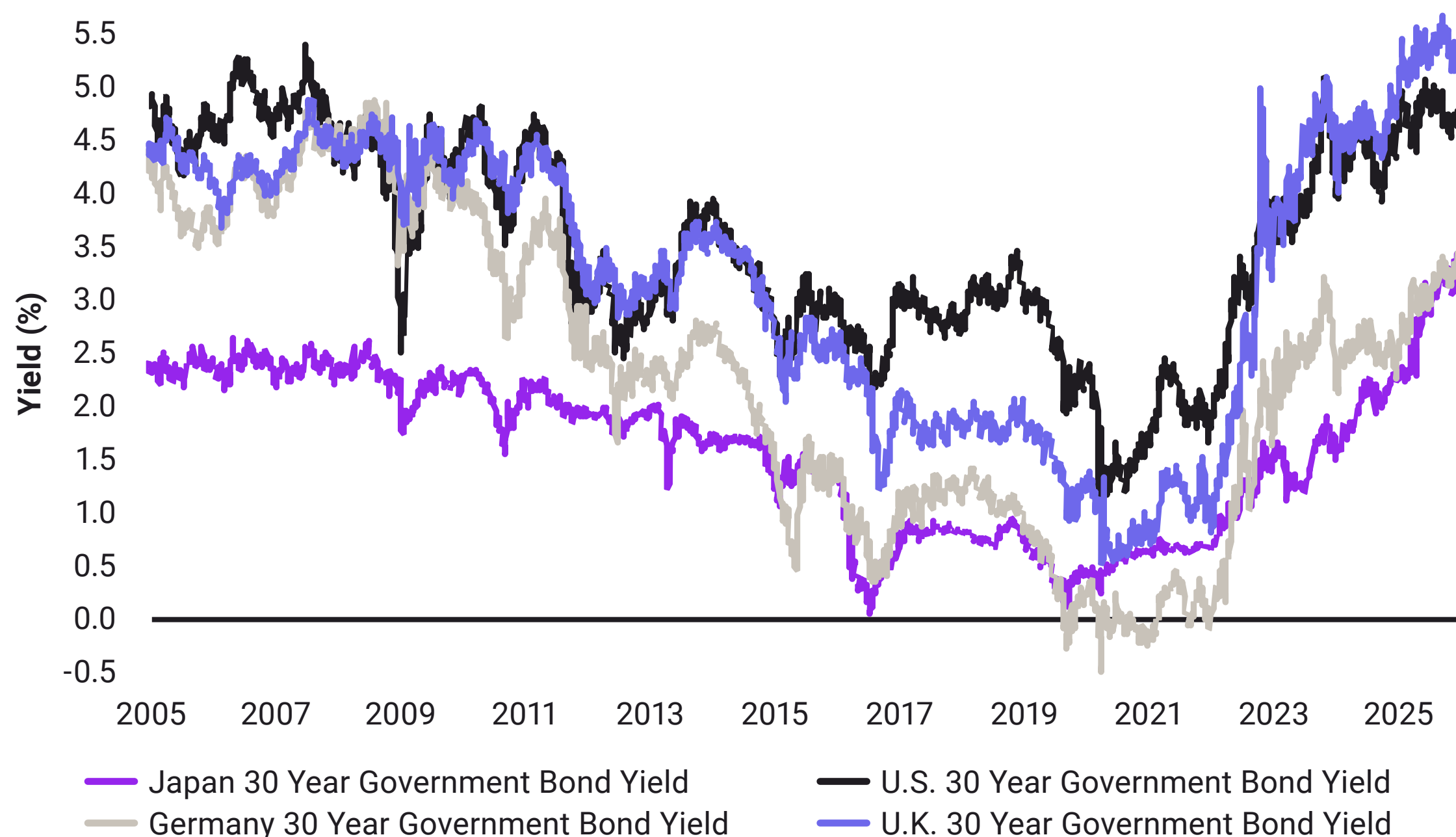
But the U.S. is not alone. In 2025, nearly every major developed country pursued aggressive fiscal expansion while their central banks have remained dovish or, at most, on hold.

