

# Sail Beyond the Surf: At the Table with BNY Experts





**Eric Hundahl**

Head of Investment Strategy and  
Model Portfolios, BNY Investments

## Debates at our Table

The accumulation of conflicting economic signals and shifting policy regimes often complicates a clear path. Over the past year, global markets have seen a series of shocks related to trade and immigration as well as fluctuating fiscal and monetary policy. However, our recent discussions suggest we are moving beyond the breakers into calmer seas and renewed economic momentum.

The year opened with an active newsfeed, but our analysis has primarily focused on the widening gap between corporate health and traditional labor market indicators. Corporate earnings remain strong and resilient, but consumption may eventually slow if the weakening labor market does not recover. As we try to reconcile a strengthening economy with a soft labor market, we are examining the potential risks to our outlook.

Divergence in central bank policy continues to be a defining discussion point. After easing in late 2025, we think the U.S. Federal Reserve (Fed) is in wait-and-see mode, waiting to see the lagged effects of its recent easing, the outcome of Supreme Court decisions and possible changes to the composition of its board. In contrast, the recovery in Europe remains uneven as fiscal dynamics differ by country, leaving the European Central Bank (ECB) on hold. As major central banks around the world continue to move in different directions and on different timetables, it is creating wider dispersion in yields, curves and currencies.

BNY Institute brings together some of our most senior, experienced investment and market experts to debate trends, challenge assumptions and surface directional views on markets and asset classes. This report — the output of our first-quarter meeting — offers you a seat at our table, sharing the disciplined analysis and diverse perspectives that shape our thinking. By looking past the surface-level noise and understanding the currents of this structural swell, we help our clients chart a confident path to get beyond the surf in today's complex markets.

# World in Motion

## United States

The U.S. economy has remained resilient, supported by steady consumer spending, and our expectation for 2026 growth remains positive. We think the One Big Beautiful Bill Act (OBBBA) will boost disposable incomes, business investment and CapEx. When also considering improving small business hiring, it points to healthier momentum ahead.

On the back of a softer labor market, 2025 closed with three consecutive 25 bps rate cuts. An expanding economy suggests less downside risk, which could mean a balanced approach from the Fed going forward. Policy direction will ultimately depend on personnel changes expected throughout the year.

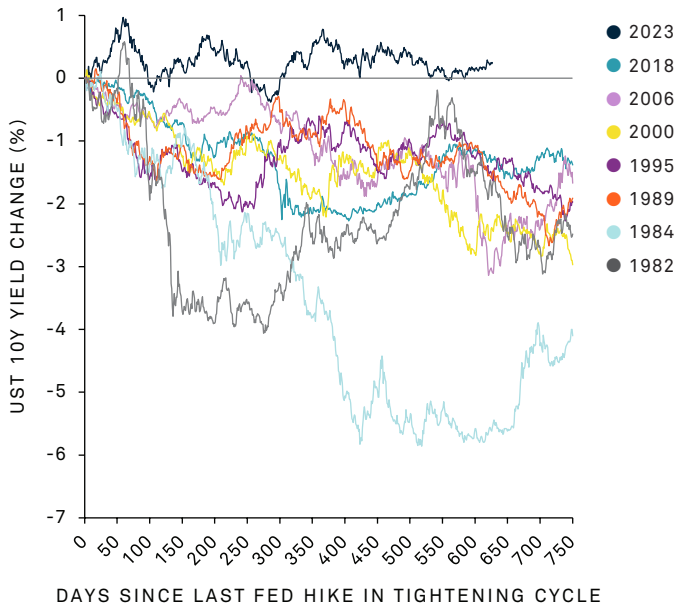
## United Kingdom

Recent data points to modest quarter-over-quarter GDP gains and improving momentum, supported by less uncertainty and increased public spending on infrastructure and housing.

The private sector still faces headwinds from soft retail demand, restrained business investment and a gradually easing labor market.

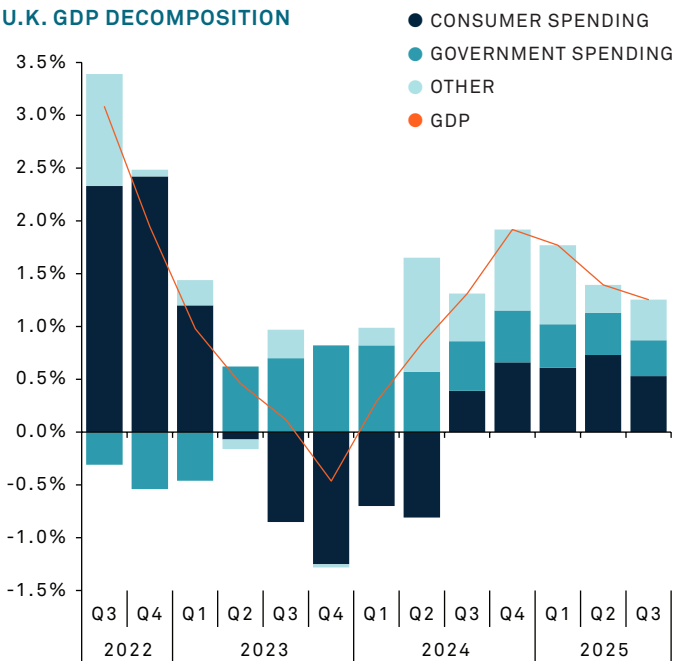
The Bank of England (BOE) cut rates four times in 2025 to stimulate growth, and while inflation remains above target, a softening labor market and lackluster growth may prompt additional cuts. Even though the Committee is divided and cautious in the new year, we expect two more cuts in 2026.

