

Q4 2026

Navigating crosscurrents



The two-headed challenge

Markets are being pulled between two powerful forces: the promise of an AI-driven productivity surge and the reality of an energy supply shock. We examine the opportunities and risks, and our response to those offsetting forces.



Chris Jeffery
Co-Head of Asset Allocation,
Head of Macro

A crowded menagerie features heavily in most descriptions of financial market conditions. Bulls battle bears, hawks spar with doves, and investors hunt for unicorns. However, when thinking about the current environment and outlook, a different animal springs to mind.

Fans of Doctor Doolittle will know that the pushmi-pullyu is the “only two-headed beast in the world”: one that resembles a llama but with a head at either end of its body. Like the pushmi-pullyu, markets have been pulled in different directions since the start of the year by the opposing influences of artificial intelligence (AI) and the commodity market consequences of the conflict in the Middle East.

A two-headed beast

The “pushmi” (AI) part of the equation has driven extraordinary earnings growth for the largest US corporates. In Q2, GAAP earnings for the Magnificent Seven grew by around 120% year-on-year.* Those numbers are flattered by the revaluation of on-balance sheet investments, but operating margins were also incredibly strong. In 2026, the rising tide of corporate earnings has spread across sectors and geographies. The market is taking the prospect of a secular increase in the capital share of income seriously as AI augments and displaces labour.

The “pullu” (oil) comes from festering tensions in the Middle East. The flow of oil and gas through the Strait of Hormuz remains severely impaired six months after the conflict erupted in the Spring. The rise in oil prices has been eclipsed by an even stronger surge in the price of distillates and liquefied natural gas (LNG), triggering soaring bond yields. China is the only major country which has been immune from that repricing with yields pinned down by depressed domestic demand. Fundamentally, it is hard to see the hiatus in oil and gas supplies extending much further without end-user demand destruction becoming necessary to rebalance the market: inventory drawdown can only run so far.

“Our response to those offsetting forces has been to dial up our equity exposure in the aftermath of the conflict flare-up while staying cautious on credit particularly in investment grade-rated markets.”

1. “Stocks for the Long Run? Sometimes yes, sometimes no” McQuarrie (2023)
*<https://insight.factset.com/mag-7-companies-reported-earnings-growth-above-100-boosted-by-investment-gains>
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Positioning for competing forces

Our response to those offsetting forces has been to dial up our equity exposure in the aftermath of the conflict flare-up while staying cautious on credit, particularly in investment grade-rated markets. Having lagged the rest of the world in the first two quarters of the year, we think tech-heavy US equities can reassert leadership. The “pushmi” strength is such that equity markets have derated relative to earnings expectations despite prices rising. We believe this could be an ideal combination for investors worried about the longevity of the market rebound.

For bonds, the “pullu” is the third major supply shock in recent years after COVID and the Russian invasion of Ukraine. Central bankers are trying hard to maintain credibility without raising rates to recession-inducing levels. We have sought shelter in Japan where underlying inflation continues to look muted and in the long-end of the curve where yields are less sensitive to changing policy perceptions. After the travails of the last few years in the bond market, it is worth remembering that investors have enjoyed annualised real returns above 2% on fixed-income assets over the last 100 years.¹ With real yields back well above zero, we believe the prospect of positive real returns on the bond market is back.

In focus this quarter

Tim Drayson, Head of Economics, discusses the resilience and the

vulnerabilities of the US consumer. Lushan Sun, Head of Multi-Asset Private Market Research explores how the 4D framework can help investors identify the structural forces behind private market outcomes, uncovering both potential opportunities and overlooked concentrations.

We have a piece on one of investors’ favourite warning signs. Elevated CAPE ratios are often cited as evidence that US equities have become too expensive, but Robert Griffiths, Global Equity Strategist, argues the link between valuations and future returns is more nuanced than many assume. John Southall, Head of Strategic Research, discusses the role of commodities in strategic asset allocation. Finally, Dash Tan, Quantitative Associate gives an update on our capital market assumptions framework.

I hope you enjoy the articles my team has put together for this quarter, and they provide you with useful insights for your client conversations.

Prepare don't predict

For more on how we approach risk and uncertainty, check out our recent blogs and podcasts.

Podcast: Private markets – myth vs reality

Rebecca Burgess and Lushan Sun unpack some of the most persistent myths surrounding private markets.

Special report: AI: A new division of labour?

Matthew Rodger explores if AI can transform productivity and growth without disrupting jobs, markets and the global economy.

Podcast: AI: victors, vulnerabilities and value

Matthew Rodger and Ewan Bowerbank discuss AI's next phase and where they're looking for opportunities.



