QUARTERLY INSIGHTS – Q4 2025

IN SUMMARY

"THE TROUBLE WITH OUR TIMES IS THAT THE FUTURE IS NOT WHAT IT USED TO BE." ~ Paul Valéry, French Poet, Essayist and Philosopher (1871-1945).

- Employment is cooling and inflation pressure will likely follow.
- Labour markets matter because they are not just "one input" into inflation. They form the foundation of capitalism, and are the transmission mechanism through which demand becomes durable:

Job security → Wage growth → Confidence → Credit formation

- This is happening at a time when AI is beginning to look less like a "free lunch" and more like a new capex cycle, which will likely lead to higher costs in the real economy before it raises productivity.
- A slowdown in AI-driven capex and investment will impact investor sentiment, and if investment does not pull the economy forward, a slowdown might become reality later in 2026.
- However, this narrative should support the policy easing cycle as central bankers and governments come to the rescue of weaking labour markets and slowing growth. The question then becomes how much stimulus is possible given already strained government balance sheets.
- In the near term we expect growth and sentiment, driven by investment, supportive policy and disinflation, to remain robust and supportive of risk assets.
- However, it is the tension between weakening labour markets driving cyclical disinflation and structural capex intensity driving higher energy costs, through which we view 2026. The message is to prepare for a regime defined by policy-driven markets, asymmetric risks, and selective opportunity.

THE BIG PICTURE – THE FORCES OF INFLATION AT WORK

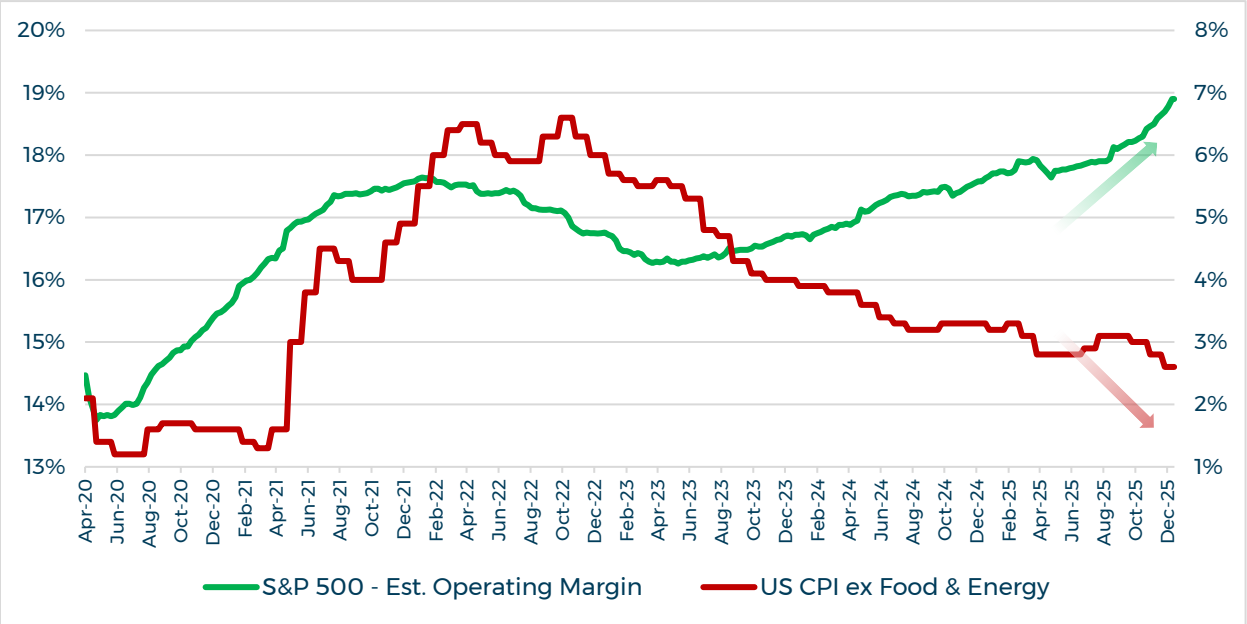
"PRODUCTIVITY ISN'T EVERYTHING, BUT IN THE LONG RUN IT IS ALMOST EVERYTHING." ~ PAUL KRUGMAN, THE AGE OF DIMINISHED EXPECTATIONS

Markets have spent much of 2025 trying to hold two ideas in their heads at once:

- *Disinflation is back (the old story).*
- *A new productivity wave is here (the AI story).*

It was an odd year in that the market's optimism proved stubbornly resilient. Although the bears reigned supreme for a few weeks at the start of 2025, even Liberation-day and the risk of returning to 1930's-style mercantilist tariff regime could not dampen enthusiasm as equity markets powered forwards. Investors were willing to treat geopolitical shocks as episodic, while viewing disinflation and AI as the structural trends that will drive resilience and corporate profit growth. In other words: the noise could be ignored, because the signal (lower inflation + AI productivity) felt too powerful.

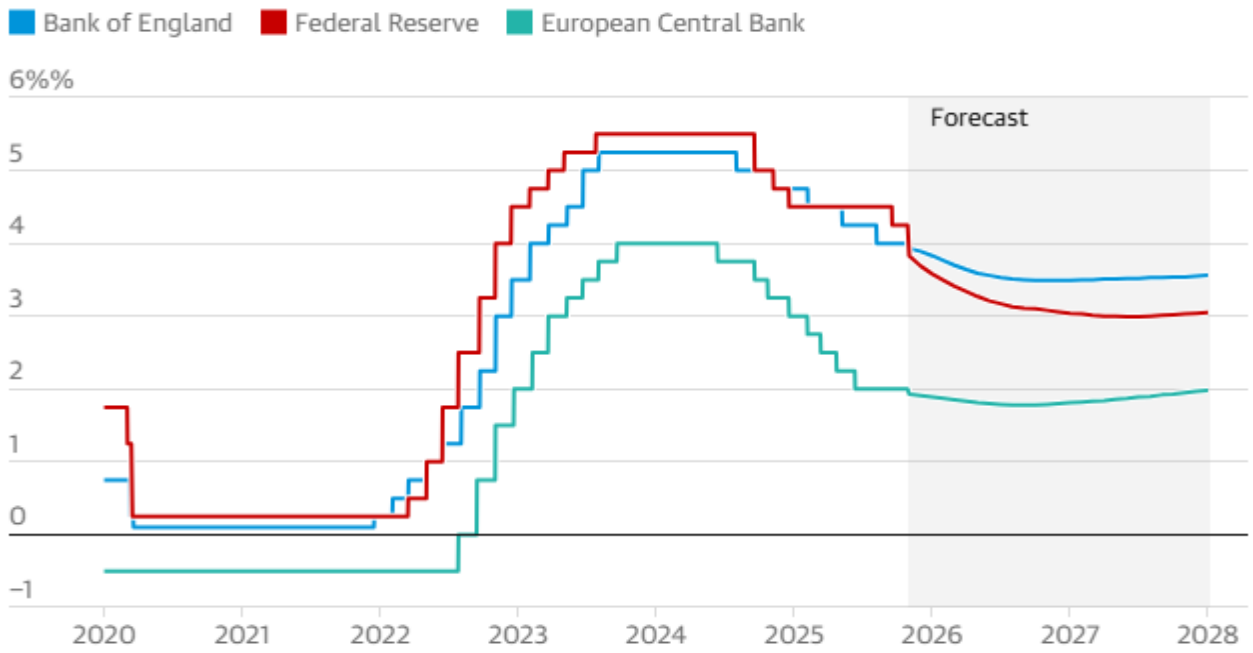
Exhibit 1: *The story of 2025: Rising profitability + Disinflation = Rally in Risk Assets*



Source: *Bloomberg, Shard Capital, December 2025*

And to be fair, the performance data reinforces that instinct. With the disinflation narrative, expectations of central bank easing cycle supported capital flows into risk assets. Indeed, from the depths of Liberation-day on April 9th to year end, the Magnificent 7, as measured by the Russell Magnificent 7 Index, were up well over 60%. That single statistic captures the year's defining feature: when the market believes the discount rate is falling and the growth story is improving, long-duration growth assets can behave like a coiled spring.