U.S. TREASURY 10-YEAR YIELDS AFTER LAST FED HIKE



Source: Macrobond, BNY Institute. Data as of 1/31/2026.

U.K. GDP DECOMPOSITION



Source: Macrobond, BNY Institute. Data as of 1/31/2026.



## Europe

Lagged effects of the ECB's 100 bps rate cuts in the first half of 2025, supportive fiscal policy and solid corporate fundamentals set the stage for a cyclical upswing in 2026. Additionally, improvement in rate-sensitive sectors could broaden in 2026. An increase in consumption due to declining household savings, as well as stronger infrastructure and defense investment, could provide further impetus for growth. Conversely, ongoing manufacturing softness, tariffs, potential delays to fiscal spending and lack of AI-related CapEx could weigh on growth.

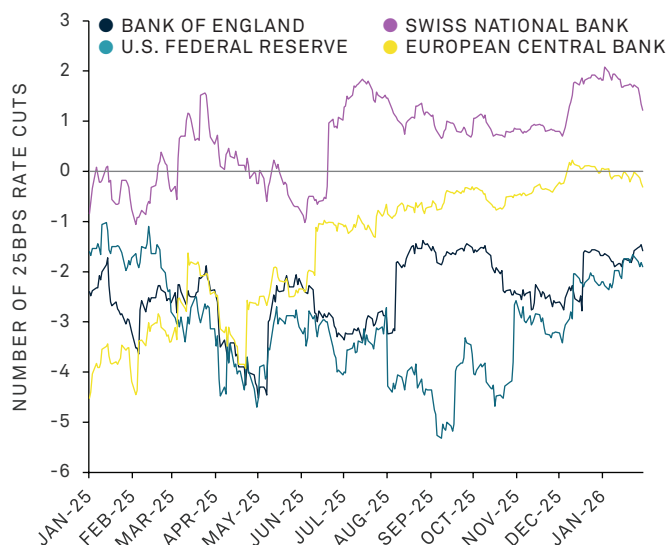
Given the scale of recent cuts, the ECB's wait-and-see approach is prudent. Weaker energy prices, a stronger euro and further declines in Chinese import prices could also drive rates lower.

## Japan

Solid business confidence and improving household spending support Japan's growth outlook. However, stringent rare earth restrictions from China could hamper manufacturing conditions. Expectations for further fiscal expansion have boosted equities and pressured the Japanese yen and government bonds.

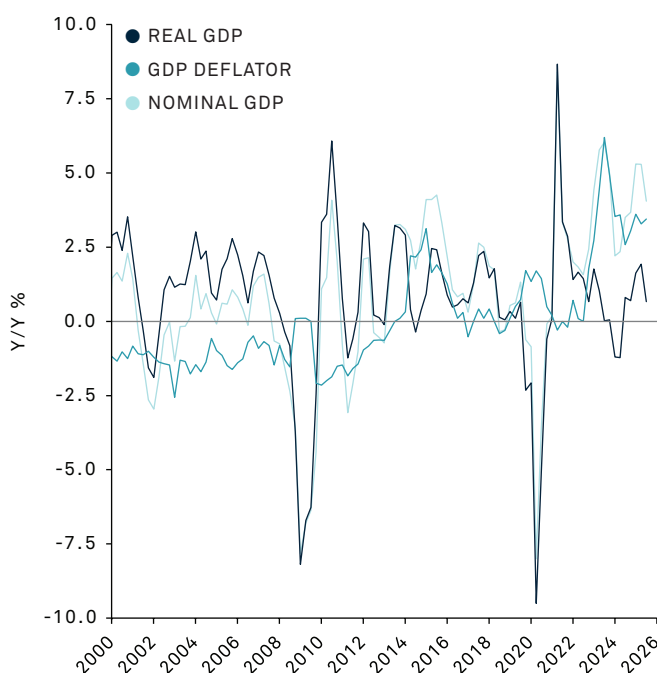
While the tightening cycle is ongoing, the Bank of Japan (BOJ) raised its policy rate to 0.75%, the highest level in three decades. The central bank action failed to halt the yen's slide, so continued FX intervention risks remain. Even though government bond yields have risen, the (tenor-adjusted) average cost of funding Japan's large public debt remains lower than nominal GDP growth, stabilizing Japan's debt-to-GDP ratio and reducing near-term sustainability risks.

### INTEREST RATE EXPECTATIONS FOR MAJOR CENTRAL BANKS OVER THE NEXT 12 MONTHS



Source: Macrobond, BNY Institute. Data as of 1/31/2026.

### JAPAN GDP GROWTH: NOMINAL, REAL & THE DEFLATOR



Source: Macrobond, BNY Institute. Data as of 1/31/2026.

## Asia Pacific

Strong technology demand, early export front loading and improving forward earnings support growth. While global AI demand is expected to remain a key tailwind, evolving U.S.–China trade strategies increase supply chain risks. Overall, current account balances are still holding up on subdued oil prices and improving net trade positions with the rest of the world.

Asian central banks delivered meaningful monetary easing as inflation softened and the U.S. dollar weakened. However, amid upside economic and earnings surprises, further rate cut expectations are waning, with Japan as the key outlier.