Overview		Strategic allocation				
Equities						
Duration						
Credit						
Inflation						
Real estate						

Fixed income		Strategic allocation				
Government bonds						
Investment grade						
High yield						
EM USD debt						
EM local debt						

Equities –Regional, Thematic, & Relative Value		Conviction		
		+1	+2	+3
Artificial Intelligence Equities				
Long Nasdaq 100 vs. Europe & UK				

Currencies		Strategic allocation				
US dollar						
Euro						
Pound sterling						
Japanese yen						
EM FX						

Key risks: Asset allocation is subject to change.

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An update on our dynamic positioning

Equities

- Valuations remain contained by strong earnings growth
- No immediate recession risks but uncertainty remains
- Reignition of oil price shock, oil & natural gas prices decoupling
- Signs that US tariff impacts have been well absorbed

Credit

- Credit spreads at tight levels across the board
- Opportunities are asymmetric, with limited upside and wider downside risk
- Underlying cashflow remain solid, but new issuance could pressure spreads
- Equities remain our preferred risk asset given more upside potential

Duration

- Oil price shock passthrough a wild card for inflation forecasting
- AI likely to be viewed as disinflationary over the long term
- Inflation and debt sustainability concerns pressuring longer-dated bonds
- Real yields can still provide potential opportunities for long-term investors
- Wage disinflation supports anchoring of US inflation expectations

Currencies

- + AI expecting the theme's beneficiaries to broaden
- + Nasdaq vs. Europe and UK equities, pushing against muted sentiment

Bonds

- + Longer dated Japan relative value preference within government bonds
- IG credit expensive vs. government bonds with more downside
- EM local debt excess return vs. developed bonds doesn't justify risk
- + Romania India Mexico, providing idiosyncratic opportunities

Alternatives

- + Listed private credit BDCs vs. public market credit

Currencies

- + Turkish Lira vs. US dollar given improving fundamentals & attractive carry
- China Renminbi vs. Taiwan Dollar benefiting from high carry
- Australian dollar vs. New Zealand dollar due to short-term valuation concerns

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AI is helping, but consumers still drive US growth

The US consumer remains the primary engine of economic growth, but, as income growth slows and household spending becomes increasingly linked to equity markets, the resilience of the consumer may be more important, and more vulnerable, than investors realise.

Tim Drayson, Head of Economics

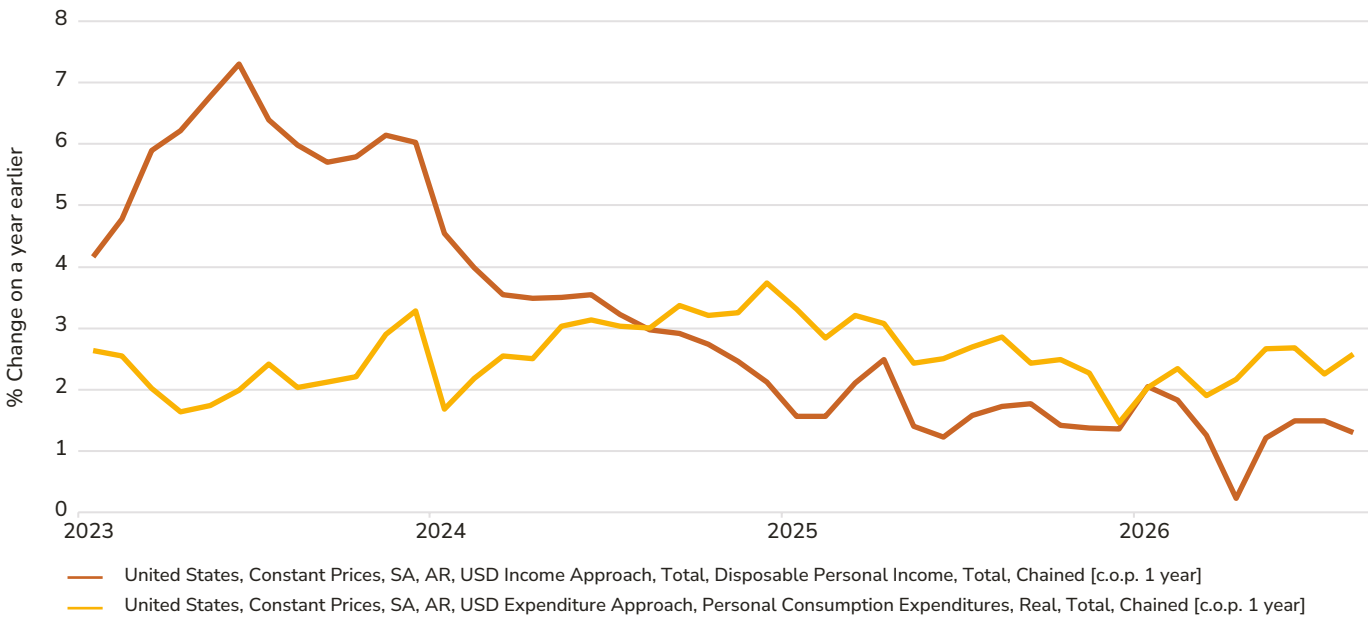
The US economy continues to display resilience in the face of shifting tariffs, higher energy prices, rising interest rates and general geopolitical uncertainty. Some of this is down to booming AI investment, but, when accounting for inflation (especially memory prices) and the heavy concentration

