Future Quality Insights: making sense of the current regime

By the Global Equity Team

June 2026

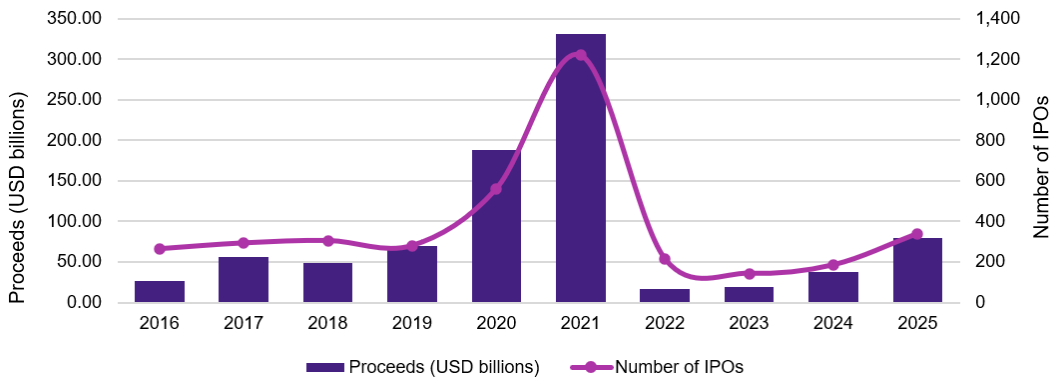
In periods of market dislocation, it is important to step back, think rationally rather than emotionally, and assess the key factors driving equity performance. Long-term investing offers many possible approaches, and it is critical to be clear on the one you intend to follow, particularly when conditions become more challenging. We have seen these conditions become more challenging than expected for our Future Quality philosophy.

An acronym we have historically used for assessing macro drivers is **LIVES**—Liquidity, Interest Rates, Valuation, Earnings and Sentiment. A clear understanding of these factors provides a strong framework for assessing market direction and developing insight into what may come next.

Liquidity–This is less easy to measure empirically, but the underlying rationale is straightforward: equities are a financial asset, and the balance between capital available to invest and the supply of equity will influence aggregate market valuations. With many markets close to all-time highs, liquidity has been supportive; however, looking ahead, a number of factors warrant attention:

- Equity supply has historically been constrained as the largest companies have generated high levels of free cash flow and returned it to investors via share buybacks. However, rising capital intensity among hyperscalers suggests this dynamic is now weakening.
- IPO activity is returning, and deal sizes are likely to be significant. With companies such as Space X, Anthropic and Open AI potentially coming to market, issuance could reach USD 300–450 billion, even assuming relatively modest 10–15% free floats and mooted valuations on listing. By comparison, US IPO issuance in 2025 was approximately USD 56 billion.

Chart 1: US IPO activity by year



Source: Amova Asset Management, Bloomberg

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- We are now in a capex-led growth cycle, where capital is increasingly directed toward tangible assets, leaving less available for financial markets. The scale and urgency of AI-related capex are key drivers of this shift.
- Quantitative tightening remains the dominant trend among major central banks. As a result, for now the allocation and utilisation of capital is the key variable to watch rather than overall money supply.

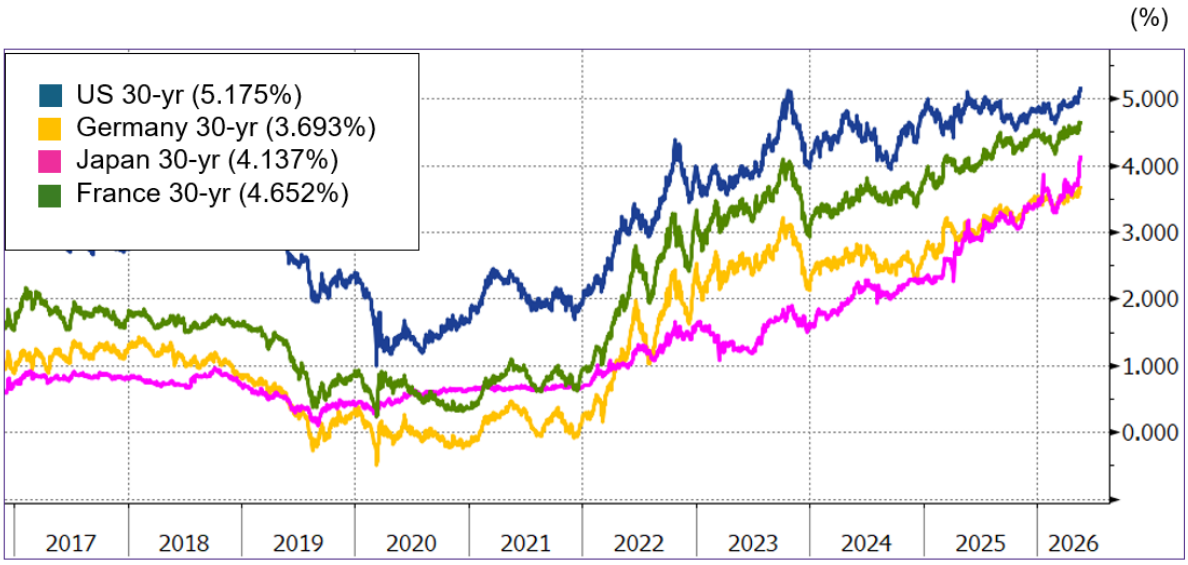
Our view: *Rising leverage within financial assets may be masking a tightening in underlying liquidity. A sustained AI-driven capex cycle will differ meaningfully from the QE-led consumption era and is likely to be less supportive for financial asset valuations.*