Exhibit 2: *The disinflation narrative ensured expectations of continued easing cycle from major Central Banks remain intact:*

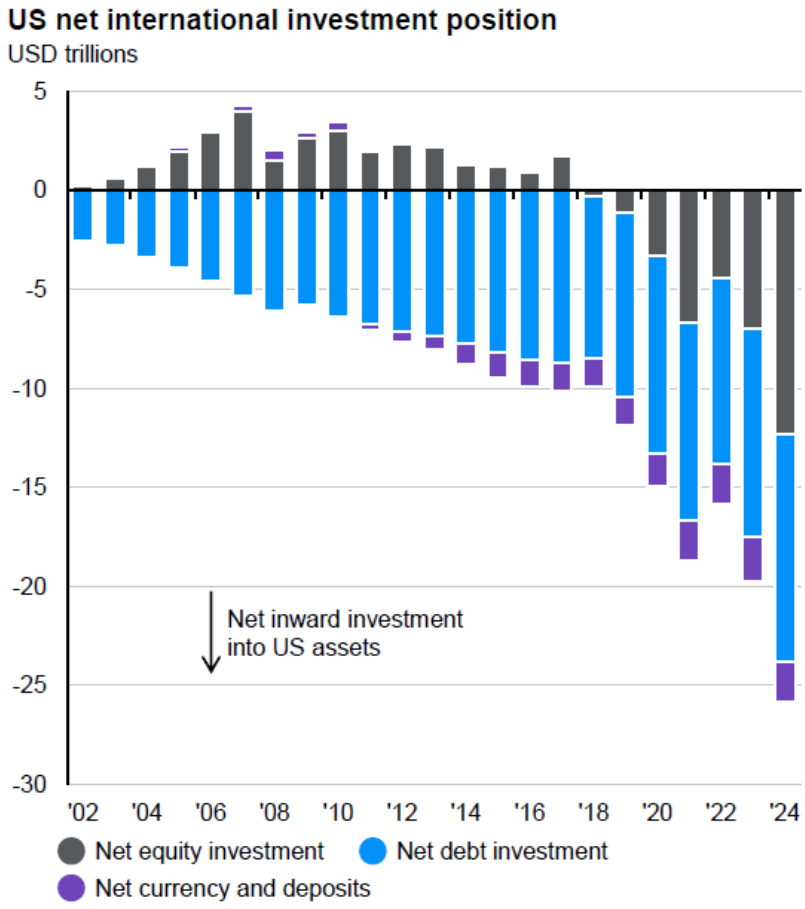


Source: *Bank of England, November 2025, Graphic by The Guardian*

But the year was not simply a repeat of the "growth wins" playbook. Something else shifted beneath the surface. Investors opened their eyes to the capex cycle and realised that not all benefits will flow to the Hyperscalers. There will be many other winners that do not have to spend billions on building out the datacentre network but can merely benefit on the back of it. This was subtle, but important: the AI story broadened from a narrow "platform monopoly" narrative into a wider industrial chain narrative: power, cooling, grid, semis, components, cyber, defence, and the enabling infrastructure that surrounds the Hyperscaler core.

That broadening helped explain why capital didn't stay confined to US mega-cap tech. Alongside a weaker US Dollar, money was quick to find its way into foreign equity markets. The "rest-of-the-world" trade – so often a value trap when the dollar is strong and US growth dominates – began to look like an optionality trade when the dollar softened, US policy eased, and global manufacturing and value exposures offered leverage to any incremental improvement in demand.

Exhibit 3: *So much money has flown into US assets since the Covid-pandemic – boosting not only the US Dollar, but all US Dollar denominated assets – that a weaker US Dollar trend could sustain a "rest-of-world" trade for some time:*

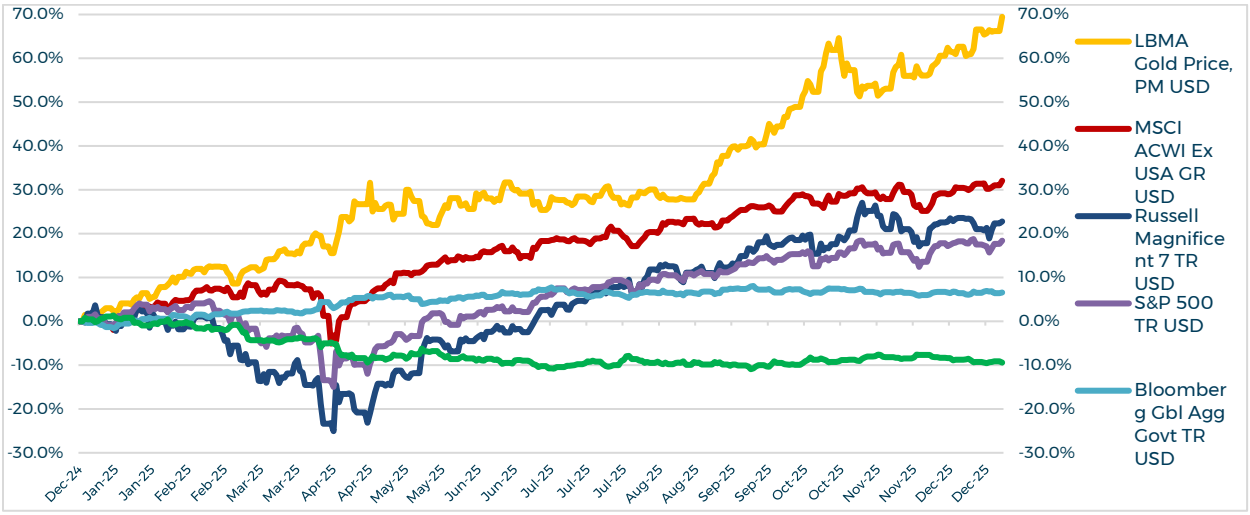


Source: *JPM Morgan Guide to the Markets, BEA, Bloomberg, November 2025*

Yet the same broadening did not deliver a rally in bond markets. Perhaps the memory of inflation and fear of its return kept rates elevated. That sentence is arguably the most important behavioural insight of the year. 2025 was the year markets remembered both the central bank put and the risks of irresponsible deficit spending. The inflation shock didn't just change policy; it changed psychology. Investors started to price a world in which inflation might fall but could also rebound quickly if policy were to loosen, energy became constrained, or supply-side shocks returned.

Which brings us to what may prove the most revealing outcome of 2025: The big winner of the year was gold. Fiscal irresponsibility, rising deficits and debt requirements as we embark on the Fiscal Age, meant capital saw safety in gold rather than governments bonds, despite the lack of interest. But Gold's strength was not a "risk-off" trade. It was a referendum on credibility: on the sustainability of fiscal promises, on the political tolerance for austerity, and on whether governments can truly prioritise price stability if unemployment rises. Gold outperformed not because it yields, but because it does not promise.

Exhibit 4: *Selected asset performance in 2025 (as at 22 December):*



Source: *Morningstar Direct, Bloomberg, Shard Capital, December 2025*

But capital flows and market performance often hide the fragility of the real world. The most important source of fragility today is not a balance sheet, a credit spread, or a single geopolitical flashpoint. It is the labour market.

Exhibit 5: *Unemployment in the US and UK are clearly accelerating:*

Source: *ONS, BLS, Shard Capital, December 2025*

Labour markets are weakening, and we expect it to put downward pressure on growth and inflation. That is the near-term uncertainty: will a cooling labour market be enough to deliver a durable disinflation path without tipping into recession? If the answer is yes, the disinflation narrative extends; if the answer is no, risk assets discover that earnings are cyclical despite their secular narratives.

There is however a policy feedback loop that investors cannot ignore. On the back of a weaker labour market a dissipating inflation risks, central banks will most likely embrace loser monetary policy, and alongside ever-growing fiscal deficits and reckless government spending, inflation