of imported components, we believe this is probably only adding a few tenths to real GDP growth.

The US consumer remains by far the largest contributor to economic growth. Consumption is 68% of US GDP and has proven remarkably stable in recent years, growing consistently in real terms in the 2-3% range.²

The strength in 2023 and 2024 was driven by large gains in real incomes. More recently, real income growth has sharply cooled. This is due to a combination of slowing employment growth, moderating wages and sticky inflation.

US real income and spending



2. Source: US Bureau of Economic Analysis, September 2026.

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Could robust spending trends continue?

To sustain spending growth, households appear to have run down their saving rate. However, savings are prone to revision, as we saw in September's annual update to the national accounts. It is possible that statisticians continue to discover some additional income which helps to justify recent consumption strength. Tax cuts, which took effect earlier this year have also provided some boost, but this support is now fading.

Whether the saving rate is revised up again or not, we believe that over the next few quarters real consumption growth will likely need to align with real income growth, especially given the headwind from rising interest rates. This implies some downside risk to the consensus view of a continuation of recent robust spending trends.

Supporting consensus forecasts probably requires a combination of somewhat stronger employment growth than recent trends and an inflation moderation. The latter requires no additional rise in energy prices.

The equity wealth effect

The other major contributing factor to consumer spending has been the rise in equity wealth. A recent Federal

Reserve [paper](#) argues the sensitivity of aggregate consumption to changes in the stock market has increased by three times since 1990. This is a function of the soaring share of equity wealth in household balance sheets. This is despite the increasing concentration of equity wealth in the top end of the wealth distribution and adjusting for the lower marginal propensities to consume out of wealth among these cohorts. The authors calculate that were the US stock market to fall 25%, this alone would likely lead to a contraction in consumer spending before even considering the adverse effect on employment and wage growth. Today, we read in the [Beige Book](#) and Federal Open Market Committee (FOMC) discussions about the bifurcation of the consumer with reports of solid high-end purchases driving overall consumer spending growth while lower income groups struggle with the cost of living. The Fed research suggests that, in the event of an equity market correction, it is the wealthy consumer who would likely be responsible for the weakening in overall consumer spending growth.

We remain optimistic about the prospects for AI, but we are also aware much is riding on this theme. If AI investment plans were to be curtailed, this would directly drag on business investment but would likely also impact expected earnings growth and equity prices. The negative wealth effect on consumer spending could be much more significant this cycle.

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Identifying the megatrend drivers of returns

Our 4D framework helps investors look through asset classes and identify the structural forces driving portfolio outcomes, revealing both opportunities and hidden concentrations in private markets

Lushan Sun, Head of Multi-Asset Private Market Research

There are four structural forces that we believe will reshape private market portfolios over the long term. We called them the “4Ds”: decarbonisation, digitalisation, deglobalisation and demographics. We have followed up our original work with a scoring framework that would enable investors to assess their portfolio’s alignment to the 4Ds.

More granularity

We have translated the four megatrends into 16 granular sub-trends to enable more nuanced differentiation between return drivers (for example, clean energy generation versus grid upgrade). We then scored the major real asset sectors against the sub-trends on two metrics: “exposure” (how much the trend touches the sector) and “impact” (is the trend a headwind or tailwind for asset performance) over a medium-term (five-

year) horizon. For simplicity, we applied equal weights to the 16 sub-trends. The 4D scoring framework allows us to ask: is the portfolio genuinely diversified or are the different strategies all leaning on the same structural driver? Are we deploying capital towards trends most likely to shape long-term returns? What are the hidden concentration risks?

Decarbonisation	Digitalisation	Deglobalisation	Demographics
Clean power and renewables	Digital infrastructure and connectivity	Supply chain regionalisation and reshoring	Ageing populations and longevity
Grid, storage and power system flexibility	AI, compute and intelligent software	Industrial policy, defence and national security	Urbanisation, migration and city evolution
Electrification of end demand	Cybersecurity, data governance and resilience	Resource, energy and commodity security	Household formation and affordability
Industrial decarbonisation, energy efficiency and low-carbon fuels	Industrial and consumer digitisation	Friction in cross-border flows of people and capital	Workforce transformation and labour constraints

It should be noted that diversification is no guarantee against a loss in a declining market.