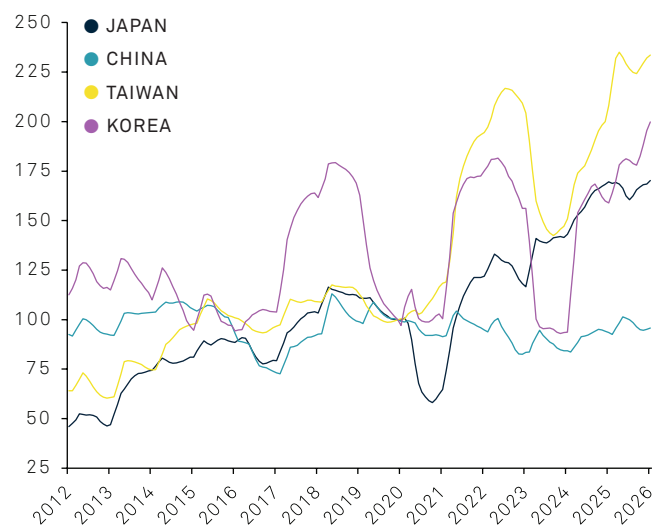
## China

China's growth mix has shifted toward manufacturing and exports. While U.S.-bound shipments declined, China's penetration in non-U.S. export markets accelerated. Overproduction, however, is resulting in persistent deflation. Additionally, an adverse wealth effect from lower real estate prices is slowing loan demand and blunting credit easing.

Policymakers are balancing cutting capacity to stabilize prices against stimulating industry to meet growth targets, which could deepen deflation. With ample central bank liquidity, additional easing is likely to support further fiscal policy stimulus in 2026. However, a long-term solution to increase household consumption and domestic absorption of manufacturing output seems hazy.

### EPS TRENDS: TAIWAN, KOREA, CHINA & JAPAN

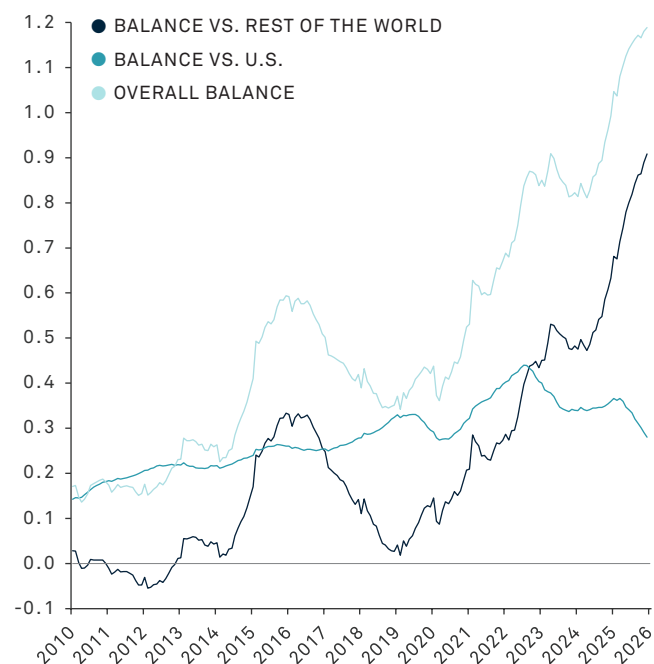
Three-month moving average



Source: Macrobond, BNY Institute. Data as of 1/31/26. Rebased to 100 in December 2019.

### CHINA TRADE BALANCE TRENDS (ROLLING 12-MONTH SUM)

USD, Trillion



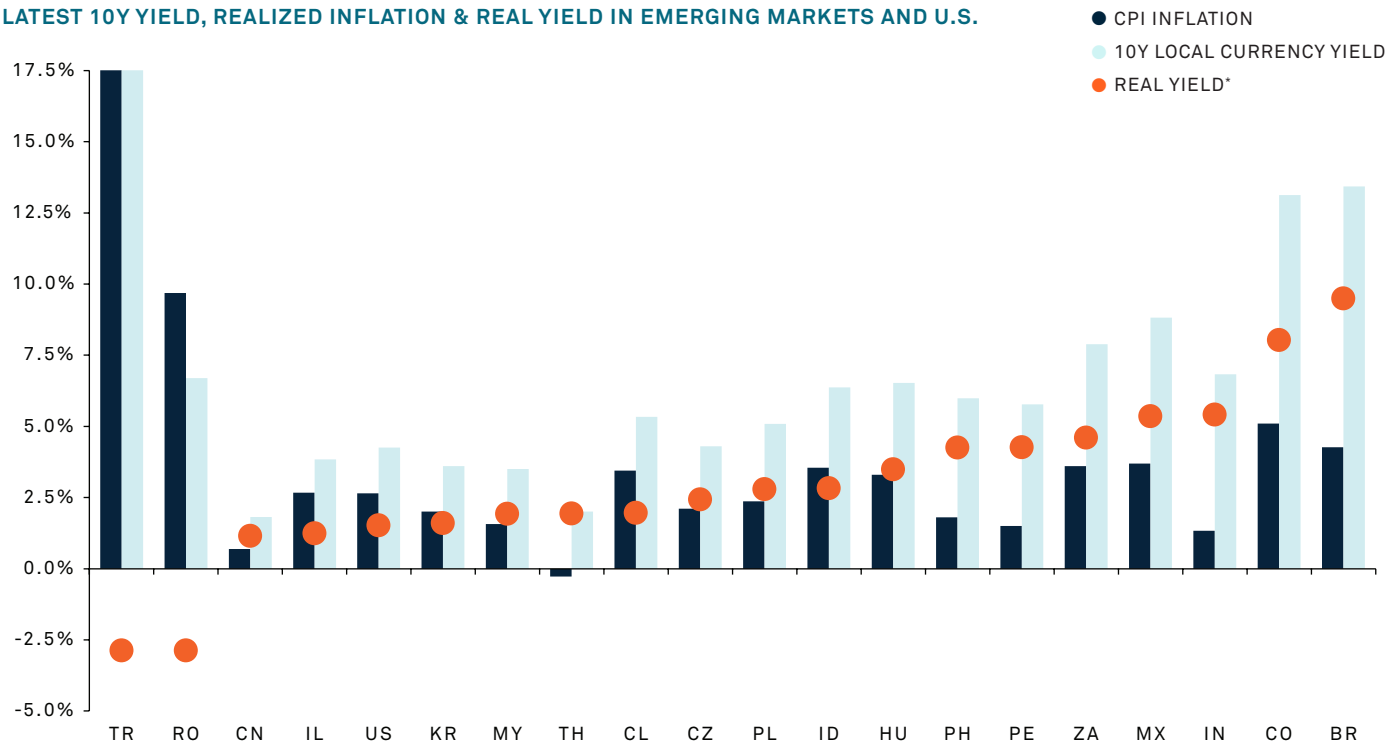
Source: Macrobond, BNY Institute. Data as of 1/31/2026.

