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Q4 2026

AFI Outlook

Growth signals
beneath the surface



Growth signals beneath the surface

While oil prices and government bond yields have dominated market attention, resilient economic growth, China’s policy response and the AI investment boom may offer more meaningful clues about where the cycle is heading.



Colin Reddie
Head of Active Strategies and
Co-head of Active Fixed Income

The third quarter has been dominated by the highly correlated relationship between higher oil prices and higher government bond yields. However, look beyond the headlines and you can see other powerful forces influencing markets, principally a robust US economy and improving growth expectations outside of the US.

Chart 1 below highlights US and EU economic data that has surprised to the upside, underscoring a growth backdrop that appears more resilient than many may have expected. But we’re also interested in China’s ‘6 Networks’ infrastructure project in a global growth context. This could prove significant, even if it continues China’s longstanding preference for stimulating growth via debt-funded, capacity-expanding capital expenditure (capex) rather than consumption. At the very least, it is hopefully a sign that policymakers will more aggressively address the chronic demand shortfall in China. If they do that, the implications could be important not just for China but for the whole globe.

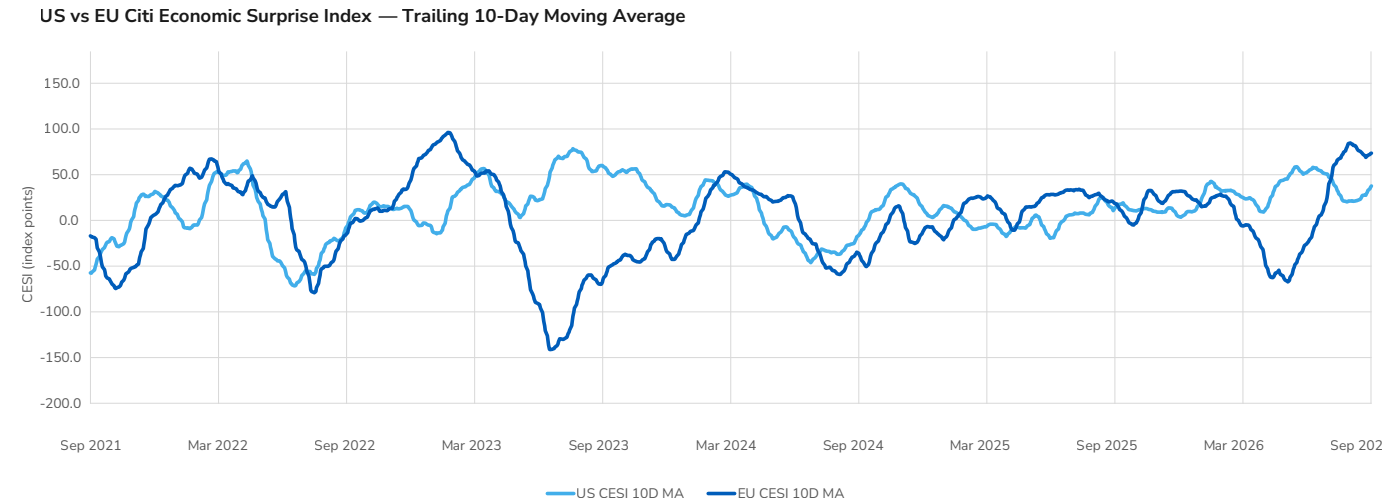
This backdrop has been sufficient to force central banks into action. The US Federal Reserve raised interest rates in September, just nine months after cutting rates in December 2025. That marked the shortest pivot from easing to tightening since the mid-1980s.

At the same time, it remains impossible to stray too far from the AI theme. We continue to marvel at arguably the biggest investment boom America has seen in our lifetimes. No longer just an equity market story, the involvement of international debt markets is now crucial to the AI investment thesis, while also providing useful signals to gauge where we are in the cycle. As the cycle evolves from mid to late stage, early participants can earn outsized returns (e.g. technology equity) while credit expands to fund more of it (hyperscaler debt). At this stage, it is important to recognise the opposing dynamics at play: debt carries fixed obligations that fall due on a set schedule, whereas equity returns are tied to future outcomes.