Investors have largely treated this as a synchronized “dual-stimulus” environment and global stock markets have rallied considerably. So have bond yields though which is concerning to us.

The global debt overhang is substantial, and several countries face heavy refinancing pressures that could pressure interest rates higher and trigger financial stress if rates remain elevated longer than expected.

On top of this, if inflation also remains sticky it will also limit global central banks’ ability to cut interest rates aggressively without igniting even more price pressures. Policy missteps, either easing too much or too little, may carry unusually high consequences.

**FIGURE 25**  
**Global Long-Dated Bond Yields Have Climbed to Multi-Year High**



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2005 to Dec 2025.

**FIGURE 26**  
**Global Debt Spending Shows No Signs of Slowing**

	ACTUAL/ FORECASTS (% OF GDP)									
COUNTRY	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
<b>G-20</b>	-2.9	-3.4	-9.7	-6.5	-4.4	-4.8	-5.1	-4.9	-5.0	-4.9
<b>COUNTRIES</b>										
<b>Australia</b>	-0.6	-1.2	-12.3	-4.0	-1.1	-2.1	-1.5	-1.0	-1.5	-1.2
<b>Brazil</b>	-7.0	-5.8	-13.3	-4.3	-4.6	-8.8	-8.5	-8.2	-8.0	-7.5
<b>Canada</b>	-0.9	-0.6	-1.7	-12.3	-3.1	-1.2	-1.9	-2.3	-2.2	-2.0
<b>China</b>	-4.1	-4.9	-6.2	-3.8	-4.6	-4.5	-4.8	-5.6	-5.7	-5.7
<b>France</b>	-2.3	-2.4	-8.9	-6.6	-4.7	-5.4	-5.8	-5.4	-5.4	-5.1
<b>Germany</b>	1.9	1.3	-4.4	-3.2	-1.9	-2.5	-2.7	-2.9	-3.5	-3.8
<b>India</b>	-3.6	-4.4	-6.0	-6.2	-6.9	-5.9	-4.9		-4.5	-4.4
<b>Japan</b>	-2.5	-3.0	-9.0	-6.2	-4.2	-2.3	-2.0	-2.8	-3.2	-2.9
<b>Mexico</b>	-2.1	-1.6	-2.8	-2.8	-3.2	-3.3	-5.0	-4.3	-4.1	-3.5

Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. 2018 to 2027. Data as of Dec 13, 2025.

## The Risk of a Bond Vigilante Response

If inflation were to remain elevated and even re-accelerate, driven by fiscal stimulus and loose monetary conditions, the long end of global yield curves could reset even higher which could then pressure stock market valuations.

Such a shift would tighten financial conditions even if short-term policy rates continue to fall.

This is a risk of fiscal dominance, where monetary policy becomes increasingly captive to political and borrowing considerations.

It is uncertain how bond markets will react to if monetary decisions become increasingly guided by government financing needs rather than by inflation control at the margin.

