WALTER SCOTT

MARKET INSIGHT

A POSITIVE PERSPECTIVE

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Key takeaways

- Lots of companies will benefit from their investment in AI, but there are a few things to watch out for along the way
- Dull economies do not equal dull companies – learn more about the leading European businesses showing their mettle
- Some tests lie ahead for markets, but there are plenty of opportunities for the bottom-up investor

Global stock markets continued to march higher in the fourth quarter, rounding off another robust year for equity returns. Underpinning the bullish tone, economies and corporate earnings proved more resilient than expected, while the Federal Reserve and European Central Bank obliged investors with interest rate cuts.

While this benign backdrop could remain in place in 2026, there has been a change in market complexion. After a lengthy period during which market gains were driven by companies involved in the build out of AI infrastructure, such as Nvidia, investors have grown more wary of the AI narrative.

We believe that over time, companies across many sectors will successfully monetise the opportunities afforded by the evolving technology. However, there is a risk that some of the massive investments being made in AI infrastructure, sometimes via significant debt financing, will not be justified by the ultimate returns. The history of technological development is often punctuated by periods of 'bubble-type' euphoria and over-investment.

Among potential hurdles, rising power costs and infrastructure bottlenecks are perhaps underappreciated. Revenue models – such as those adopted by neo-clouds like CoreWeave, which effectively rents out graphic processing units (GPUs) – may prove unsustainable. The sheer pace of technological change could mean that their investments in GPUs become obsolete more quickly than they are depreciated.

However, against this backdrop, we believe that Microsoft and Amazon have managed their data centre expansion judiciously. They are financially strong behemoths at the forefront of AI development, with a higher-margin model that caters to many thousands of clients and provides a more comprehensive range of services than simply renting out compute capacity. You can read more about this here.

Don't forget the incumbents

The AI disruptors-versus-incumbents narrative has continued to do the rounds. Many leading software company share prices have been under pressure, with the market concerned about the potential disruptive impact of AI startups on their longstanding and successful business models.

We think investors may be underestimating the deep competitive advantages enjoyed by many incumbents, as well as their own ability to innovate and leverage AI. Many have a sticky customer base, are integrated into customer workflows, have proprietary data on which to build their AI functionality, or have strong R&D capabilities founded on experience, know how and financial strength. Recent results for Adobe would suggest that the successful leveraging of these attributes is proving a bulwark against disruption, while there are signs of the company improving its monetisation of AI.

A brief tariff tantrum

The US administration has once again demonstrated that tariffs are its weapon of choice in achieving broad policy goals. The willingness to use them as a threat against commercial and strategic partners suggests they will continue to be a source of market volatility.

Europe can be thankful, for now, that this latest tariff reprieve is one bullet dodged. Higher levies would complicate the economic picture in the region. In Germany, for instance, industrial production has already been impacted by previous tariffs, tepid demand, and competition from China, especially in the automotive field.

Despite macro headwinds, investor sentiment towards Europe has reflected the German government's expansive fiscal stimulus programme, the European Central Bank's loose monetary policy, and the shift towards the continent's rearmament.

Dull economies ≠ dull companies

While Europe's economy is currently lacklustre, it does not define the fortunes of its leading global businesses. For instance, markets have been welcoming the recovery in some of the region's well-known consumer companies. The strong share price performance of LVMH in the fourth quarter reflected the gradual rekindling of the appetite for the company's iconic brands across all regions, except Europe. Similarly, fashion designer and retailer Inditex, with its differentiated, consumer-responsive business, saw sales growth gather momentum throughout 2025 following a period of relative weakness in late 2024.

Conversely, Ferrari's share price fall seems to be an over-reaction to the company's typically conservative long-term guidance and volume numbers. However, Ferrari is not about volume growth. A tightly controlled, low-volume production strategy preserves exclusivity and supports strong residual values. The brand power of *il Cavallino Rampante*, a near-unique franchise with a deep moat, enables steady price increases. Buyers readily tick expensive options boxes and queue up for exclusive models, thereby boosting margins and returns on capital. Complemented by limited editions, one-off models, and special series variants, there are more options than ever to tempt customers to open their wallets.

Another pedestrian economy, Japan, saw solid gains over the quarter, although a weak yen took the sheen off returns in US dollar terms. New prime minister Sanae Takaichi's pro-growth agenda has been welcomed by investors, with a US$135bn stimulus package aimed at boosting economic growth, easing the cost of living for consumers, and bolstering national security through investment in strategically important industries. However, a number of companies in the technology and industrial sector continue to experience cyclical headwinds.

Things to watch out for

The tilt towards fiscal largesse in Japan has been marked by a significant increase in bond yields, with the 40-year Japanese government bond breaking through the 4% level for the first time since they were issued in 2007. Bearing in mind the significant amount of overseas debt held by Japanese investors, there are concerns that this increasingly attractive yield might induce a repatriation of money out of overseas bond markets, which could push up yields elsewhere.

This is at a time of bloated budget deficits in Western economies. So far there has been little sign of bond vigilantism. However, notwithstanding a looser monetary environment in the West, growing fiscal concerns could lift bond yields. This might imperil the weaker borrowers in the burgeoning private credit market and increase the cost of debt for consumers and businesses. This would not escape the attention of equity markets. The positive aspect of a disturbance in debt markets is that it would likely prompt investors to pay greater attention to fundamentals and balance sheet rigour.

According to the December Bank of America Fund Manager Survey, its participants are bullishly positioned. Cash levels in portfolios are at a record low and economic optimism has been picking up. Concerns linger about the AI capital expenditure boom, albeit 'Long Magnificent Seven' remains a crowded trade.

But after a prolonged period of market strength, investors will be increasingly vigilant regarding valuations, and the economic and indeed the political picture is not clear cut. A more widespread deflation of heightened AI return expectations could see a significant downturn in related share prices, exacerbated by an outflow of the passive money that is parked in this area. It is likely that adjacent areas and indeed, the broader market would not be immune from a collapse in sentiment.

Our bullish view

From our perspective, and despite such caveats, there is much to be encouraged by in 2026.

In the pursuit of AI or other themes, the market has left behind some great businesses. For example, while share prices in the healthcare sector saw a resurgence in the fourth quarter, they have largely moved in the opposite direction to technology in recent years. The lingering effects of Covid-19, combined with heightened political scrutiny has seen the sector trading close to valuation lows not seen for decades despite durable long-term growth drivers.

This bullish view extends to the wider global equity opportunity set, with an array of quality growth stocks across many sectors seeing their valuations shrink to multi-year lows despite delivering good earnings growth. In 2025, for the first time since 2008, the MSCI World Quality Index lagged the MSCI World on a 5-year basis. We do not believe this is sustainable.

Whatever the near-term direction of stock markets, we believe that over time they reward fundamentally strong, cash-generative businesses with sustainable earnings profiles and durable competitive advantages – key focus areas for Walter Scott.

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