Interest rates–Inflation remains above central bank targets, and without a resolution to geopolitical tensions in the Gulf, short rates are likely to remain broadly stable. The more important issue is the behaviour of term premiums—the additional yield investors demand to hold longer-dated bonds rather than short-term debt. In our view, large fiscal deficits, declining confidence in the dollar as the reserve currency, and rising debt servicing costs are all pushing pressure onto the long end of the yield curve in most markets.

Key areas to monitor include:

- Fiscal policy across developed markets continues to prioritise "spend to grow," with limited evidence to date that this is translating into higher productivity or sustainable growth. However, AI investment may be helping validate these policies for now due to its contribution to better growth outcomes.
- Historically, savings-rich nations such as Germany and Japan have exported capital. Rising bond yields in both countries suggest this dynamic may be reversing, potentially increasing funding pressure on more indebted economies such as France and the UK that have a need for these external portfolio flows.

Chart 2: 30-year bond yields for US, Germany, Japan and France



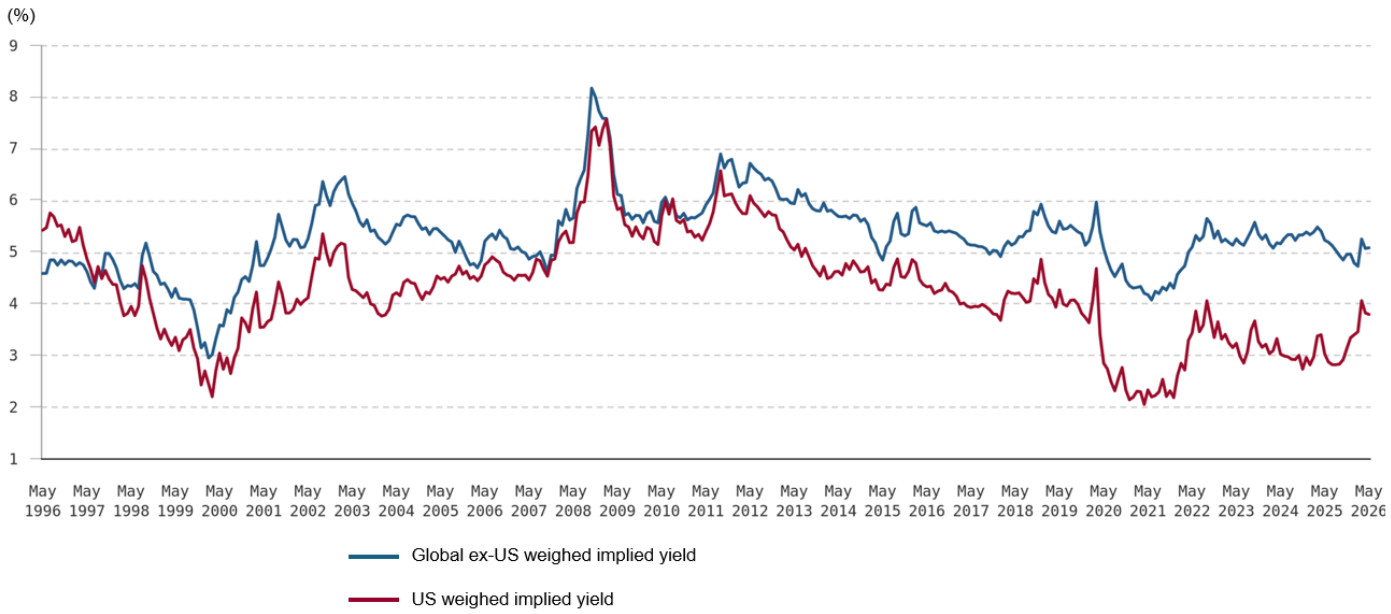
Source: Bloomberg, 19 May 2026

- Credit spreads remain near historical lows despite signs of congestion in private market funding. While calls for widening have proven premature, history suggests the risk is asymmetrically skewed when spreads eventually adjust.

Our view: *The cost of capital is more likely to rise than fall. Movements in the yield curve, particularly the risk of long-term rates rising faster than short-term rates, require close attention.*

Valuation–Aggregate market valuations appear fair to expensive at current levels. This is shown by the market implied yields in Chart 3 below.