We keep a close eye on signs of euphoria, where prices detach from cashflows, “this time is different” narratives appear, and leverage and novices pile in. It brings us back to one of the golden rules of investing: managing money well has little to do with how smart you are and a lot to do with how you behave.

Consider the abrupt unwind of the AI-focused Situational Awareness hedge fund, that grew rapidly in under two years before suffering a 67% loss in July 2026,¹ and the painful impact of single-stock leveraged ETFs when prices stop rising. These episodes are a reminder of the behaviours that emerge when investors start to see organic returns as less compelling. When demand for yield or spread or growth exceeds the natural supply of ‘good’ assets, the system turns to manufacturing its own or buying existing ones at the ‘wrong’ price, because it is incentivised to do so. The history of market cycles is full of examples where periods of strong confidence lay the foundations for future volatility.

Chart 1: Economic surprises point to stronger growth



Source: Bloomberg, as of 30 September 2026

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1. Reuters as of 1 August 2026

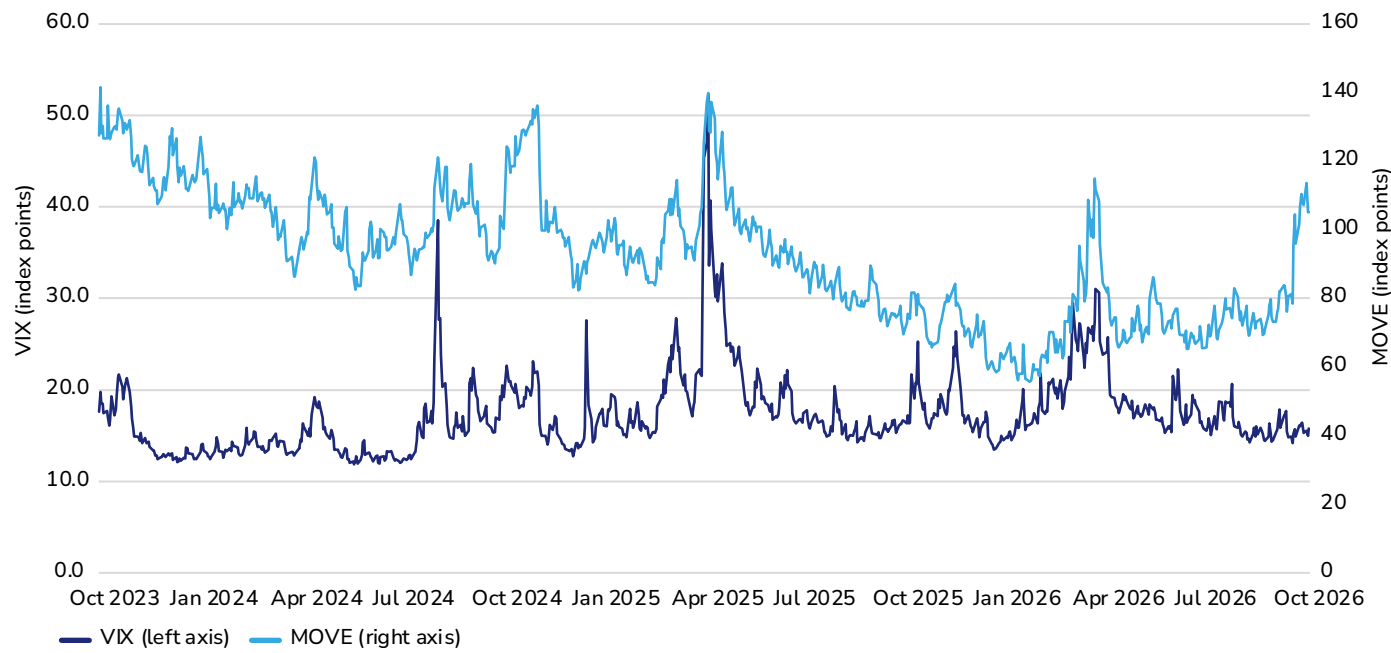
M&A activity has always been a clear expression of corporate management confidence in both the cycle and their own business prospects. Even away from AI-related capex generating extraordinary demand for capital, deal volumes continue to accelerate. Second quarter data suggested we were on track for the highest volumes this year, but the third quarter has been surprisingly slower.