# Emerging Markets

Strong AI-related CapEx, resilient semiconductor demand in APAC and rising metals prices are underpinning terms of trade for many emerging economies. Increasing foreign direct investment from global multinationals and Chinese private firms is likely to create new opportunities and offset lingering tariff drags or trade imbalances. Geopolitical and domestic political disturbances remain risks, but many emerging market countries have improved policy credibility.

Emerging market inflation has continued to ease on high real rates (adjusted for realized inflation), reduced energy costs and the weakening U.S. dollar. Inflation has likely bottomed in most APAC economies but is poised to decline further in Latin America and EMEA.

LATEST 10Y YIELD, REALIZED INFLATION & REAL YIELD IN EMERGING MARKETS AND U.S.



\*Adjusted for Realized Inflation  
Source: Macrobond, BNY Institute. Data as of 1/31/2026.

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# In Conversation: Piloting Equity Market Currents



**Alicia Levine**

Head of Investment Strategy  
and Equities, BNY Wealth



**Bob Savage**

Head of Markets Macro Strategy,  
BNY Markets

## **Q: What trends are we seeing around region and sector equity allocations?**

**Bob:** A central question for investors is whether diversification beyond U.S. equities will finally be rewarded. Three consecutive years of double-digit U.S. returns have continued to challenge the case for allocating outside the U.S. equity market. While developed markets delivered solid performance in 2025, momentum faded in the second half, with U.S. dollar weakness driving returns more than underlying earnings or growth. As a result, valuation discipline and the durability of U.S. equity leadership remain key investor concerns.

Regional positioning remains heavily skewed toward developed markets: iFlow data indicate 93% of exposure is in developed equities, with 71% allocated to the U.S. Emerging markets (EM) represent just 7% overall, with emerging economies in APAC comprising roughly 72% of that exposure.

Within global equities, materials accounted for the largest allocations and inflows since the new year started, while consumer staples remained the only sector with net-short positioning. In the U.S., positioning highlighted overweight exposures to materials and industrials relative to their 2025 levels. Sector momentum currently favors consumer staples, as investors cover their shorts, as well as materials, real estate and energy, whereas IT, utilities, financials and communication services continue to lag.

## **Q: Is the cyclical rotation and broadening of earnings enough to carry the market?**

**Alicia:** Earnings are increasing globally and broadening beyond big tech in the U.S., which has led to a cyclical rotation that we think can persist in 2026. International stocks, which carry a larger weight in cyclicals compared with U.S. large cap equities, have continued to outperform with MSCI ACWI ex-U.S. up 8.7% since November. This outperformance has been led by value, up 13.5% — more than triple growth's return of 4%. In the U.S., cyclicals have also led since November, with small caps (7.7%) and value (6.3%) beating the S&P 500's 1.3% gain, while the Mag-7 (-5.6%) and growth (-2.8%) lagged.

S&P 500 earnings are expected to grow almost 14% in 2026 with the rest of the market outside the Mag-7 remaining the key driver — a trend that has steadily increased in the last several years. Positive earnings revisions are also increasing and led by U.S. small caps while Europe is expected to deliver 10% earnings growth for the first time since 2022.

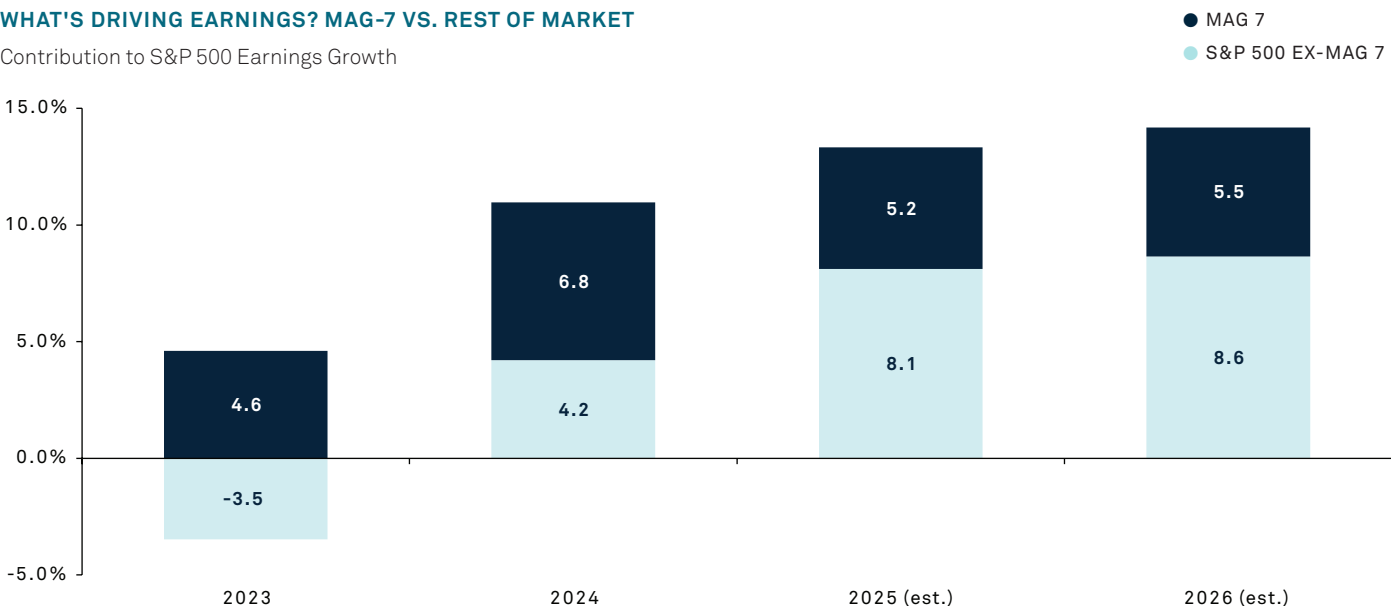
**Q: What do we expect to drive future returns?**