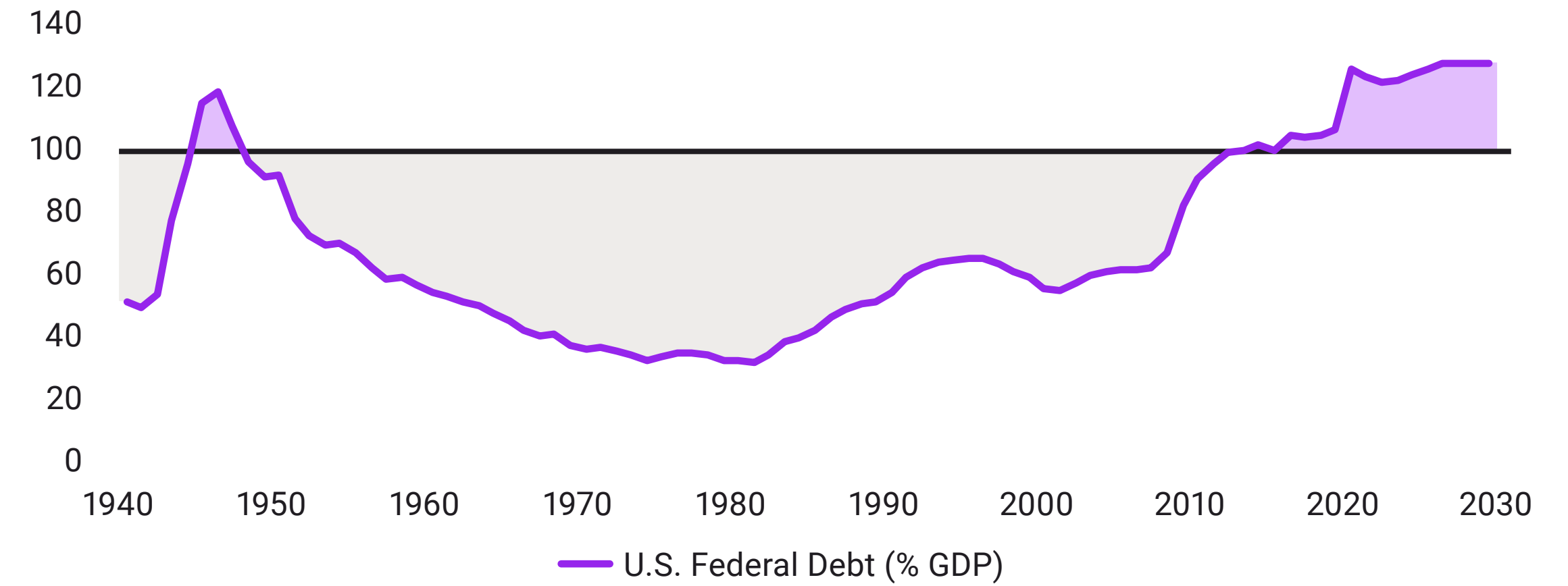
## Fiscal Dominance: A Theme that will shape the future

The U.S. is running exceptionally large, structural deficits while simultaneously funding expansive programs across energy transition, defense, reshoring, infrastructure, and digital capacity. Meanwhile the interest costs on this debt continues to rise taking up more of the U.S. government’s budget each year.

As debt servicing costs grow, the Federal Reserve will face increasing pressure to maintain accommodative financial conditions even if inflation remains elevated. **This environment creates two structural challenges:**