During stronger periods of growth, M&A volumes tend to be less sensitive to rates overall as these can be sizeable, strategic acquisitions. However, how rates rise (or fall) is important. The US 10-year Treasury yield has risen almost 1% since the end of the second quarter.² Looking at the relationship between bond and equity market volatility (chart 2) suggests that some stabilisation in rates markets may be desirable for management teams contemplating transactions.

My colleague, Jason Shoup, discusses the implications of the upcoming midterm elections in the US through the lens of AI. However, a possible consequence of a Democrat 'clean sweep' next month is that companies accelerate their plans if they believe they only have two years to get larger, more aggressive deals done.

For now, we remain keen observers. Rates may be high by recent historical standards, but economic growth is real and company earnings are strong. We aim to be sceptical rather than cynical as we watch more concerning signs of excessive risk-taking in financial markets.

Chart 2: Bond and equity market volatility indices



Source: Bloomberg, as of 7 October 2026

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2. Bloomberg as of 7 October 2026

AI enters its political phase: implications for US credit

As the AI buildout collides with US politics, we believe US credit investors will need to weigh supply pressure, infrastructure constraints and issuer dispersion against the long-term growth potential of the asset class.



Jason Shoup
Co-head of Active Fixed Income and CIO,
L&G – Asset Management, America

Over the past few years, artificial intelligence (AI) has primarily been viewed as a technology and investment story. However, it is now becoming a political one in the US and globally. The November US midterms may matter less because of the precise composition of Congress than because they reveal which AI concerns resonate with voters. AI still trails the economy, immigration and foreign affairs as a priority, but public anxiety about its consequences is increasing. For US credit investors, the key question is where that anxiety begins to constrain the investment cycle, alter the supply outlook and change the compensation required for AI-linked risk.

The emerging fault line is not simply Democratic versus Republican. President Trump’s administration has emphasised American AI leadership, competition with China, faster infrastructure development and relatively light federal regulation. Democrats generally favour stronger safeguards, but the coalitions are more complicated. Populist Republicans are also questioning the costs and concentration of AI, while governors and state legislators from both parties have resisted attempts by Washington to pre-empt state rules or limit their ability to regulate data-centre construction.

That makes AI unusual: Both parties want the US to lead China, but neither can ignore the domestic costs of that race. We believe three political paths could emerge after the midterms, each with important implications for US credit.

First, China could win the political argument

If national security and technological competition dominate, policymakers may continue to prioritise rapid infrastructure development, permitting reform and access to energy. Bottlenecks in power, chips, powered buildings and skilled labour would likely extend the investment cycle rather than stop it. For US credit investors, this would support continued issuance from hyperscalers, utilities, data-centre developers and the broader supply chain – potentially including large, well-telegraphed deals from mega-cap technology issuers as well as securitised and project-related financings tied to data-centre capacity. The opportunity would remain substantial, but so would supply pressure and the need for issuer and structure selection.

Second, an infrastructure backlash could become the primary constraint

The first meaningful restrictions may fall not on frontier models but on the infrastructure surrounding AI: data centres, electricity, water and tax incentives. These costs are visible to households and can generate bipartisan pressure in ways that abstract model-safety arguments cannot. Local opposition is already raising project costs and timelines, and could change where data centres are built.

For US bondholders, this scenario could increase permitting, completion and refinancing risk. Attempts to secure capacity could pull capital expenditure and issuance forward, worsening market indigestion. Longer term, fewer projects could limit overbuilding risk and benefit completed assets. The result would probably be greater dispersion between operating projects and speculative developments, and among utilities able to allocate infrastructure costs without provoking a political response.

Third, labour could become the enduring political fault line

In the near term, the buildout is creating demand for specialised construction, engineering, electrical and technical workers. Those shortages can raise wages, construction costs and inflation before AI produces economy-wide disinflation. Over time, broader enterprise adoption could displace workers, particularly in entry-level and routine cognitive roles.

The absence of widespread layoffs this year does not settle that question. Enterprise deployment is harder than many expected: Companies must connect models to proprietary data, redesign workflows and build the governance, security and evaluation processes required for reliable use. Limited displacement today may therefore say more about implementation frictions than AI's eventual labour-market effects.