Winning sectors are aligned to several megatrends

Megatrend alignment is highly uneven across sectors (shown in the chart as the exposure score x impact score³). Energy transition infrastructure (grid, renewables and storage) performs the strongest, benefiting from decarbonisation and, increasingly, digitalisation. Industrial real estate is also well-positioned given its exposure to a multitude of trends (data centres, reshoring, urbanisation, e-commerce to name a few). Demographics dominate a distinct cluster: residential, social infrastructure and senior housing.

At the other end, office and retail score less well and drag down the overall score for private real estate given they

still account for 25-40% of the asset class. Most real asset sectors outscore broad market equities (represented by MSCI ACWI⁴) which is moderately tilted towards digitalisation given the concentration of semiconductor and AI-related stocks.

Scores ≠ investment performance

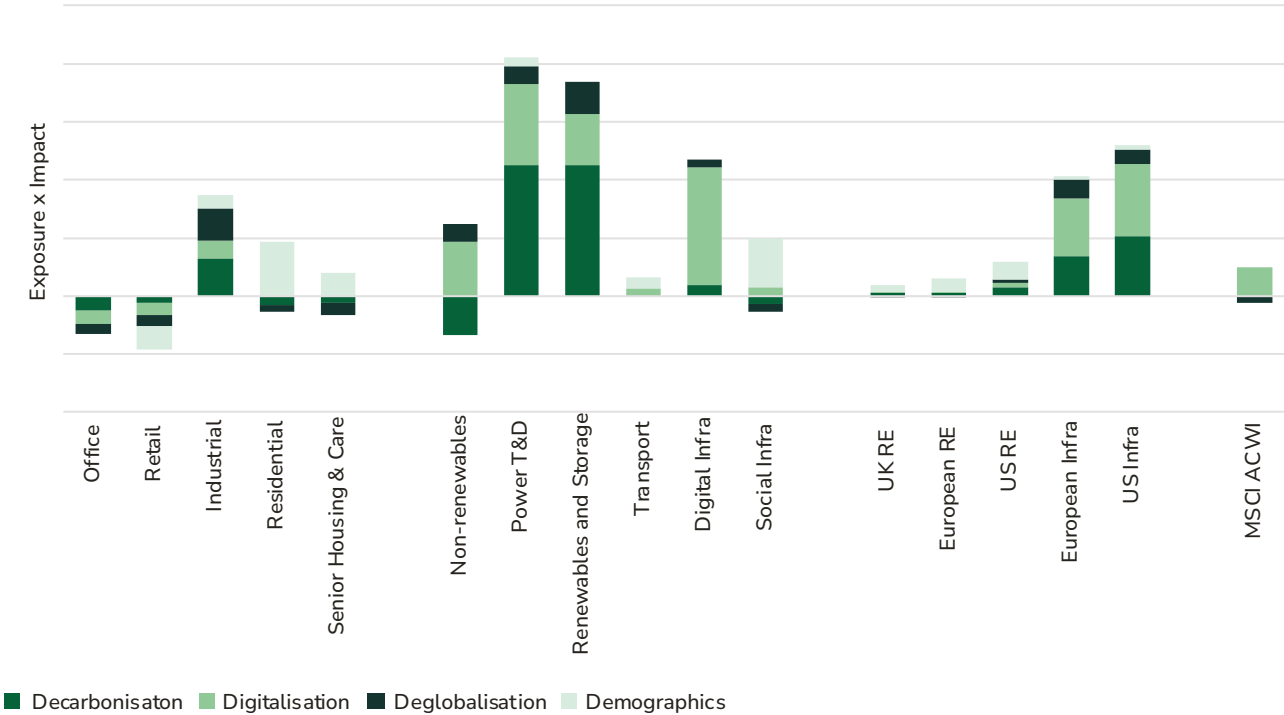
Under a total-portfolio approach, investors increasingly want to see through individual asset classes to their underlying return drivers. Such transparency is particularly valuable in private markets.

The important caveat here is that these scores do not equate to investment performance. A high score signals a structural tailwind not a guaranteed

return. Asset selection, execution, market timing and even luck could all contribute to the investment outcome. A high score could also indicate crowding and the need to be disciplined. Conversely, sectors that score poorly are not uninvestable. In our view, office and retail may offer some of the richest value-add opportunities. The presence of structural headwinds may imply a need for greater selectivity within these sectors.