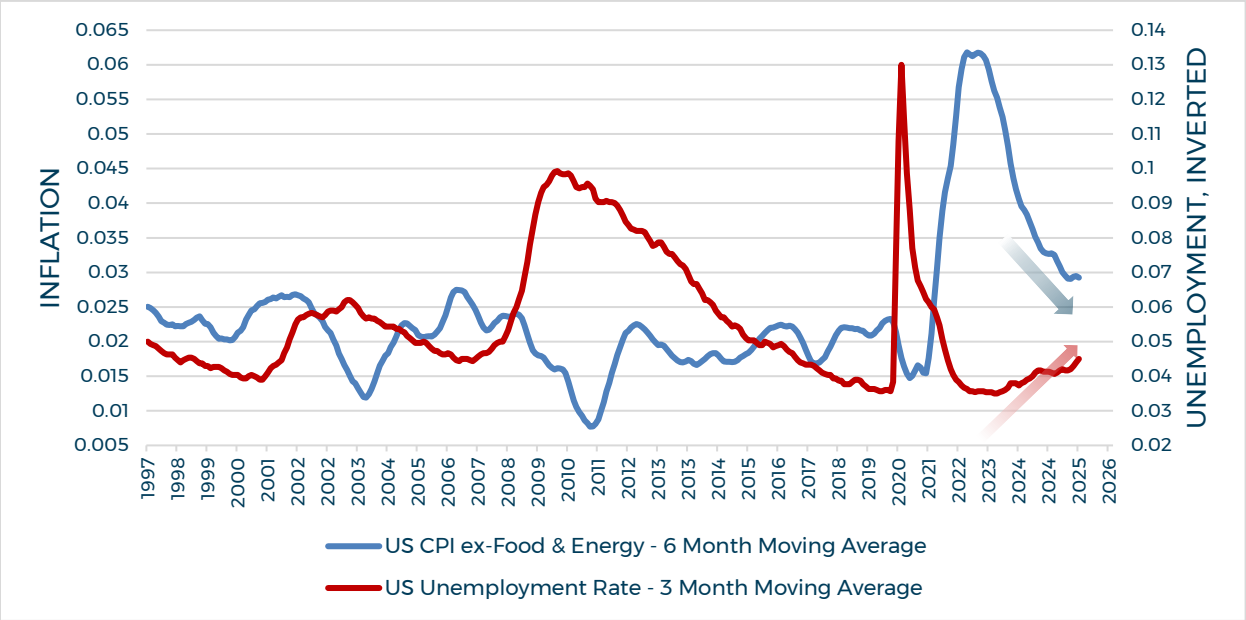
might just rear its head again. That is precisely the policy dilemma: growth weakness invites easing; easing (combined with deficit spending) risks reigniting inflation—especially if supply-side constraints intensify.

And yet, another force restrains that loop: credibility, and the memory of political pain. The fear of a repeat of 2022 and the 'cost-of-living-crisis' narrative might mean that the Fed and other major central banks keep rates higher for longer, which we believe will crush inflation risks. This is the paradox of the post-Pandemic world: even when inflation falls, central banks may hesitate to declare victory because the cost of being wrong is no longer academic – it is social and political.

At the heart of the near-term outlook is a simple truth that markets sometimes forget: *Ultimately capitalism still runs on pay cheques, and a weaker labour market means pressure on higher prices will fade.*

The simplest mechanism for disinflation is not elegant monetary theory; it is the reduction in consumers' willingness (and ability) to absorb price hikes when job security weakens. This is why labour market data sits at the centre of the inflation debate. We highlight this in the chart below.

Exhibit 6: *Inflation vs Unemployment ~ aka The Phillips Curve:*



Source: *Bloomberg L.P., U.S. Bureau of Labor Statistics via FRED®, Shard Capital, December 2025*

Importantly, markets do not need a recession for inflation to fall. History shows inflation can decelerate meaningfully as labour tightness eases. The key is the direction of travel: fewer job openings, slower hiring, and moderating wage dynamics tend to reduce pricing power with a lag.

Closer to home, the UK's inflation problem has been unusually "sticky" in services, but services inflation is ultimately a wages story. More specifically, a public sector and union driven wages story. But a cooling labour market is the first precondition for durable disinflation.

As for the rest of world, we expect similar trends in the Euro area. Inflation in November 2025 fell to 2.1% year-on-year, highlighting how far the disinflation process has already progressed in parts of Europe.

China CPI rose to a meagre 0.7% y/y in November. Still low by historical standards and consistent with subdued domestic demand.

Japan continues to be the outlier as the government and BOJ run higher inflation than many expected. Reports pin core inflation at circa 3.0% y/y in November.

Exhibit 7: *Year-over-Year change in headline inflation in major economies globally are set to decline everywhere except in China, where depression-like characteristics might be shaken off:*

Region	2024 (Actual)	2025 (Estimated)	2026 (Expectations)
United States	**2.90%**	**3.00%**	**2.40%**
China	**0.40%**	**0.80%**	**1.00%**
Eurozone	**2.30%**	**2.10%**	**2.00%**
United Kingdom	**2.50%**	**3.40%**	**2.00%**
Japan	**2.50%**	**3.00%**	**1.80%**
World (Aggregate)	**5.80%**	**4.20%**	**3.40%**

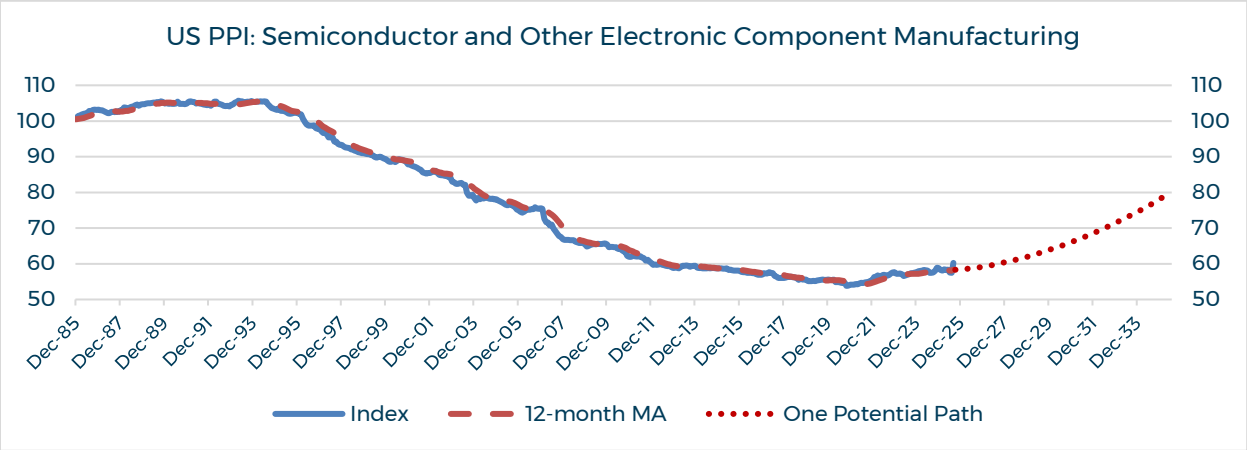
Source: *Bloomberg, Shard Capital, December 2025*

But the inflation outlook is not a one-dimensional, near-term story only. It is also a question of what happens when the AI buildout moves from narrative to infrastructure – and whether the infrastructure is as cheap and frictionless as investors assume.

The counter narrative starts with an assumption that has underpinned the modern economy for decades: Moore's Law. The belief that compute gets cheaper over time, and technological advance push prices down and productivity higher. That assumption is now being tested.

As the chart below shows, the era of cheap compute may be coming to an end. The question we need to ask is whether the arrival of AI will mark the moment that the tech-deflation tailwind disappears, only to be replaced by higher capital intensity and rising energy demand?

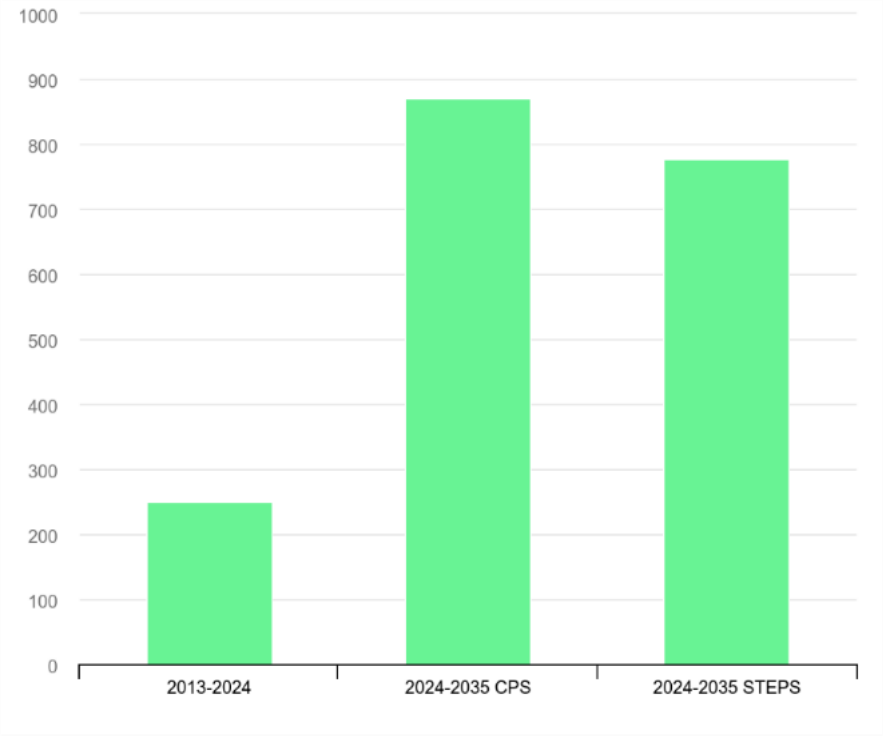
Exhibit 8: *The end of Morre's Law?*



Source: *U.S. Bureau of Labor Statistics via FRED®, Shard Capital, November 2025*

This is the medium-term uncertainty, and it is fundamentally different from the labour market story. Labour market weakness is disinflationary because it suppresses demand. Rising capital intensity is potentially inflationary because it raises the cost base and because it can tighten constraints in the real economy (power, grid capacity, components, engineering labour, and critical infrastructure).