That uncertainty has market implications. A gradual transition could support productivity, profits and company fundamentals. A more abrupt displacement cycle could impair consumption and create weakness in consumer, banking and lower-quality sectors of the market, even if GDP remains supported by investment. It could also produce a complicated rates outcome: weaker employment and disinflation at the front end, but stronger productivity, fiscal responses and a higher neutral rate at the long end.

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From politics to financing

Across all three paths, politics ultimately becomes a financing question. A year on from the first mega AI debt deals, the buildout is clearly dependent on public bonds, securitised debt, private capital and hybrid structures. Recent research from Goldman Sachs tracks \$578 billion of global AI-related debt issuance through mid-September this year.³

This year has also shown that with risk-free yields elevated and AI deals receiving a choppy reception, capital is not unlimited. Equity and IPO funding can strengthen the cushion beneath creditors, but safety, political and return-on-investment concerns could undermine valuations. The most consequential question is therefore whether the industry can finance the buildout, manage its physical footprint and demonstrate that its benefits are broadly shared.

For US credit investors, the implication is a more selective – not simply more bearish – view of AI-linked risk. Strong demand, elevated all-in yields and disciplined issuance windows can still support spreads, particularly for well-capitalised hyperscalers and data-centre assets with clear contracted cash flows. But valuations leave less room for broad market tightening, and the next phase of the buildout is likely to bring more differentiation by issuer quality, funding structure and exposure to political or infrastructure constraints.

The better opportunities may come where technical pressure has created adequate compensation in higher-quality AI-linked issuers, balanced with defensive duration and select wider-trading credits that can benefit if conditions merely stop worsening. The main risks are supply indigestion, weaker earnings quality, refinancing pressure and the possibility that politics turns AI from a growth tailwind into a constraint on where, how and at what cost the buildout can be financed.

This backdrop reinforces our constructive but selective approach to AI-related US credit, which we view as a relative-value, issuer-specific opportunity rather than a single-sector allocation. Within technology, we favour hyperscalers with stronger balance-sheet capacity, greater funding visibility and more attractive valuations, while remaining cautious toward issuers facing repeated issuance or less predictable financing needs.



3. Goldman Sachs, as of 18 September 2026

Are cashflows the new growth in global high yield? Why HALO assets matter again

As the global high yield market is increasingly defined by dispersion, investors may be rewarding certainty over potential. Businesses with scarce physical assets and resilient cashflows may be among the best-positioned opportunities in credit today, in our view.