Ultimately, the 4D scoring framework is not a shortcut to returns but aims to offer investors a sharper lens into their exposure to these long-term trends so asset allocation can be aligned intentionally rather than by accident.

Real Assets megatrend tilts



Source: L&G as of October 2026. The real estate and infrastructure asset level scores are based on sector weights in the unlisted/private market.
3. We scored exposure on a scale of 1 to 5 and impact from +3 to -3. The scoring is based on our judgement of how each sector’s fundamentals and performance is likely to be affected by the trends over a medium term time horizon
4. This varies on a regional level: US and Asian public equities are significantly more exposed to digitalisation than European equities.

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CAPE fear?

The elevated CAPE ratio is often cited as evidence that US equities have become too expensive. We examine why the relationship between valuation and future returns may be more nuanced than commonly assumed.

Robert Griffiths, Global Equity Strategist

The cyclically adjusted price/earnings ratio (CAPE) is one of the most widely used measures of equity market valuation. Rather than comparing current prices with recent or forecast earnings, it uses the average of the previous 10 years of inflation-adjusted earnings, helping to smooth out the effects of economic cycles and temporary fluctuations in profitability.

At 40.5x, the US CAPE currently sits in the 98.9th percentile of its near 150-year history, offering a useful soundbite to those concerned that US equities have moved decisively into bubble territory.

What CAPE can and can't tell us about future returns

How worried should we be about the elevated level of this measure? We believe there are a number of factors which temper the bearish message some might draw from such an elevated reading, and we review a few of them here.

First, the common scatter charts often circulated as evidence of the apparent relationship between starting-point CAPE and subsequent long-term

returns (i.e. the higher the starting point multiple, the lower the subsequent return) are built upon shaky statistical foundations. Second, we are currently in a regime of historically rapid earnings per share (EPS) growth. Of course that might not last, but even some tentative extrapolations forward will bring down the CAPE rapidly as the 10-year earnings window shifts. And third, outside of the US, valuations on most measures, CAPE included, are simply not that extended.

Producing a scatter chart of CAPE versus subsequent 10-year real returns creates an apparently compelling inverse relationship: the higher the starting point price-to-earnings (PE) ratio, the lower the subsequent 10-year returns, and vice versa. Such analysis is at the core of the concern around the currently elevated level of the CAPE. However, as my colleague John Southall has discussed at length across a range of [blogs](#), the optics of this chart do not stand up to scrutiny.

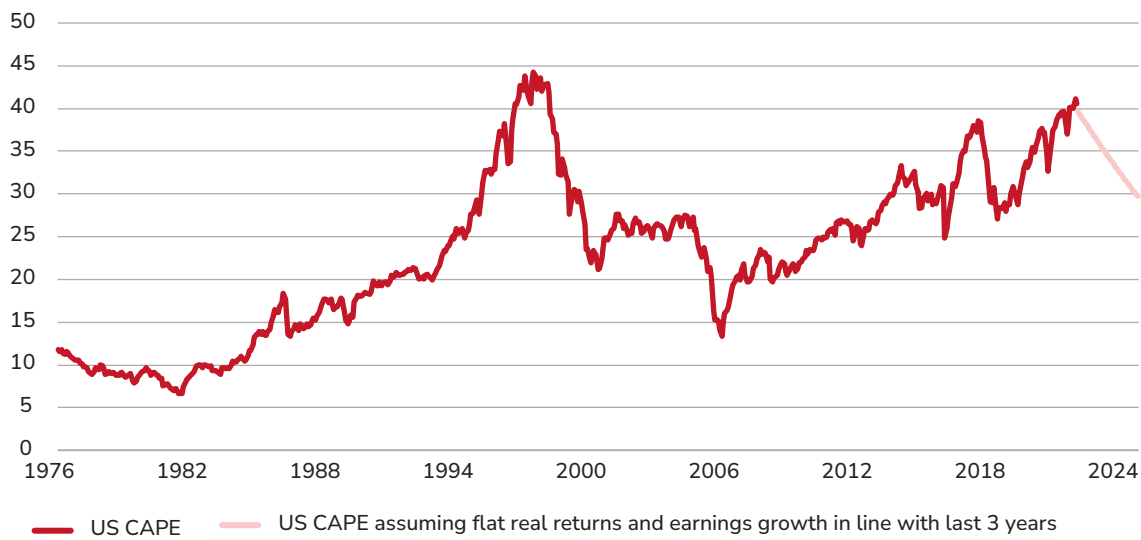
First, the apparent relationship rests on significant overlapping of data: the actual number of independent datapoints is relatively small. Second, what counts as cheap or expensive

changes through time: a 5% earnings yield would have been expensive in 1995, and thus implied low returns, but now looks average. And third, such analysis rests on a finite pool of data. One hundred years may sound like a reassuringly large dataset, but John argues persuasively that it's a pool of datapoints which can inflate our confidence in the ability to predict equity returns, which are an inherently volatile asset class.