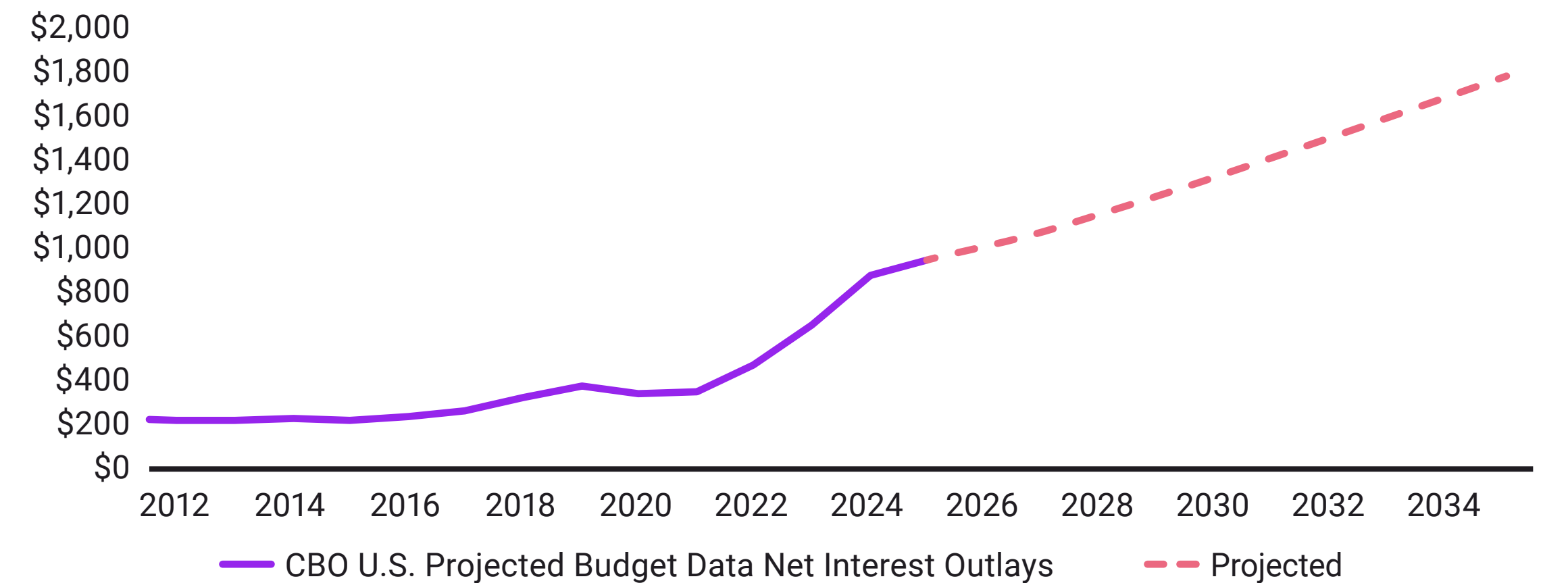
- 01. A higher tolerance for “moderately elevated” inflation to keep debt-service manageable.
- 02. A growing risk that bond markets begin to question policy credibility.

FIGURE 27  
U.S. Federal Debt Reaches an All-Time High



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. 1940 to 2030. Data as of Dec 13, 2025.

FIGURE 28  
Interest Costs as a Share of Federal Spending Continue to Rise



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. 2012 to 2035. Based on Congressional Budget Office Projections.

This fiscal dominance raises important risks that could derail our constructive outlook:

- If inflation re-accelerates or the bond market loses confidence in the Fed's willingness to control prices, long-term yields could rise sharply.
- Such a move would tighten financial conditions, pressure risk assets, and potentially derail the recovery.
- The recovery is viable so long as the bond market remains cooperative; if it pushes back, the cycle could end earlier than expected.
- Are precious metals, real yields, and the shape of the Treasury curve becoming critical early indicators of policy credibility?