John Ryan
Head of Global High Yield

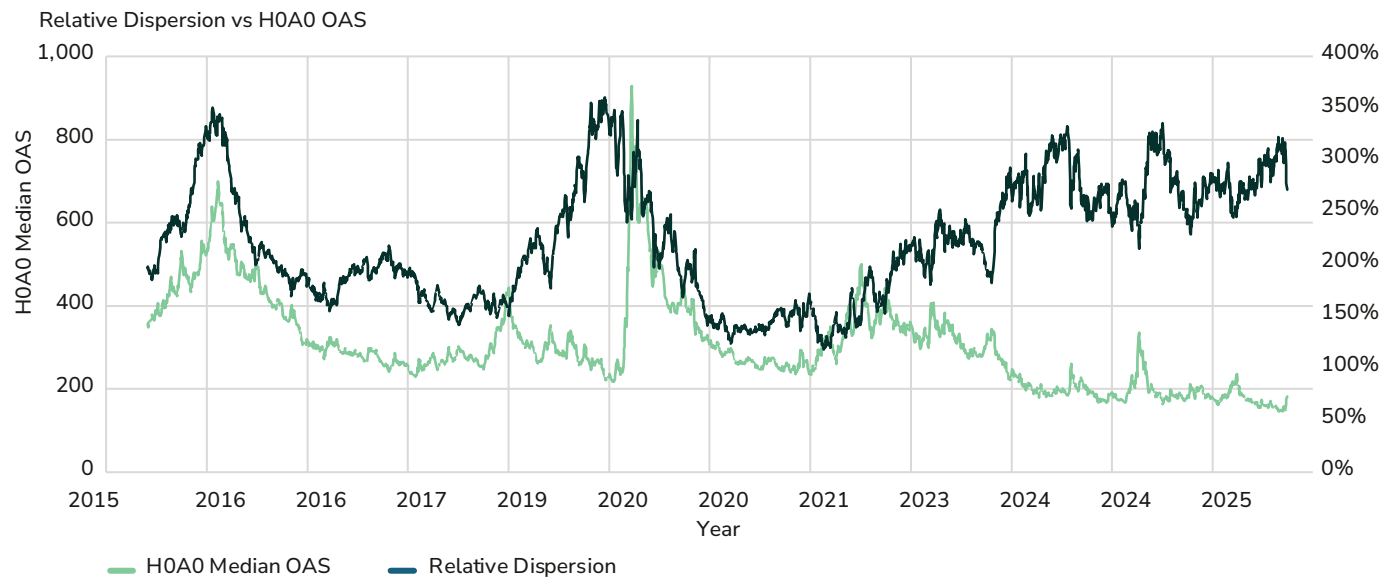


Sophia Hunt
Senior Fixed Income
Investment Specialist

For much of the last decade, high yield investors were rewarded for backing growth, disruption and longer-term business models. However, as high yield spreads tighten, dispersion increases and investors become more selective, there is a growing premium on certainty, resilience and downside risk mitigation.

We believe this backdrop can create an attractive environment for hard assets, low obsolescence (HALO) assets: businesses supported by tangible assets, constrained supply, resilient cashflows and disciplined capital allocation.

Credit dispersion at multi-year highs



Source: L&G and ICE BofA Indices US High Yield Index.

Shown for illustrative purposes only. Dispersion calculated as 90th percentile minus 10th percentile OAS difference divided by the median OAS and converted to percentage. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested.

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Dispersion beneath tight headline spreads

One of the most notable developments in credit markets is the rise in dispersion. Although headline spreads remain near historical tights, performance beneath the surface has become increasingly differentiated as investors place greater emphasis on company-specific fundamentals.

Businesses with strong free cash flow generation, balance sheet discipline and tangible sources of value are increasingly being rewarded. In this environment, security selection matters more than broad market exposure, creating potential opportunities for active investors to identify issuers with durable characteristics and resilient business models.

Even a digital world depends on physical assets

The prevailing narrative dominating headlines is that the global economy is becoming increasingly digital. Yet many of the most important constraints on growth today remain decidedly physical. Many of the factors driving credit performance remain rooted in the physical economy.

Recent events, from disruption risks around the Strait of Hormuz to weather-related shocks associated with El Niño, have highlighted how dependent supply chains remain on physical infrastructure, transportation networks and access to resources. Even in an increasingly technology-driven world, economic activity ultimately relies on real assets and construction.

AI is a powerful example of this trend. While the opportunity is significant, scaling often depends less on software and more

on access to semiconductor capacity, power, transmission infrastructure, land, cooling systems and skilled labour.

As a result, the early winners of the AI build-out may be those that control the scarce physical assets that underpin growth. For high yield investors, we believe ownership of this critical infrastructure can support stronger cash flows, enhance competitive positioning and improve resilience through the cycle.

HALO assets are being rewarded

Over the past 12 months,⁴ spreads in the broad high yield index have widened, while those in the energy and industrials sectors have tightened which illustrates the divergence across the market.

A push to finance future revenues and cashflows, and recurring supply constraints and disruptions, have created a favourable backdrop for businesses with scarce, hard-to-replicate assets. Across credit markets, investors have increasingly favoured sectors where asset ownership, high barriers to entry and strong cash generation support resilience and pricing power. Infrastructure, industrials, transportation assets and selected energy and asset-backed businesses have generally demonstrated stronger performance and more stable fundamentals than the broader market.⁵

Importantly, many HALO assets sit at the heart of powerful growth themes. Power and grid infrastructure are benefiting from rising electricity demand, logistics and transportation networks continue to support evolving supply chains, while digital infrastructure is enabling the rapid expansion of AI and cloud computing. These businesses combine structural growth opportunities with tangible asset backing, creating a compelling mix of growth, resilience and downside risk mitigation.