Beyond those theoretical pushbacks, it is also important to recognise that recent earnings growth may reflect a structural shift rather than a typical point in the cycle.

Across the 150-year Shiller data set, the real earnings compound annual growth rate (CAGR) has been 2.2%. Over the last 10 years, US equities have delivered an earnings CAGR of 9.4%, and over the last three years that rises to 14%. That puts the last three years near the 90th percentile for three-year earnings growth, which is all the more remarkable given that it is not a period of recovery from recession or crisis.

Shiller CAPE: 50-Year history with forward projection



Source: Robert Shiller Online Data, Yale University; L&G calculations. As of 9 September 2026

Could earnings growth bring valuations back down?

Looking ahead, this powerful earnings uplift will inevitably start to bring down the elevated CAPE level. By way of example, if the US equity index level tracks inflation higher over the next three years (i.e. is flat in real terms), and US equities deliver the same EPS growth as seen over the past three years, the US CAPE would fall to 29x, putting the valuation in the 20th percentile seen over the last decade. Those are optimistic assumptions on earnings of course, but the simple maths does illustrate the power of earnings to de-rate the US market, even on a CAPE basis.

5. Source: Sibilis Research, June 2026
6. Source: Sibilis Research, June 2026

Finally, given the high weighting in fast-growing tech companies today in the US, it feels less appropriate to use an earnings base from a notably different index 10 years ago when computing valuation. Non-US indices have seen less transformation (though the weighting of tech, direct and indirect, has risen in all cases), and here valuation multiples on a CAPE basis are just unremarkable, though moving toward the upper end of historic ranges in some cases.

In Europe, the CAPE is around 20, in China 18 and in Hong Kong less than 10x.⁵ Yes, US equities are about 63% of global market cap,⁶ but as we often highlight, our own approach to investing continues to highlight diversification, and the opportunities offered by unloved assets. Elevated US valuations are therefore best viewed as a regional phenomenon rather than a definitive verdict on global equity markets. A high US CAPE today is not a stick to beat global equities with.

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The role of commodities in strategic asset allocation

Commodities can provide diversification and inflation protection, but their long-term return potential remains debated. We examine the evidence for a commodity risk premium and what it might mean for strategic asset allocation.

John Southall, Head of Strategic Research

Commodities occupy an unusual place in strategic asset allocation. Determining their strategic role requires balancing their diversification and inflation-hedging benefits against how much return investors should expect to be rewarded for holding them relative to other assets.

A helpful question is whether commodity returns have historically been higher than we'd expect from their exposure to traditional market risk. In academic language, that excess return is often described as Jensen's Alpha.

I draw on two studies: Levine et al. (1877–2015 sample period), who used an equal-weighted index of 29 commodity futures, and Doeswijk et al. (1960–2017), who constructed returns for the global investable market portfolio⁷ ("GMP") including commodities.

The return puzzle

The realised arithmetic risk premium in the Levine study was 4.8% per annum, versus an estimated 1.7% I calculated we'd expect from beta alone.⁸ That leaves a Jensen's Alpha of around 3.1% per annum. I calculated this has a "p-value" of 0.03, meaning if the true alpha were zero, you'd only observe this alpha or higher with a 3% chance.

My equivalent calculation using the Doeswijk data⁹ produces a slightly larger alpha, around 3.5% per annum, but with a much higher p-value of 0.17 due to the shorter sample period.

The Levine study provides statistically significant evidence of positive alpha. However, evidence against a zero alpha is not the same as evidence that the true long-run alpha is 3.1%. The key question is how much weight to place on these historical estimates when forming a forward-looking assumption?

Why might a premium exist?

There are several theories for why commodities earn a positive risk premium. One is hedging pressure: producers and consumers often have commercial reasons to transfer commodity price risk, and investors willing to absorb that risk may earn compensation in return. This is not captured by a simple CAPM¹⁰ framework, where expected returns are explained solely by exposure to broad market risk. Another explanation relates to a "convenience yield" which is the benefit of owning a commodity that is in short supply or urgently needed.¹¹

Why be cautious?

The obvious objection is: if expected excess returns are really that attractive, why haven't they been competed away? Markets aren't perfectly efficient in our view, and there are limits to arbitrage, but it remains healthy to be sceptical of large alpha opportunities.

There's also the problem of relevance. Long histories provide more observations. But by the time we have

enough data to make strong statistical claims, the market we're studying may have become more efficient. That's a recurring problem in financial research. The fact commodities don't generate cashflows also reduces our confidence in any estimate of their expected return.