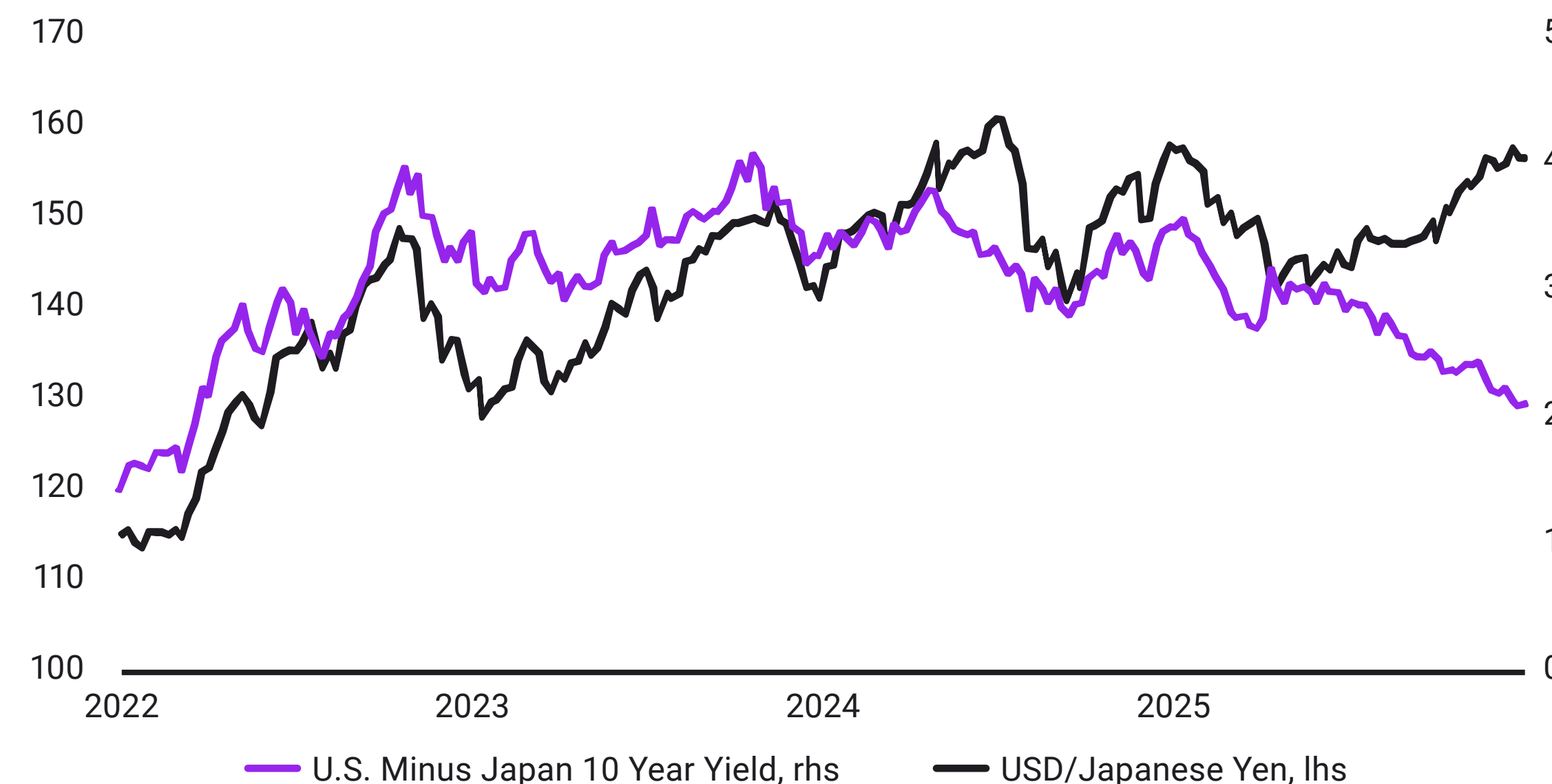
## Japan and the Yen Carry Trade: A Canary in the Coal Mine?

For three decades, Japanese policy makers have fought deflationary pressures with long-standing low interest rate policy and significant fiscal deficits. Japanese inflation has now been above the Bank of Japan's 2% target for over three years and the Bank of Japan has embarked on hiking rates to try to normalize policy. However, the persistence of large deficits over decades has resulted in Japan having the highest gross public debt-to-GDP ratio in the world, exceeding 260% or almost double that of the U.S.

Increases in interest rates make this debt much more difficult to sustain and may lead to difficult decisions for Japanese policy makers. Markets may be sniffing out a problem here as is evident from the Japanese Yen trading much weaker relative the U.S. dollar than interest rate differentials might suggest.

We are surprised that these recent Japanese trends haven't had a more sobering effect on global stock markets and risk assets especially as Japanese government bond yields continue to move higher.

**FIGURE 29**  
**U.S. Dollar & Japanese Yen Are Decoupling From Interest Rate Differentials**



Source: Apollo, Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2022 to Dec 2025.

For years, ultra-low Japanese rates quietly funded leverage across global markets. As long-dated Japanese government bond yields rise, the cost of yen-funded leverage increases (although recent Yen weakness has helped offset this). One can envision a scenario though where yields continue to rise and currency volatility intensifies forcing significant deleveraging pressure across the globe.