**Alicia:** While the elevated level of price-to-earnings ratios (PE) can be justified by higher profitability over time, we think the potential for further multiple expansion to drive markets higher is limited. The contribution to annual S&P 500 returns has shifted in the last several years from multiple expansion to earnings growth, a trend we expect to continue. In 2023, PE expansion accounted for more than 70% of the S&P 500's ~24% return. However, in 2024 and 2025, the largest driver of returns was earnings growth, which increased from 55% to 85%. For more cyclical areas of the market, such as value, small caps and international indices where valuations are lower, both earnings growth and higher multiples can contribute to continued appreciation.

**Bob:** Ultimately, U.S. equity performance will hinge on earnings delivery and the extent to which AI adoption drives margin expansion and productivity gains. While we expect the U.S. dollar to weaken further in 2026, it has remained range-bound despite increased hedging activity. Outside the U.S., the top 20 non-U.S. market-cap leaders are modestly outperforming the Mag-7, suggesting factors beyond currency weakness may shape equity leadership in 2026.

**WHAT'S DRIVING EARNINGS? MAG-7 VS. REST OF MARKET**

Contribution to S&P 500 Earnings Growth



Source: FactSet. Data as of 2/3/2026. Past performance is no guarantee of future results.



**Q: What risk is the market underpricing or not discussing enough?**

**Alicia:** Multiples remain elevated and could decrease if we get further rotation out of tech or the highest multiple names into cyclicals, or if the current constructive outlook weakens. In the U.S., the Fed’s leadership transition, Supreme Court decisions on tariffs and 2026 midterm elections will shape expectations for monetary, fiscal and regulatory policy and could lead to a pickup in volatility. Inflation remains sticky and elevated globally, which could keep monetary policy tighter for longer than current market expectations. If the global economy remains resilient and reaccelerates in 2026, inflation could increase, leading to higher yields and potentially tighter, not easier, central bank policy.

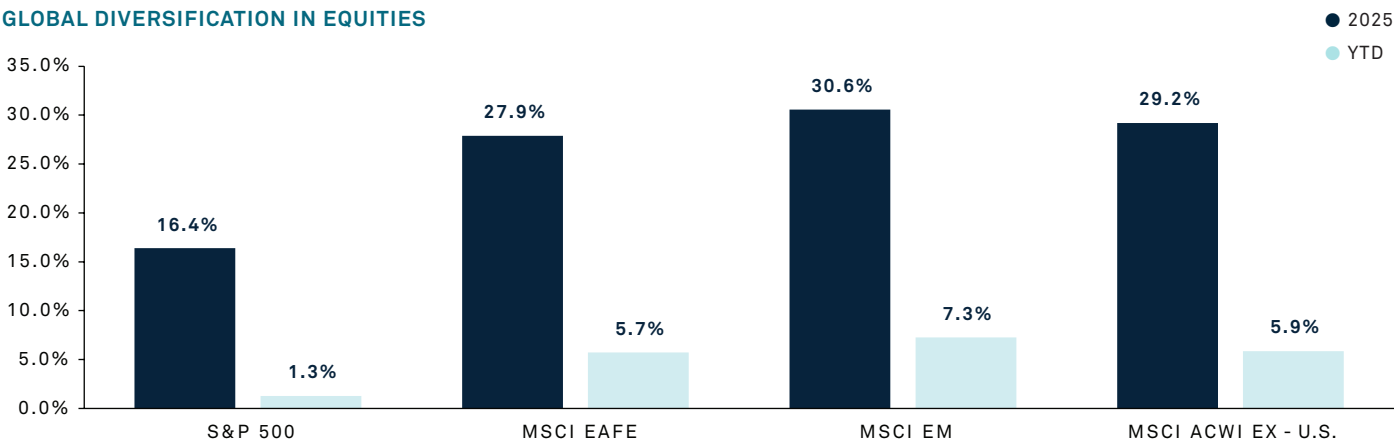
Weaker-than-expected returns on AI-related CapEx could dampen enthusiasm for tech and lead to lower valuations, especially since tech carries the largest weight in the S&P 500. While we remain constructive, the degree of difficulty for the market to rise in a linear fashion compared to the last several years has increased.