The theoretical case is also not one-sided. Storage costs and other factors can create a drag on returns for long futures investors.¹²

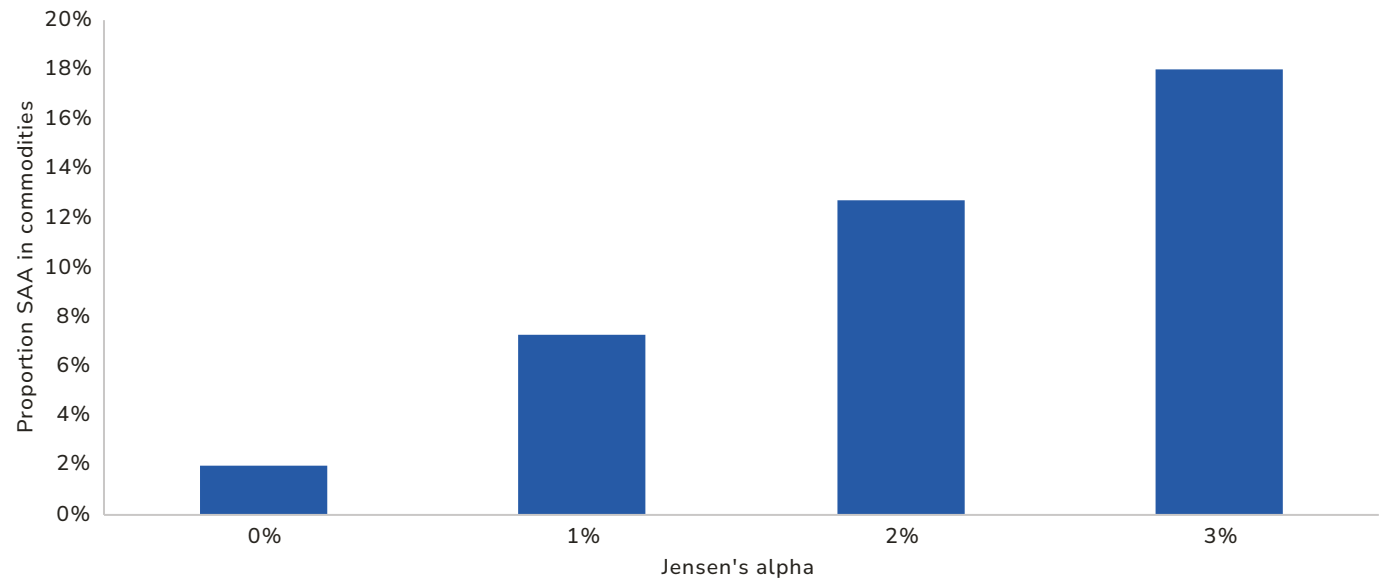
Finally, investors may like commodities for their inflation-hedging properties but that cuts both ways because they should, all else equal, command a lower expected return.

What does this mean for strategic allocations?

A natural starting point is the GMP, as this is the average allocation held by investors. Because futures (the instruments financial investors typically use to gain exposure) have zero net supply, the investable weight of commodities is difficult to estimate. I assume a 2% allocation, broadly in line with the Doeswijk study.

If I also assume no Jensen's Alpha, that points to a very modest allocation (2%) if the investor has average risk appetite and average desire for inflation hedging. If I allow for a forward-looking alpha of 1% per annum, my calculations¹³ indicate the allocation could rise to around 7%; with 2% alpha, around 13%. Those figures illustrate how sensitive the answer is to the assumed excess return.

Commodities: From alpha to allocation



Source: L&G calculations. Uses correlations and volatilities from Doeswijk study, October 2026. Assumes investable market cap exposure of commodities is 2% of the GMP, the investor has average risk appetite and average desire for inflation hedging.

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A measured conclusion

The strongest case for commodities isn't exceptional returns. It's that the empirical evidence is difficult to entirely dismiss, there are credible theoretical reasons for a risk premium, and their diversification and inflation properties can be valuable at the portfolio level.

For a diversified multi-asset investor, commodities may deserve a small strategic role, and there is a reasonable case for increasing that role when inflation sensitivity is especially valued. A low-single-digit allocation may be a neutral starting point; something closer to 5% or 10% might be justified where investors place more weight on the historical and theoretical case

for a commodity premium. Beyond that, the burden of proof should rise. Commodities are useful, but they aren't exempt from the usual discipline of strategic asset allocation: be clear what risk is being taken, why it's rewarded, and how it improves the portfolio as a whole.