Exhibit 9: *Electricity demand from Data Centres is set to triple over the next decade (TWh/yr):*

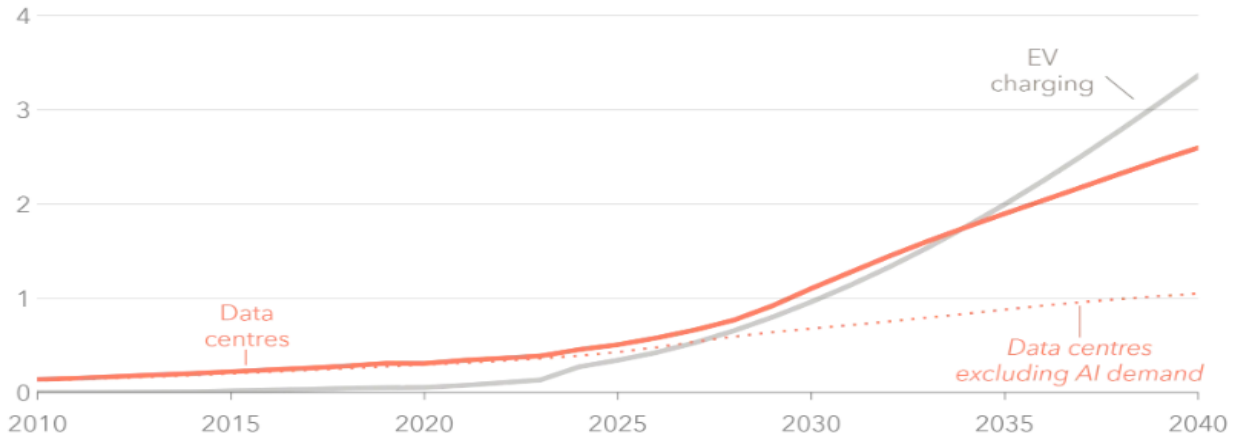


Source: *https://www.iea.org/reports/world-energy-outlook-2025, December 2025*

Rising energy demand from data centres and compute requirements is well understood. But the consequences on the price of electricity and its impact on a basket of consumer goods

perhaps less so. Electricity is not just an input to data centres and EV's. It is an input to everything – manufacturing, logistics, housing, services – the full economy. If the marginal demand for power rises faster than supply and grid capacity, the price mechanism has to do the balancing. And higher electricity costs do not remain contained to "tech"; they will ultimately leak into broader consumer baskets over time.

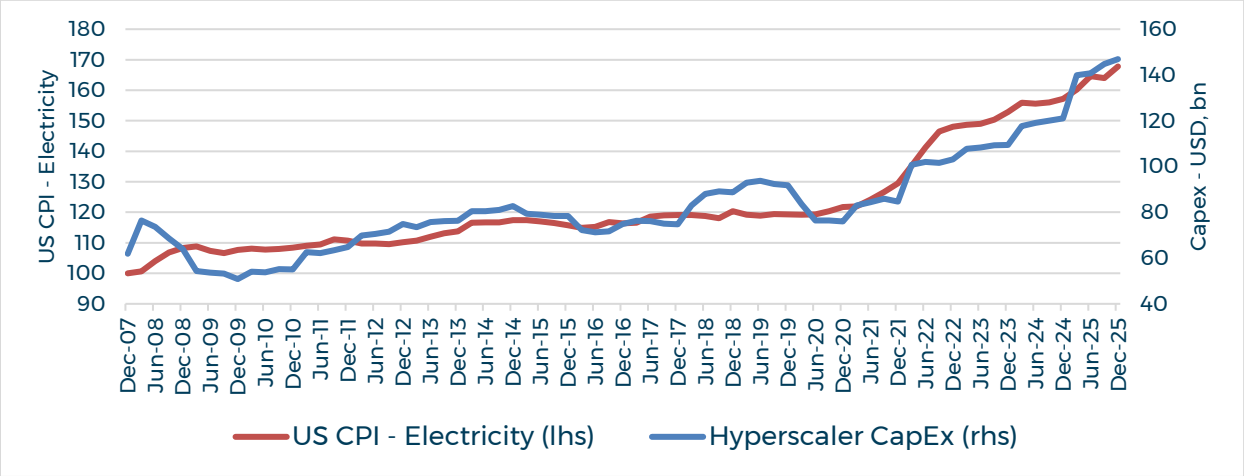
Exhibit 10: *Artificial Intelligence and Electric Vehicles will drive the majority of marginal demand growth for electricity in the coming years. The chart shows world electricity demand from data centres and EV charging, in PWh/yr:*



Source: *https://www.dnv.com/energy-transition-outlook/, December 2025*

Chart below captures the full extent of the narrative: rising capex from Hyperscalers have supported the growing electricity demand from Data Centres, as well as the subsequent rise in electricity prices in the CPI basket.

Exhibit 11: *A rise in electricity prices, despite the weakness in oil, have coincided with rising capex spending from the Hyperscalers:*



Source: *Bloomberg L.P., Shard Capital, 23/12/2025; CPI data indexed to 100 on 31/12/2007*

To be clear, we are not arguing that this is tomorrow's inflation problem. In the very near term, we do not see this as the most significant risk to capital markets. The nearer-term driver remains labour market momentum and the policy response to it. But we are arguing that the medium-term narrative may shift from "AI productivity boom" toward "AI's Capital Intensity", with all the capex, energy, and constraint dynamics that the infrastructure implies.

Indeed, the inflation debate will not disappear simply because the labour market cools. It will evolve.

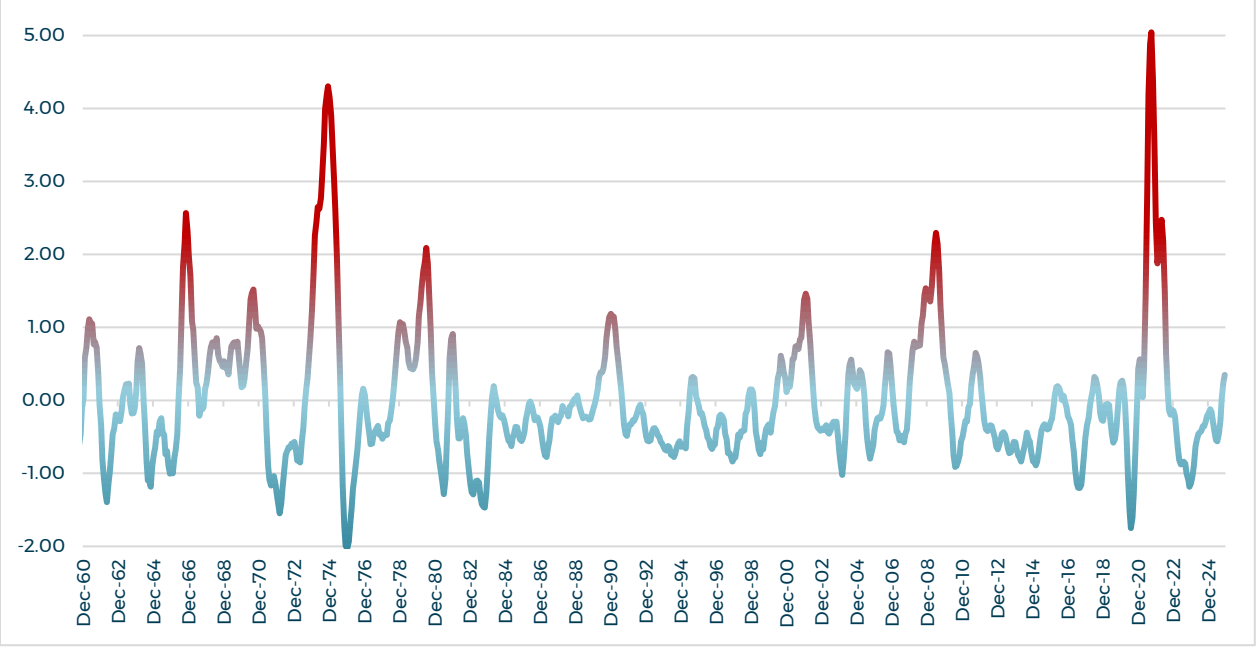
The direction this narrative will evolve into depends on many factors. The worst-case scenario is a meaningful rise in the Misery Index, depicted below. It is not called the Misery Index for nothing, rising inflation prevents central banks from cutting rates, whilst rising unemployment will reinforces stagflation.