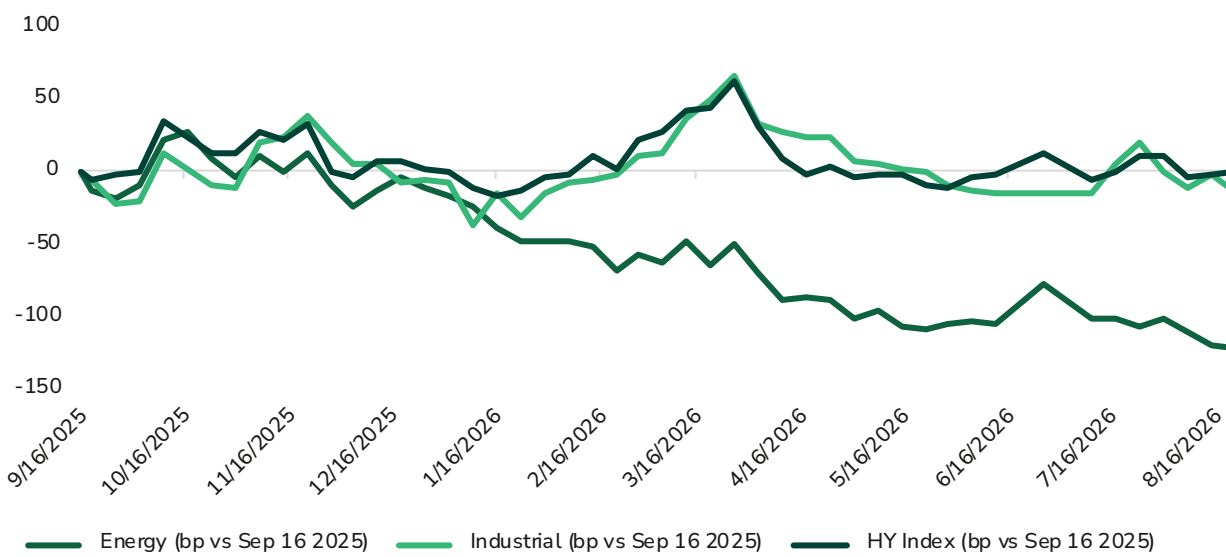
Back to basics

We believe the opportunity within global high yield is not about abandoning growth. Growth remains a key driver of equity valuations and upside potential, but credit markets capture that upside differently. With spreads close to historical tights, the convexity of bonds – where prices are ultimately capped by redemption at par – makes it harder for investors to participate fully in growth upside, while volatility can have a more immediate impact. In this environment, investors are placing a higher value on certainty, hard assets, resilient cash flows and tangible sources of value that may be better placed to deliver attractive risk-adjusted returns.

In our global high yield portfolios, we are leaning into areas of the market where resilient cashflows, asset backing and supply constraints support stronger fundamentals. This has led us to favour selected industrial, energy, infrastructure-related and transportation issuers while remaining highly selective, as elevated dispersion continues to reward active security selection.

In the AI age, the physical economy still matters. The companies best placed to benefit may not simply be those shaping the future, but those that own the assets the future depends on.

Spread move over 1 year of high yield energy, high yield industrials and broad high yield index



Source: Bloomberg, Barclays Indices as of 19 September 2026.

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4. As of 16 September

5. Source: ICE BofA High Yield Sector Indices, September 2025 to September 2026. Energy and Industrials high yield spreads tightened materially while the broader high yield index widened, highlighting stronger investor demand and more resilient sector fundamentals.

Navigating El Niño: the implications for EMD

We believe the extreme weather event will be a story of country-specific outcomes, shaped by existing macro-economic factors.