7. The market-cap split of commodities estimated by Doeswijk et al tends to be dominated by gold.
8. Source: L&G calculations. This was estimated using beta to US equity given a lack of global market portfolio return data. However, it's a reasonable approach given that market risk is dominated by equity risk. A slightly more refined approach where we proxy the market as 50% stocks, 50% bonds, and assume stocks and bonds were 35% correlated, gives a Jensen's alpha estimate for commodities of 3.5%.
9. This calculation uses GMP returns and a 3% observed correlation between their GMP and commodity series returns.
10. Capital Asset Pricing Model.
11. This can lead to backwardation and positive roll returns.
12. Many commodity markets spent long periods in contango after 2000.
13. Source: L&G calculations, using data from the Doeswijk study.

CAMERA: Capital market assumptions update

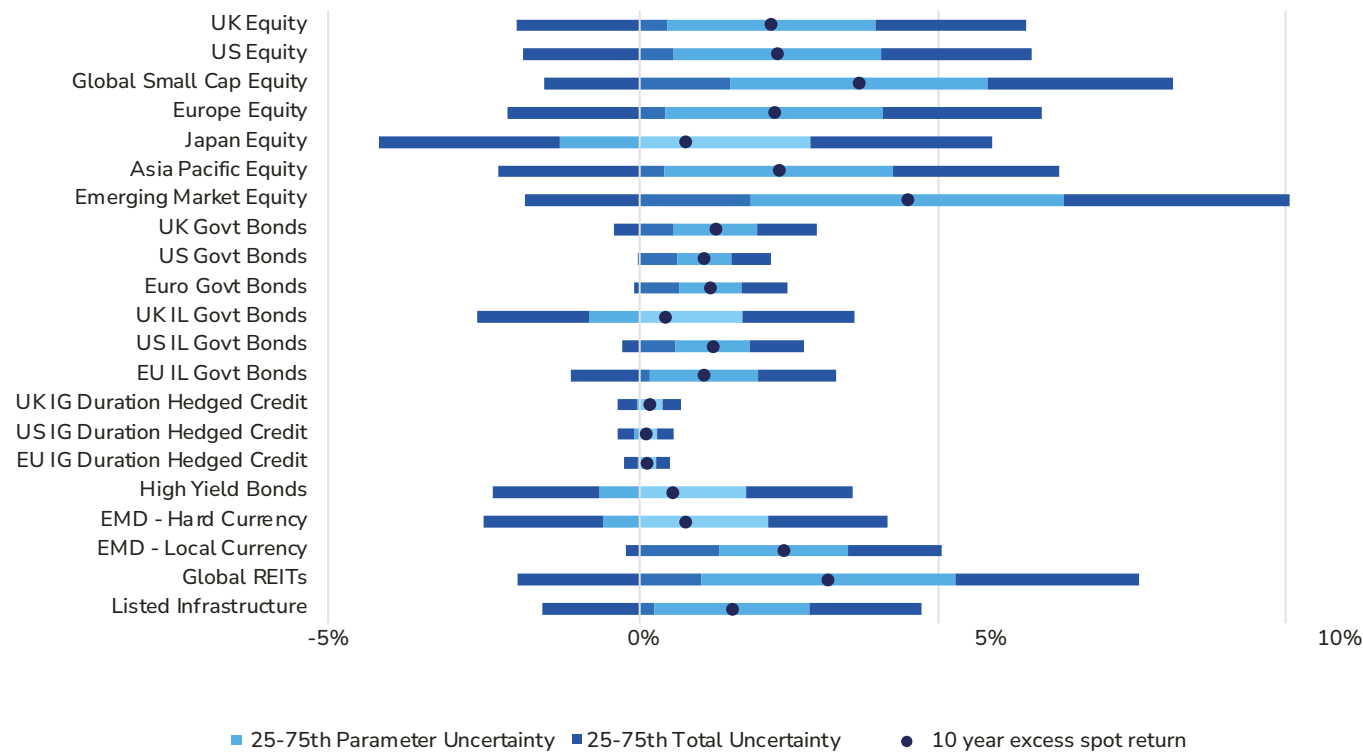
Dash Tan, Quantitative Associate

Our capital market assumptions framework, CAMERA, combines expected returns from two complementary perspectives – an equilibrium-based model driven by risk considerations, and a valuation-based model driven by fundamentals and market pricing. This framework recognises that while expected returns are likely to converge towards equilibrium over the long run, shorter-

term return expectations may deviate from those levels as valuations become stretched or depressed. Over the last two quarters, valuation-based estimates have declined across most asset classes, with government bonds being the notable exception. This has led to modest reductions in expected return assumptions.



10-year excess return distributions



Source: L&G as of 31 August 2026

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