**Q: What are the biggest lessons from 2025 that investors should carry forward?**

**Alicia:** 2025 was a year of historically elevated policy uncertainty, low sentiment and growth concerns. The average U.S. Economic Policy Uncertainty Index in 2025 was the highest on record while more than half of the 10 worst University of Michigan Consumer Sentiment readings occurred last year. Market-implied U.S. recession odds peaked at 64%, yet consensus now forecasts above trend or 2.4% growth while the global economy is estimated to expand 3.0%, which is in-line with the prior 10-year average. All this to say, economic growth has remained resilient, more than expected.

On a related note, markets track earnings, not headlines. In this environment, focusing on fundamentals, filtering out the noise and remaining invested and diversified can help investors win. Like growth, earnings were better than expected in 2025, leading to positive equity returns. In addition, equity returns were widespread across regions, highlighting the importance of global diversification. Investors who remained invested earned 16.4% from the S&P 500, while missing just the 10 best days pushed returns into negative territory, down 12%. The best days typically occur during periods of heightened volatility, and the top months each year usually happen after the worst.

**GLOBAL DIVERSIFICATION IN EQUITIES**



Source: Bloomberg. Data as of 2/6/2026. Returns are price returns.

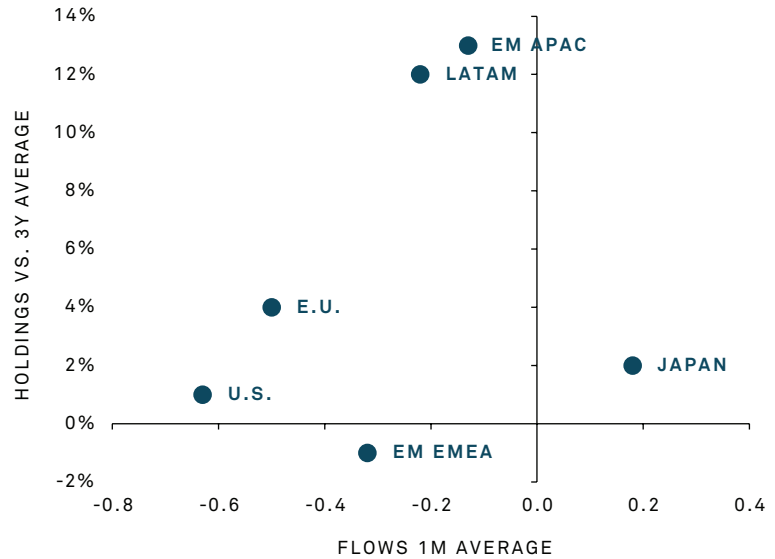
# Investors in Motion

Despite a cautious start to 2026, investors are relatively optimistic about growth prospects in global markets.

Early 2026 has seen modest equity de-risking, while Asia and Latin American EM remain favored.

Japan continues to attract inflows, even with elections and BOJ policy concerns.

**GLOBAL EQUITY HOLDINGS VS. FLOWS JANUARY 2026**

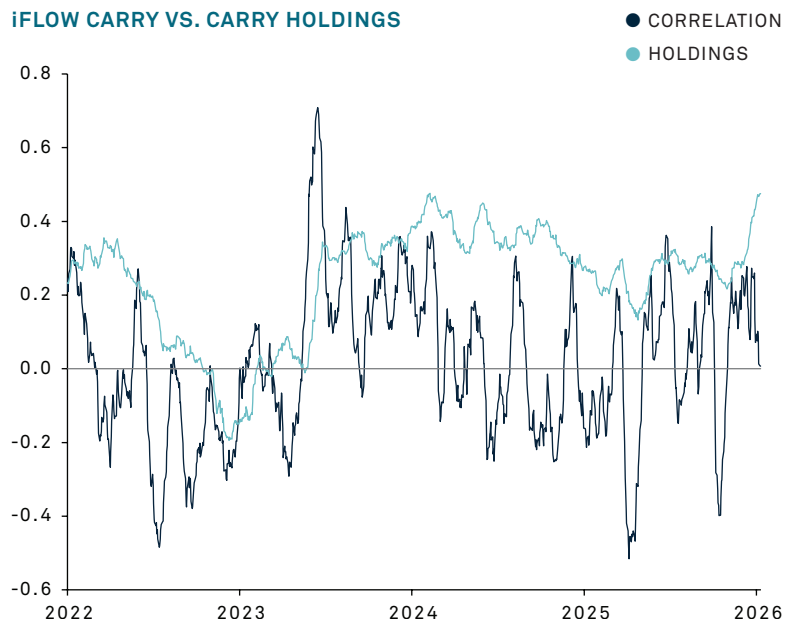


Source: BNY iFlow. Data as of 1/9/26.

Despite elevated holdings of the carry trade given low volatility and wide rate differentials, it has limited potential as a driver of FX.

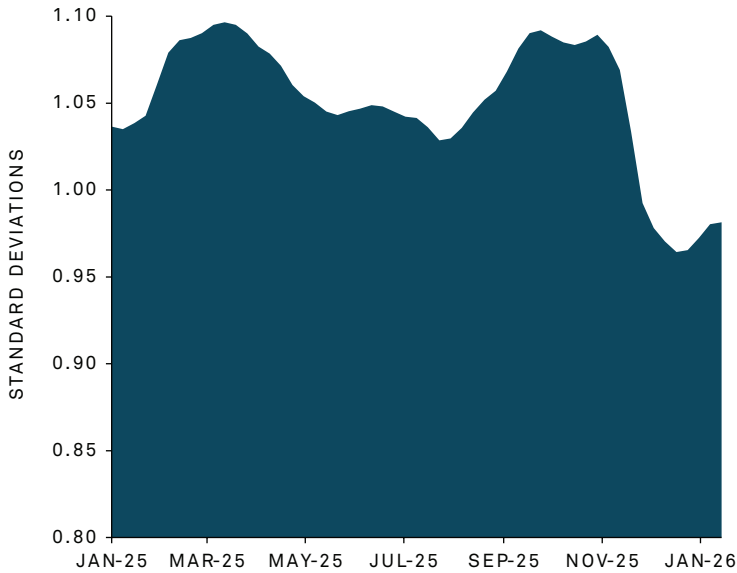
While the broader G10 FX markets have been relatively calm, the holdings in the carry trade focused on Latin America and EM in EMEA are at two-year highs.