Raza Agha
Head of Emerging
Markets Sovereign
Strategy

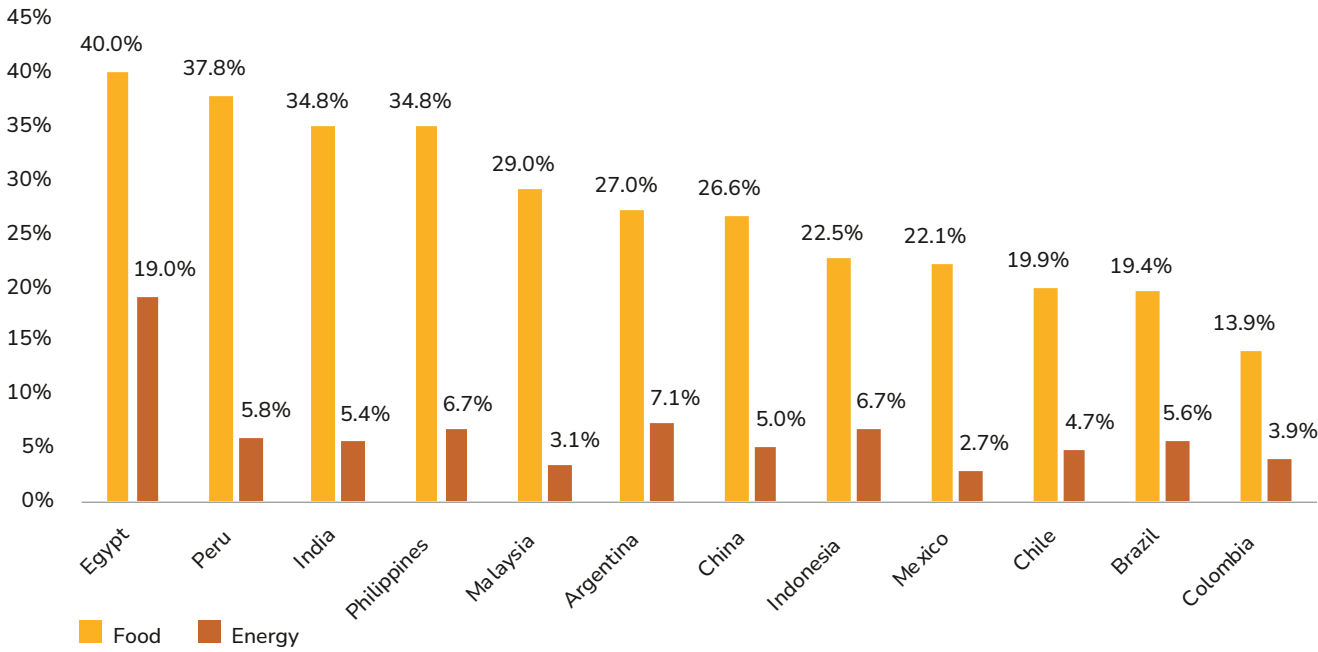


Viraj Nadgir
Senior Fixed Income
Investment Specialist

El Niño is back – and this time the meteorological signal is unusually strong. In September, the National Oceanic and Atmospheric Administration (NOAA) estimated a greater than 90% probability of a very strong El Niño during the Northern Hemisphere autumn and winter, while the World Meteorological Organization expects the episode to peak towards year-end and persist into early 2027. This comes at a time when global monetary policy remains restrictive, inflationary pressures are beginning to re-emerge and ongoing conflict in the Middle East is adding further strain on global supply chains.

However, for emerging market investors the strength of El Niño does not necessarily translate into an equally large economic shock. The more important question is where weather-related disruption intersects with existing macroeconomic vulnerabilities. The most direct transmission channel is food. Droughts, excessive rainfall and higher temperatures can disrupt agricultural production, pushing up domestic food prices. This matters particularly in emerging economies, where food typically accounts for a larger share of consumer price baskets than in developed markets. Higher food inflation can slow the disinflation process, delay monetary easing and, in more extreme cases, generate second-round inflationary pressures. History also suggests that higher food prices may lead to social unrest in many emerging economies.