That is why our "Big Picture" conclusion is deliberately nuanced: inflation may fall in the near term because paycheques drive demand, but inflation uncertainty may rise in the medium term because infrastructure drives costs. The investment challenge for 2026 is not choosing a single story – it is holding both, and positioning for a world where disinflation and reflation pressures can coexist across different time horizons.

Exhibit 12: *The below chart is a formatted version of the Misery Index: Unemployment + Inflation.*

We consider the 6-month change in the Misery Index. We then normalise the data and smooth it by taking a 4-month moving average.

The key is: a number greater than 1 indicates significant 'misery', driven by an extraordinary rise in either inflation or unemployment.



Source: *BLS, Shard Capital, December 2025*

AI: THE DOUBLE-EDGED SWORD – CAPITAL INTENSITY, POWER INTENSITY, AND SECOND-ORDER EFFECTS

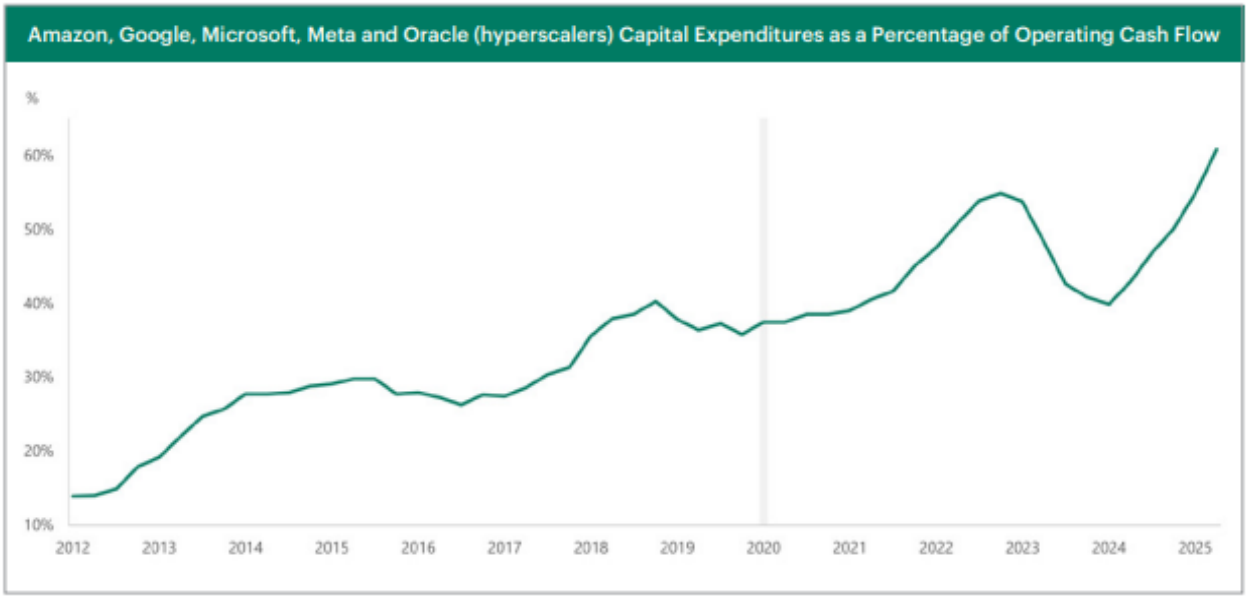
"WE TEND TO OVERESTIMATE THE IMPACT OF TECHNOLOGY IN THE SHORT RUN AND UNDERESTIMATE IT IN THE LONG RUN." ~ Amara's Law, Roy Amara, American researcher, scientist, futurist.

We agree that AI is a structural force. We disagree that it is "capital light".

The prevailing narrative still treats AI as software: magical, scalable, margin-expanding, and crucially, deflationary. But the world does not run on narratives; it runs on balance sheets, grids, and input costs. And in Q4, the market finally began to connect the dots: AI is increasingly looking like an infrastructure cycle. Less like an app store and more like an industrial buildout.

This buildout is already consuming balance-sheet capacity. Hyperscalers' aggregate capex has surged relative to operating cash flow, as show below. Amazon, Alphabet, Microsoft, Meta and Oracle are now spending around 60% of operating cash flow on capex, a record share, and still rising.

Exhibit 13: Aggregate Hyperscaler capex:



Source: *Bloomberg, Apollo Chief Economist:* 2026 Outlook, December 2025

This matters for two reasons. First, it breaks the "AI is free" illusion. Second, it changes who wins. As we highlighted above, investors are realising that not all benefits will flow to the Hyperscalers. Many of the winners may be the "enablers" who sell picks and shovels without having to fund the mine.

Crucially, at the component level, cost pressures are increasingly visible. Exhibit 8 above (semiconductor PPI "turning") captures the essence: the Producer Price Index for semiconductors and electronic components has clearly turned and moving higher for the first time in 40 years.

Effectively 'memory' is becoming a bottleneck as AI servers absorb supply. Prices for certain segments have surged, and on recent earnings calls, firms are explicitly warning that tightness could persist as demand for AI infrastructure reshapes the whole memory complex.

Even if AI ultimately boosts productivity, it may do so via a capex wave that is inflationary at the input level (chips, memory, power equipment, grid upgrades) before it becomes disinflationary at the output level (cheaper services, higher measured productivity). That sequence matters for markets, because investors price the long-term benefit but often ignore the short-term bill.

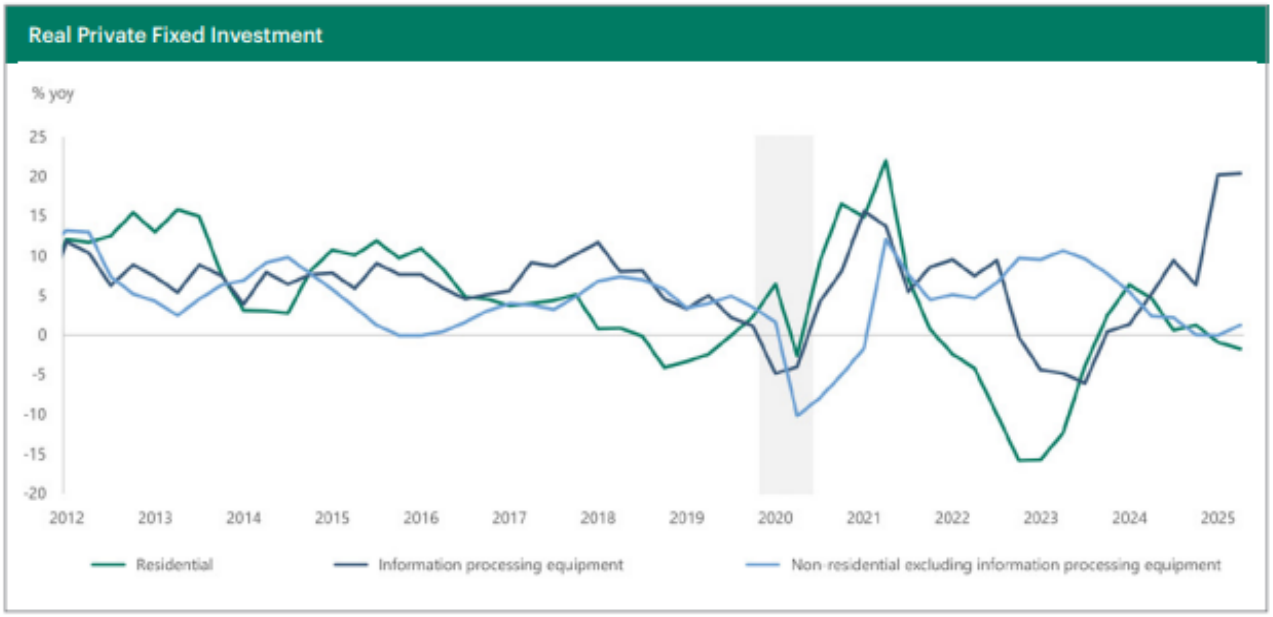
Most importantly, we see energy demand as a major factor. It is not a footnote, and if anything, it is likely to be the constraint. Energy is the binding factor of the AI era. As shown in exhibit 9 above, the IEA now projects global electricity consumption for data centres could triple over the next decade.
This is not just "more power." It is more power in the wrong places, at the wrong times, behind congested grids. Which is why your Exhibit 11 is so powerful: rising capex from Hyperscalers has coincided with rising electricity prices in the CPI basket, even while oil has been weak.