**iFLOW CARRY VS. CARRY HOLDINGS**



Source: BNY iFlow. Data as of 1/9/26.

## UST HOLDINGS

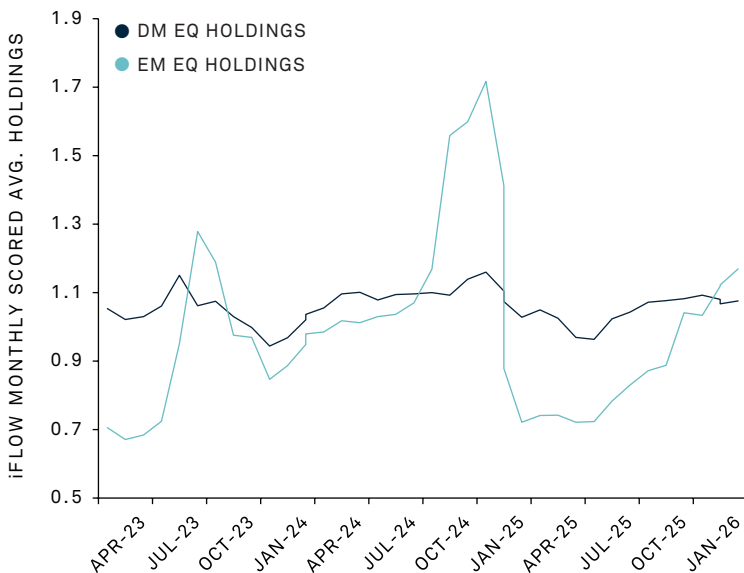


Source: BNY iFlow. Data as of 1/9/26.

Investors have reduced their holdings of U.S. Treasuries since the beginning of November, in part because issuance slowed at the end of last year.

This suggests there isn't much of an overweight left to be reduced, mitigating fears of a sell-America trade.

## iFLOW EQUITY HOLDINGS DEVELOPED VS. EMERGING MARKETS



Source: BNY iFlow. Data as of 1/26/26.

Developed markets (DM) equity holdings were elevated in the second half of 2025 and are still overheld against the longer-term average. EM equity holdings are now greater than DM, which last occurred in the third quarter of 2024, also led by flows in tech sectors.

The difference between 2024 and now for EM is the role of commodity-linked buying, where metals and energy EM stocks are leading as well.



**Sebastian Vismara**

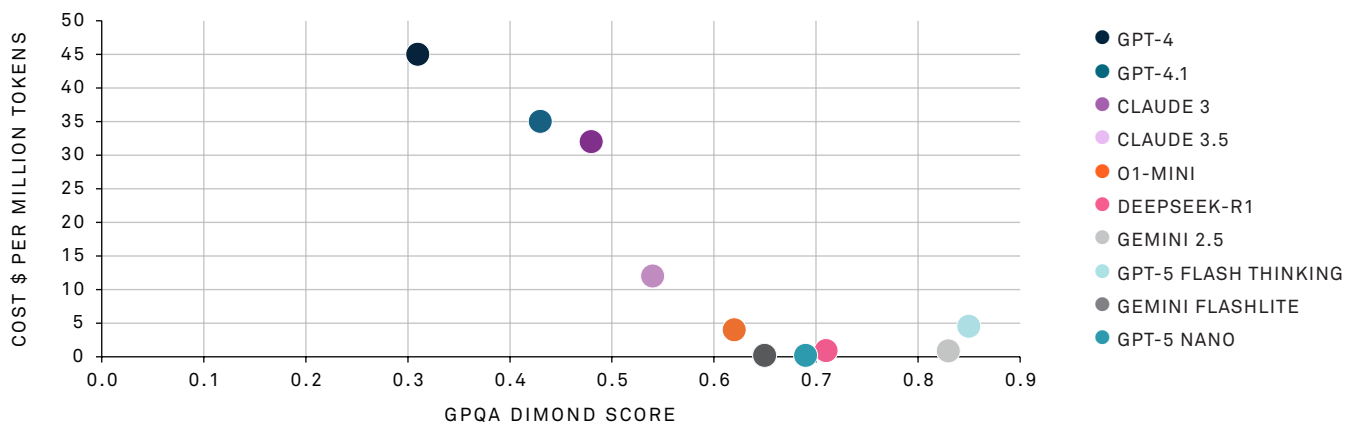
Head of Investment Strategy and Research, BNY Investments

## The Growing Wave of AI Adoption

In our [2026 outlook](#), we introduced a framework to quantify AI diffusion across global markets, moving beyond headlines focused on a handful of large technology firms to help investors identify diversified sources of AI-related return and reduce concentration risk.