Select countries with food and energy as major components of CPI

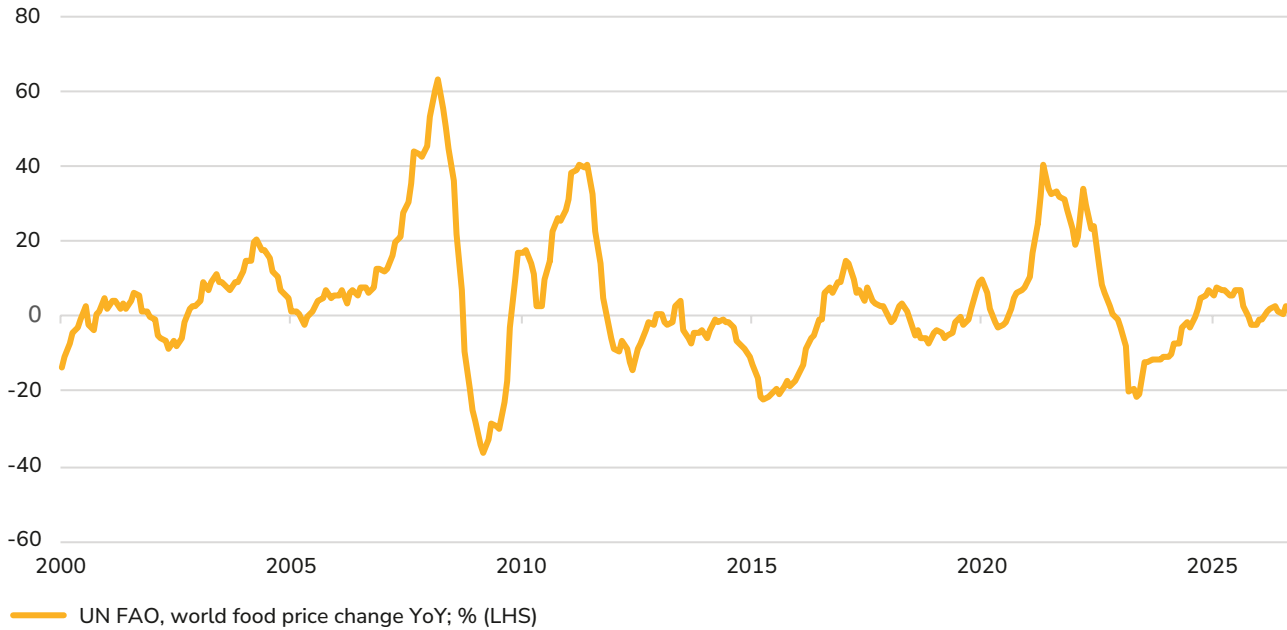


Source: HSBC Research, as of June 2026

Yet the global backdrop provides some protection. Food and Agriculture Organization of the United Nations (FAO) data show that certain grains such as global cereal inventories remain relatively comfortable, with the weather-related disruption yet to translate into a broad-based global food-price shock.⁶ This makes local conditions – rather than global commodity prices – the key variable to watch.

Energy remains another important channel to monitor. In hydro-dependent economies, lower rainfall can reduce electricity generation and force greater reliance on more expensive thermal power, at a time when oil prices are under pressure due to the Middle East situation. Colombia stands out in this respect: weaker reservoir levels could raise electricity costs, adding to inflation while weighing on industrial activity. Similar dynamics can affect fiscal balances where governments respond through subsidies or other support measures.

Monthly change in internation prices of a basket of food commodities



Bloomberg, as of 31 August 2026.
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The result is likely to be considerable differentiation across emerging markets with Latin America and Asia most affected. In particular, Colombia, Indonesia, the Philippines, India, and parts of Central America appear to be relatively exposed. Agricultural sensitivity, high food weights in inflation baskets and, in some cases, dependence on hydropower increase their vulnerability. However, this does not mean a country will be automatically vulnerable. India is an example where meaningful grain inventories and policy tools can provide a buffer.

Meanwhile, not every emerging market loses. Argentina and southern Brazil could be relative beneficiaries if increased rainfall supports grain production. Chile may also benefit from improved hydrological conditions and lower marginal electricity costs. These outcomes remain probabilistic: excessive rainfall and flooding can quickly turn a benefit into a cost.

For emerging market debt investors, the key implication is that El Niño should be viewed as a dispersion trade rather than a directional call on the asset class. Local rates are likely to be the first pressure point where food or electricity inflation delays rate cuts. Hard-currency sovereign risks may become more significant where the weather shock coincides with weak reserves, limited fiscal space or poor policy credibility.

We are currently taking a wait-and-see approach before deploying any tactical El Niño positions in our EMD portfolios, given the lag with which weather-related disruptions typically feed through to economic activity and inflation. In the meantime, we remain cautious on countries with weaker existing fiscal positions, as well as those facing leadership changes following elections, where heightened policy uncertainty could amplify the impact of an El Niño-related shock.

The indicators to watch are therefore increasingly country-specific: rainfall, crop forecasts, food inventories, reservoir levels, fiscal interventions and external liquidity. El Niño may provide the catalyst, but existing macroeconomic buffers – including persistent inflation challenges and an uncertain geopolitical backdrop will ultimately determine the winners and losers.

6. Source: Bloomberg as of 31 Aug 2026.



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