Ultimately the second-order effects here are underappreciated. Electricity is not just an input into data centres. It is an input into everything. If the marginal demand for power rises faster than supply and grid capacity, the price mechanism does the balancing. And when electricity prices rise, they do not stay quarantined inside "tech". They will leak into the broader economy and ultimately in the consumer basket.

If compute becomes a larger line-item and energy becomes a binding constraint, then the long-held assumption that "compute always gets cheaper" becomes less reliable. For the Hyperscalers and optimistic futurists, this changes either the adoption curve or the Return On Investment (ROI).

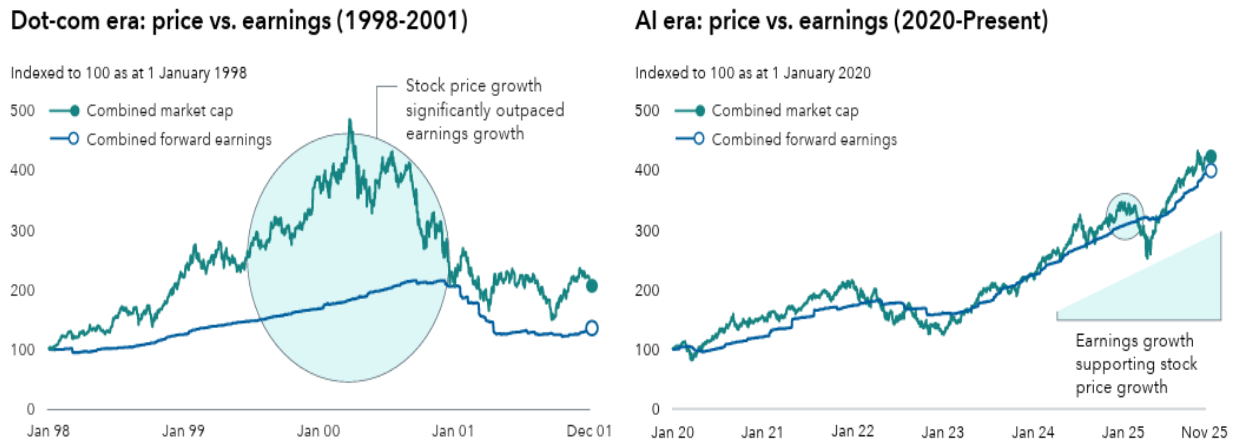
However, AI adoption will most likely still grow, and accordingly the ROI may be lumpier and the economics less linear than equity market narratives imply. Higher input costs can compress the ROI for marginal adopters; higher electricity costs can slow rollout; higher component prices can force rationing. And that sets up the paradox: a slowdown in AI investment, or even a modest disappointment versus the capex implied by valuations, could become a macro event by H2 2026. Too much sentiment has become anchored to the AI growth story, without considering the cost to build it out.

Exhibit 14: *As Apollo's Chief Economist, Torsten Slok, puts it: "While we do believe that AI will continue to grow, if there was a slowdown in the space, we expect that impact to be felt across the economy." As shown below, there has been virtually no private investment into the economy outside of AI.*



Source: *US Bureau of Economic Analysis, Macrobond, Apollo Chief Economist:* 2026 Outlook, December 2025

Exhibit 15: *One major difference between the AI-era and the Dotcom-era, is operating profit growth. Whilst narratives drive sentiment, and in-turn, equity markets, there were no profit growth to back-up the Dotcom-era equity market appreciation. Unlike today, where profit growth has been not only strong, but accelerating.*



Source: Capital Group – 2026 Outlook, *Bloomberg, November 2025.*

1998 – 2001: Data aggregates forward 12-month net income ("forward earnings") and market capitalisation ("market cap") for the "Four Horsemen" of the dot-com era: Microsoft, Cisco, Intel, and Dell, four of the largest and best-performing companies of that

2020 – Present: Data aggregates forward 12-month net income ("forward earnings") and market capitalisation ("market cap") for NVIDIA, Microsoft, Apple, Amazon, Meta, Broadcom and Alphabet, seven of the largest AI-exposed companies.

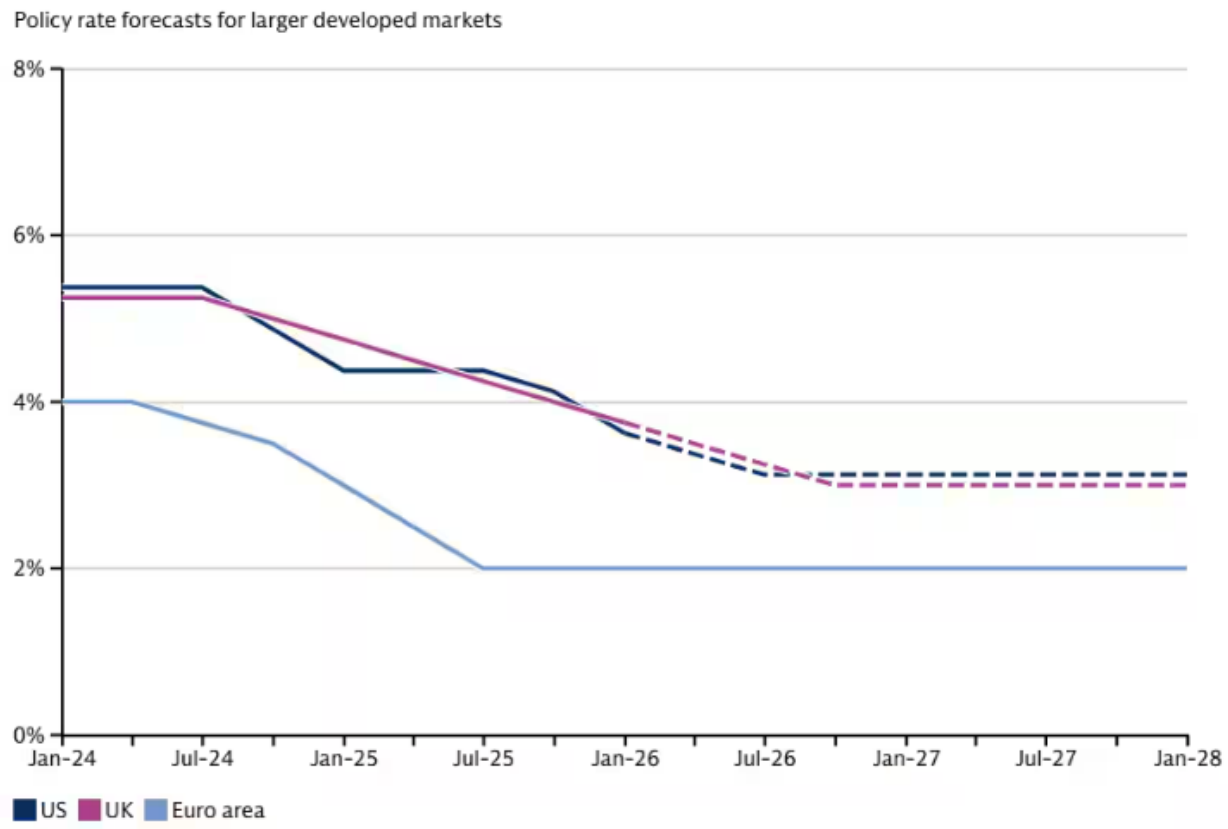
ON POLICY – LOOSER POLICY TO DRIVE GROWTH

"IN THE LONG RUN WE ARE ALL DEAD." ~ John Maynard Keynes, British Economist.
(A reminder that politicians and policymakers operate on shorter horizons than we might like to believe.)

Policy in 2026 is likely to be guided by one unglamorous reality: growth needs support. Labour markets are cooling, confidence is more fragile than equity indices suggest, and the political tolerance for economic pain has fallen since the cost-of-living crisis. That combination typically produces the same outcome: politicians and policymakers reach for the levers.