While hyperscalers continue to fund large-scale AI investments and data center capacity remains exceptionally tight, the market is increasingly recognizing that the next leg of value creation extends beyond tech. As AI buildouts scale, second-order beneficiaries, particularly in infrastructure, energy and other supply chain bottlenecks, should come into sharper focus. Equally important are companies that can convert AI adoption into margin expansion. Here, distinguishing productivity gains from value capture is critical: productivity without pricing power rarely delivers durable profits. We view firms with durable sources of market power (e.g. physical assets, regulation, networks) as well-placed to retain more of the gains, including financials and selected industrials.

### AI MODEL COST & PERFORMANCE



Source: BNY, Ethan Mollick (Wharton). Data as of 1/9/26.

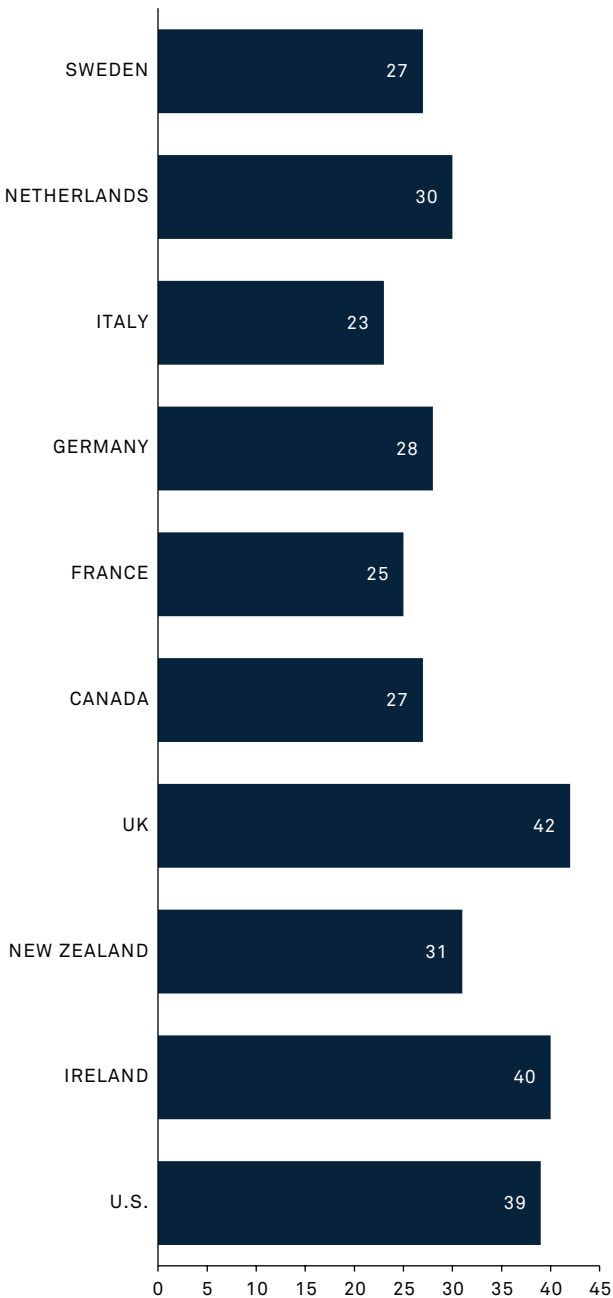
In our view, the data are starting to validate our expectation for this framework. Sector performance has indicated that AI-related value capture is already extending into non-tech areas — early evidence that the breadth of the theme is being priced beneath the surface. With productivity growth picking up, particularly in the U.S., we see an opportunity for investors to allocate more to those second-order beneficiaries who are starting to capture value from this productivity.

Adoption is also spreading outside the U.S. The cost of AI inference continues to decline as model performance improves, expanding accessibility. Meanwhile, the share of the labor force using AI at work continues to grow, signaling rising penetration and steadily declining barriers to usage. This matters most for regions leveraged to adoption rather than buildout; Europe is a prime example, where earnings upside comes from business model transformation rather than capital intensity.

The ongoing increase in global AI adoption also supports selected EM, which play a key role in supplying essential inputs and manufacturing capacity to meet the demands of increasingly inference-heavy AI workloads.

Against this backdrop, the investment challenge becomes one of balance: maintaining core exposure to leading AI platforms in the U.S. while broadening allocations to sectors and regions poised to benefit from rising adoption and pricing power. With valuations in large technology firms already elevated, highly concentrated portfolios may face increased volatility. Conversely, diversified exposure to sectors positioned to capture incremental AI-driven value can help expand return potential and reduce concentration risk in 2026.

PERCENTAGE OF LABOR FORCE USING LLMS AT WORK



Source: BNY, Hartley et al. Data as of 1/9/26.



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# Meet our Experts



**John Flahive**

Head of Wealth Fixed Income,  
Insight Investment



**Francesca Fornasari**

Head of Currency Solutions,  
Insight Investment



**Jason Granet**

Chief Investment Officer,  
BNY



**Ella Hoxha**

Head of Fixed Income,  
BNY Investments Newton



**Eric Hundahl**

Head of Investment Strategy and  
Model Portfolios, BNY Investments



**Alicia Levine**

Head of Investment Strategy and  
Equities, BNY Wealth



**Brendan Murphy**

Head of Fixed Income, North America,  
Insight Investment



**Vincent Reinhart**

Chief Economist, BNY Investments  
Dreyfus & Mellon



**Bob Savage**

Head of Markets Macro Strategy,  
BNY Markets



**John Velis**

Americas Macro Strategist,  
BNY Markets



**Chris Vella**

Chief Investment Officer,  
BNY Advisors



**Sebastian Vismara**

Head of Investment Strategy and  
Research, BNY Investments



**Jason Vitale**

Head of Global Markets Trading,  
BNY Markets



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