If bond vigilantes simultaneously push back against fiscal dominance around the world by demanding higher term premia it could lead to a rapid tightening in global financial conditions, turning an orderly rotation out of AI into a more disorderly adjustment across equities, credit, and leveraged strategies.

## A New Chair: Central Bank Independence Under Scrutiny

President Trump has made his disappointment in current Fed Chief Jerome Powell widely known. He has accused Chairman Powell of incompetence on many occasions, which appears to be related to his belief that Powell has acted too slowly in cutting interest rates.

Powell's tenure as Fed Chair expires in 2026 and betting markets have narrowed the field to four candidates that Trump currently supports.

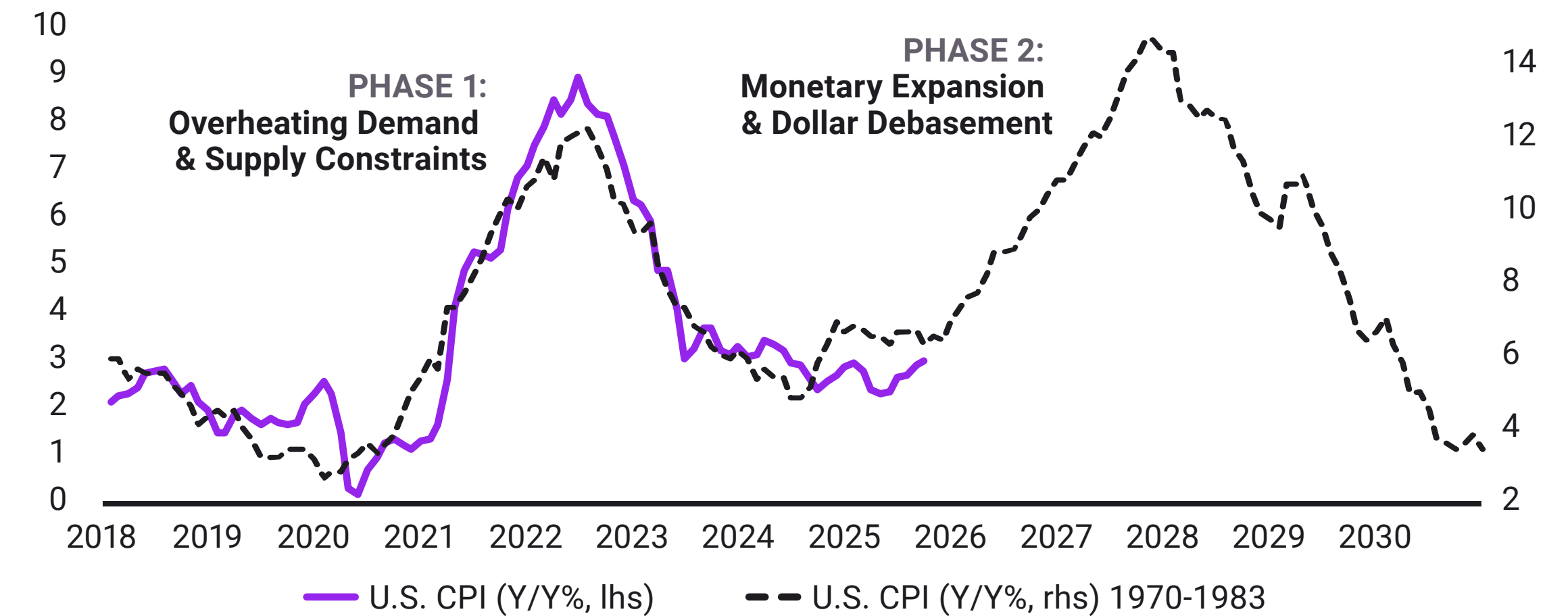
The potential appointment of Kevin Hassett or another strong Trump loyalist to the Fed raises the possibility of a central bank that is significantly more inclined to fall in line with President Trump's beliefs, signaling a more politically driven policy regime.