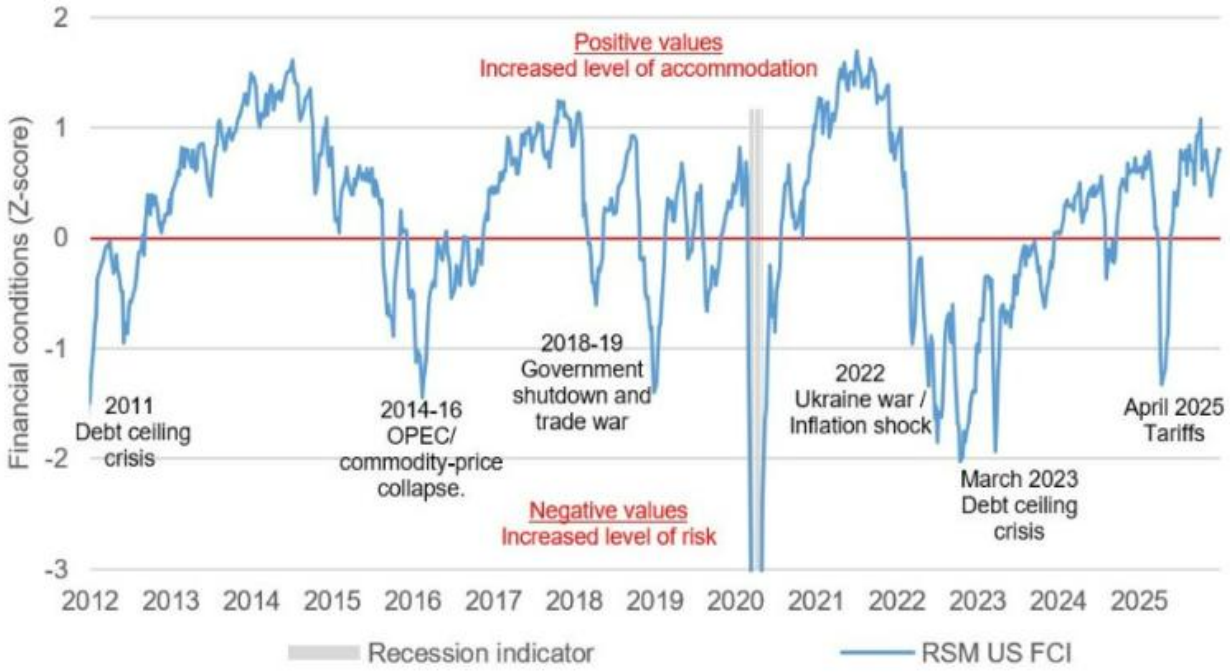
The chart below – like exhibit 2 above – says it all. The Federal Reserve has already moved. In its December 2025 statement, the Fed set the federal funds target range at 3.50%–3.75% following a 25bp cut. In the UK, the Bank of England's December 2025 decision reduced Bank Rate to 3.75%. Whilst the ECB is 'on hold', policy has already loosed significantly.

Exhibit 16: *The disinflation narrative ensured expectations of continued easing cycle from major Central Banks remain intact.*



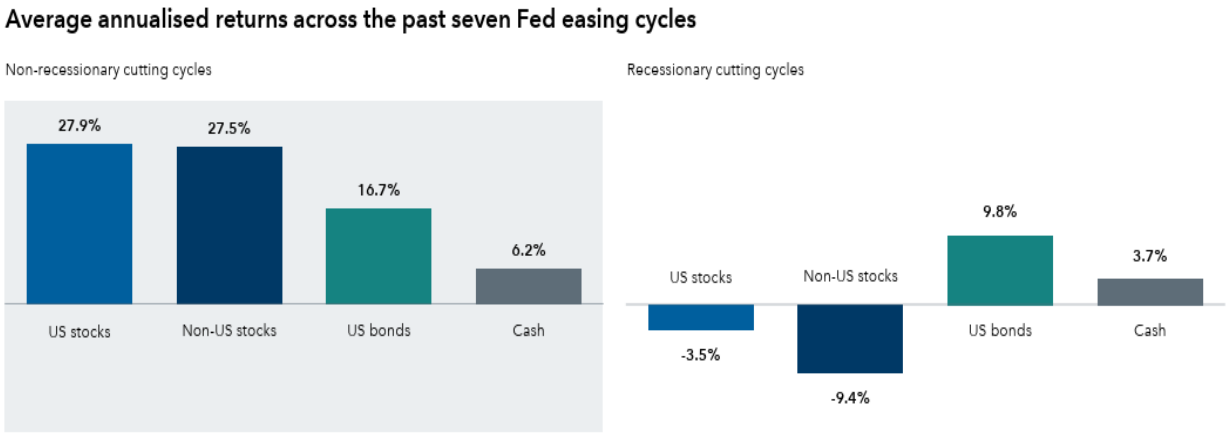
Source: *Goldman Sach – 2026 Outlook, Haver Analytics, Goldman Sachs Research, December 2025*

Exhibit 17: *Financial Conditions remain positive, indicating an accommodative environment for borrowing and lending with the potential for economic growth, especially amid the disinflationary environment we expect.*



Source: *Market Minute: A normal yield curve to start the year, Bloomberg, December 2025*

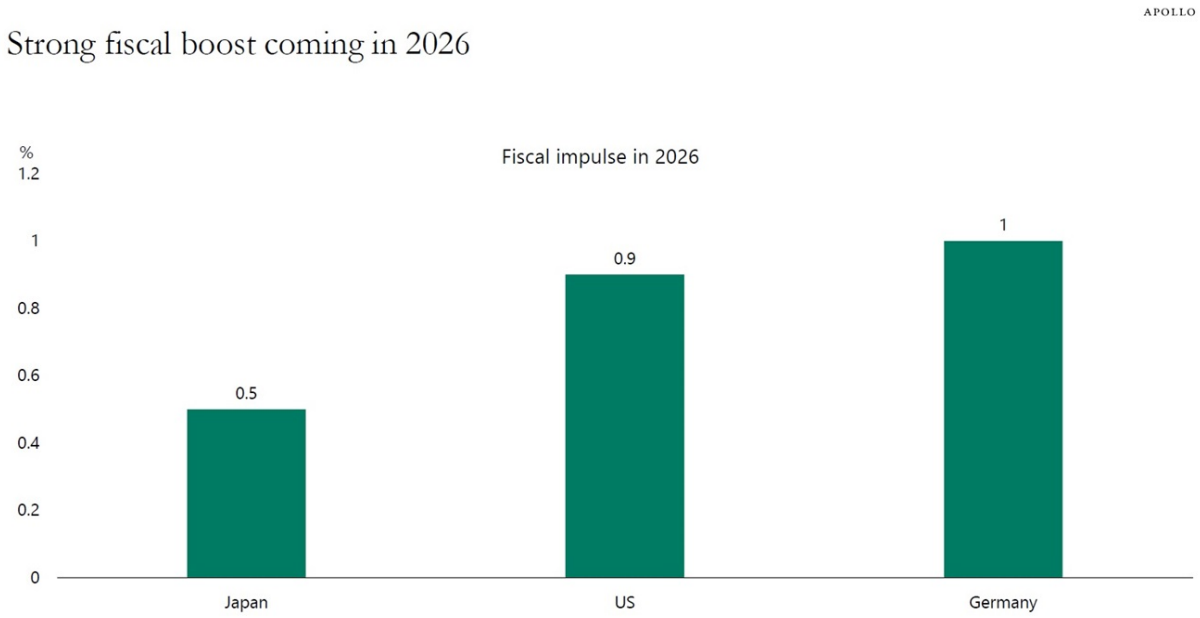
Exhibit 18: *Average annualised returns across the past seven Fed easing cycles. One should reasonably expect risk assets to continue to outperform if we avoid a recession.*



Source: Source: *Capital Group – 2026 Outlook, Bloomberg. Morningstar, Standard & Poor's, November 2025.*

The common thread is clear: central banks are now more explicitly balancing inflation control with growth protection, which should be supportive for continued outperformance of equity markets. But the more interesting question is how far they can go in the face of expansionary fiscal policy.