A Trump loyalist could be a significant step towards the end of central bank independence in the near term. We don't believe that bond markets will appreciate this.

Although it is a more extreme example, the Arthur Burns era of the 1970s offers a useful historical parallel of the dangers in the Fed losing its perceived independence from the U.S. government. Under political pressure, Burns is believed to have loosened monetary policy too aggressively given the inflationary backdrop that existed at the time. His actions contributed to persistent inflation, bond-market instability, and prolonged currency debasement.

Retiring Federal Reserve Bank of Atlanta President Raphael Bostic, who is now freely speaking his mind, left some worrying remarks confirming our concerns about the potential risks of ignoring near term inflationary pressures in an essay published Dec 17, 2025:

**FIGURE 30**  
**Inflation Could Re-Accelerate in a 1970s-Style Pattern**



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1970 to Sep 2025. Implied projection showing possible trajectory of current U.S. CPI.

“

*After wrestling with all the considerations, **today I continue to view price stability as the clearer and more pressing risk despite shifts in the labour market**, I see little to suggest that price pressures will dissipate before mid to late 2026, at the earliest, and expect inflation to remain above 2.5% even at the end of 2026... If underlying inflationary forces linger for many months to come, **I am concerned that the public and price setters will eventually doubt that the FOMC will hit the inflation target** in any reasonable time frame.*

”

## Watch The Debasement Trade

Based on pricing trends in 2025, investors are increasingly turning to commodities, precious metals, real assets, inflation-linked bonds, and alternative strategies designed to hedge against persistent monetary erosion.

Many of these assets have constructive fundamental supply and demand trends that are contributing to their performance. But they are also increasingly being viewed as monetary debasement hedges that can protect against the erosion in the purchasing power of fiat currencies if inflation is allowed to run above interest rates for an extended period.

Precious metals have emerged as an important market signal that should be monitored through 2026. Rising gold prices often reflect:

- **Concerns about central bank credibility**
- **Doubts over long-term debt sustainability**
- **Expectations of gradual currency debasement**

We don't believe that gold's strength in 2025 is signaling a potential recession. We believe it is signaling growing concern about long-term monetary stability.

Silver has amplified this message (although over half of silver demand is tied to industrial use particularly green energy, EVs, and technology where demand has been strong and new supply limited).

**FIGURE 31**  
**Gold and Silver Continue to Reach New Highs**



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2015 to Dec 2025.

# CONCLUSION: A RECOVERY WITH CONDITIONS

The economic recovery story for 2026 has improved but is somewhat conditional. Growth can broaden, and rotation can unfold, so long as bond markets remain cooperative.

If the “new market cycle” thesis holds, this environment should reward cyclical assets and previously overlooked parts of the market, as earnings breadth improves and leadership rotates beyond a small group of mega-cap winners. A gradual deflation of excess in the AI trade, through valuation compression rather than a disorderly unwind, could further reinforce this shift, allowing capital to flow into sectors and regions that have lagged during the last phase of the cycle.

However, this opportunity is inherently conditional. Inflation remains structurally above target, fiscal dominance is firmly in place, and the Federal Reserve is easing in a manner that may test bond-market confidence. As a result, the durability of the 2026 recovery will depend not only on equity narratives but also the response of the bond market.

If inflation remains contained and long-end yields stabilize, growth can broaden and rotation can unfold in an orderly fashion rewarding multiple sources of return. If bond markets push back, through rising term premia or funding stress, financial conditions could tighten quickly, narrowing the window for recovery and emphasizing the need for diversification within portfolios built for resilience.

**In that sense, 2026 may be defined by a delicate balance.**

**A year where opportunity expands, but only so long as policy credibility holds and bond markets allow the recovery to run.**



“

*The economic recovery story for 2026 has improved but is somewhat conditional. Growth can broaden, and rotation can unfold, so long as bond markets remain cooperative.*

”

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