Exhibit 19: *The IMF estimates that fiscal policy will boost growth by 1% in Germany and 0.5% in Japan in 2026. The CBO estimates that the One Big Beautiful Bill will boost US growth by 0.9%. The bottom line is that fiscal policy in the G3 will be very expansionary over the coming quarters, see chart below.*

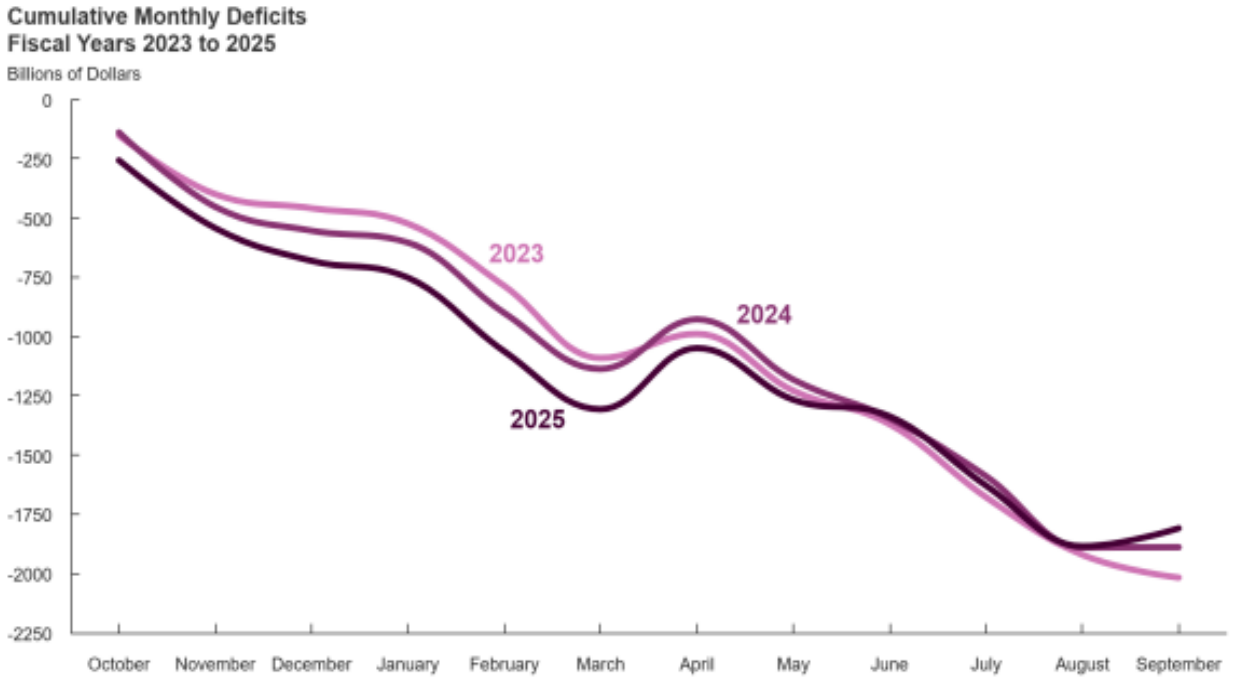


Source: *Apollo Chief Economist:* *The Daily Spark*, January 2026

The post-2022 world matters. Central bankers know the political cost of reigniting inflation. That fear can easily translate into "cut, but cautiously"; or "cut, but stop early"; or "cut, but keep financial conditions tighter than the market expects." In other words, we may see easing, but not necessarily the type of easing that guarantees a durable bond rally – especially if fiscal dynamics push term premia higher (more on that below).

Even without new stimulus, deficits remain large. The CBO estimates the US federal budget deficit was about $1.8 trillion in fiscal year 2025 (ended September 30).

Exhibit 20: *The size of the US budget is unlike any outside wartime periods:*



Source: *The Congressional Budget Office (CBO), US Treasury, October 2025*

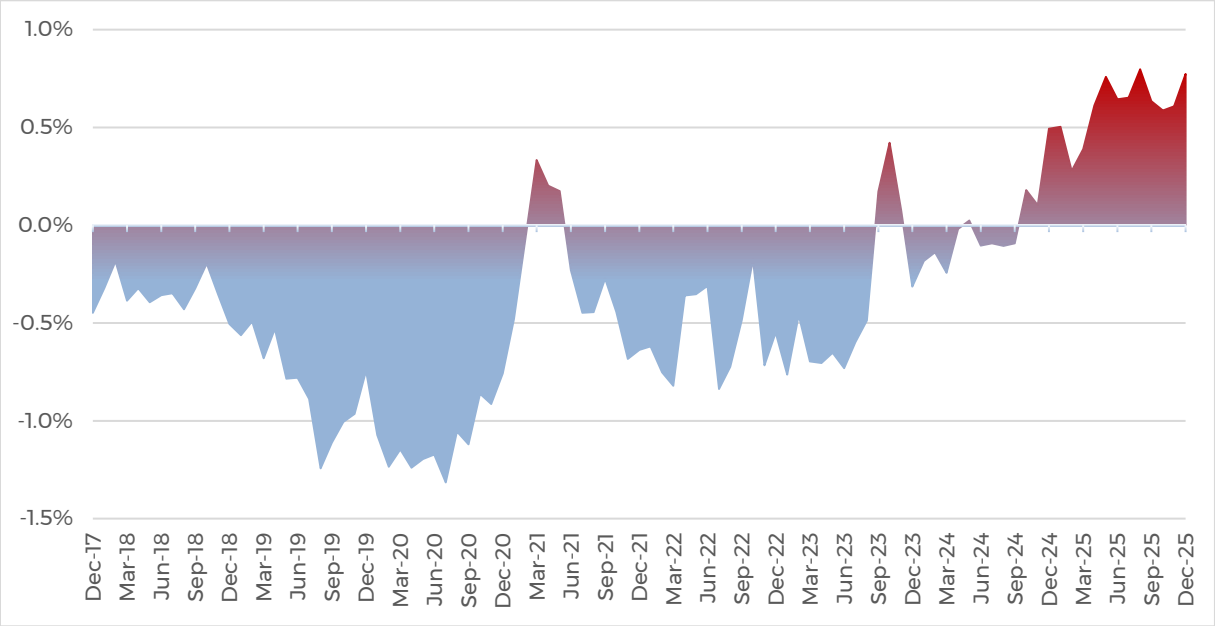
And when growth slows, fiscal math tends to worsen automatically: weaker tax receipts and stronger stabilisers. So, the risk for 2026 is not simply "bigger deficits." It is bigger deficits at the same time as higher financing costs and higher term premia. a combination that can destabilise the traditional policy mix.

This is where economic theory bites. In a world of high debt loads, policy begins to resemble what markets call "fiscal dominance": the state cannot easily tolerate high real rates for long, yet the bond market demands compensation for inflation uncertainty, issuance, and credibility risk. That tension is one reason why 2025's bond market refused to fully "believe" disinflation, and why gold behaved like a credibility hedge.

The key transmission mechanism for 2026: term premium

The missing variable in most soft-landing narratives is the term premium—the extra yield investors demand for holding long-duration government bonds amid uncertainty about inflation, issuance, and policy regimes. The New York Fed's term premium estimates (ACM model) provide a useful lens here.

Exhibit 21: *The term premium is defined as the compensation that investors require for bearing the risk that interest rates may change over the life of the bond. The below chart shows the estimated term premium on a 10-year US Treasury Bond. The bond market is telling us that* inflation, issuance, and policy risks are rising!



Source: *Federal Reserve Bank of New York: Federal Reserve Board, Shard Capital, December 2025*

In a "classic" slowdown, weaker growth and weaker inflation pull yields down. But in a fiscally strained world, its more nuanced. Large issuance and credibility risk can keep term premia elevated, limiting how far bond yields fall even as central banks cut. That is precisely the setup we expect: greater deficits and rising term premia to offset lower government bond yields resulting from weaker employment.

We expect policymakers to lean toward easing to support growth. But the "old world" playbook – cut rates, watch long yields fall, watch financial conditions loosen – may not repeat. The new world has heavier issuance, more fragile credibility, and a rising capital intensity backdrop (AI, energy, defence, grid). The result could be a policy regime that looks supportive on paper, yet produces stickier long yields, more volatile curves, and sharper market reactions to any sign that inflation could return.

CLOSING THOUGHT

The investment challenge for 2026 is not choosing between "soft landing" and "hard landing". It is recognising that we may be entering a regime where **cyclical weakness** and **structural capex intensity** coexist.

That is precisely the kind of environment where a better diversification, a robust risk management process and a more suitable Strategic Asset Allocation framework, matter most.

ON ASSET ALLOCATION

Please refer to our monthly review.

"Qui Curat Vincit"

CONTACT US

For further information on any of our services, or if you would like to arrange a meeting with an investment manager to see how we can work with you, please get in touch.

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IMPORTANT INFORMATION