Chart 3: Global market implied yields

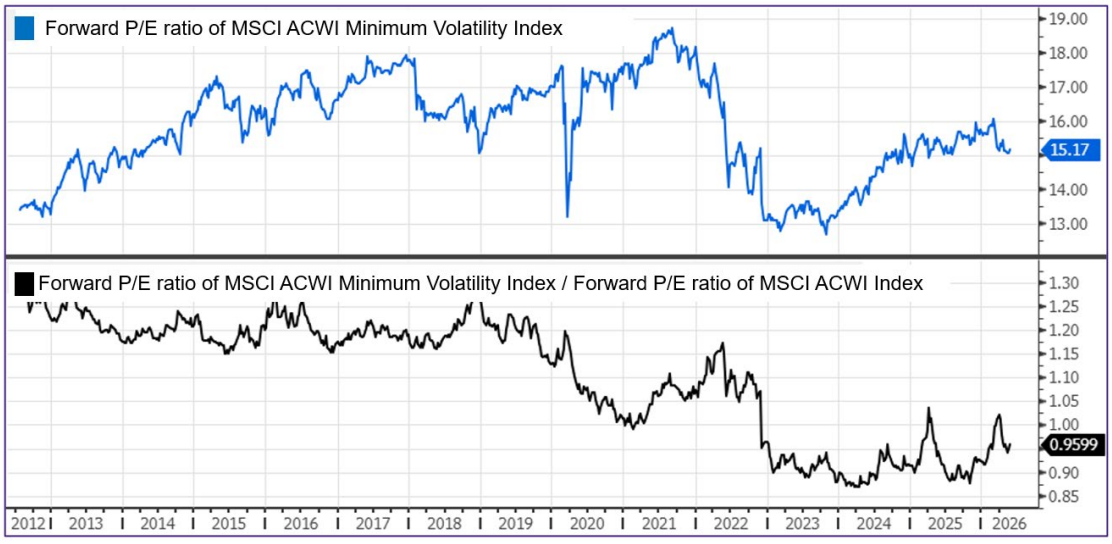


Source: UBS Holt, May 2026

However, significant shifts over the past 18 months have notably altered where the valuation risks reside within equity markets:

- AI-related capital expenditure must continue to grow strongly to justify current valuations of companies exposed to this theme.
- AI disruption is increasingly priced in ahead of proof of impact, with some businesses with durable competitive advantages now appearing relatively attractive on a historical basis.
- Low-volatility segments are close to their cheapest levels in decades, though their future relative performance may be dependent on weaker growth elsewhere.

Chart 4: Minimum volatility equities-absolute and relative P/E valuations



Source: MSCI, Bloomberg, May 2026

Our view: *Outside the AI-related cohort, much of the market has already de-rated, reflecting more subdued growth expectations. Rising equity issuance and higher long-term bond yields are likely to act as constraints on valuation multiples.*

Earnings–Earnings growth has been strong but highly concentrated, with a clear divide between AI beneficiaries and the rest of the market. More recently, commodity prices—including precious metals, DRAM and energy—have provided additional support.

While timing cycles is inherently difficult, periods of exceptionally high profitability are typically followed by mean reversion as supply adjusts for commodity-related firms. AI capex durability is the key driver of sustained profit growth for the overall market.

Our view: *This environment does not resemble a traditional valuation bubble. However, it may represent a profit cycle peak, particularly if AI investment momentum weakens. As this occurs, valuation dispersion is likely to widen.*

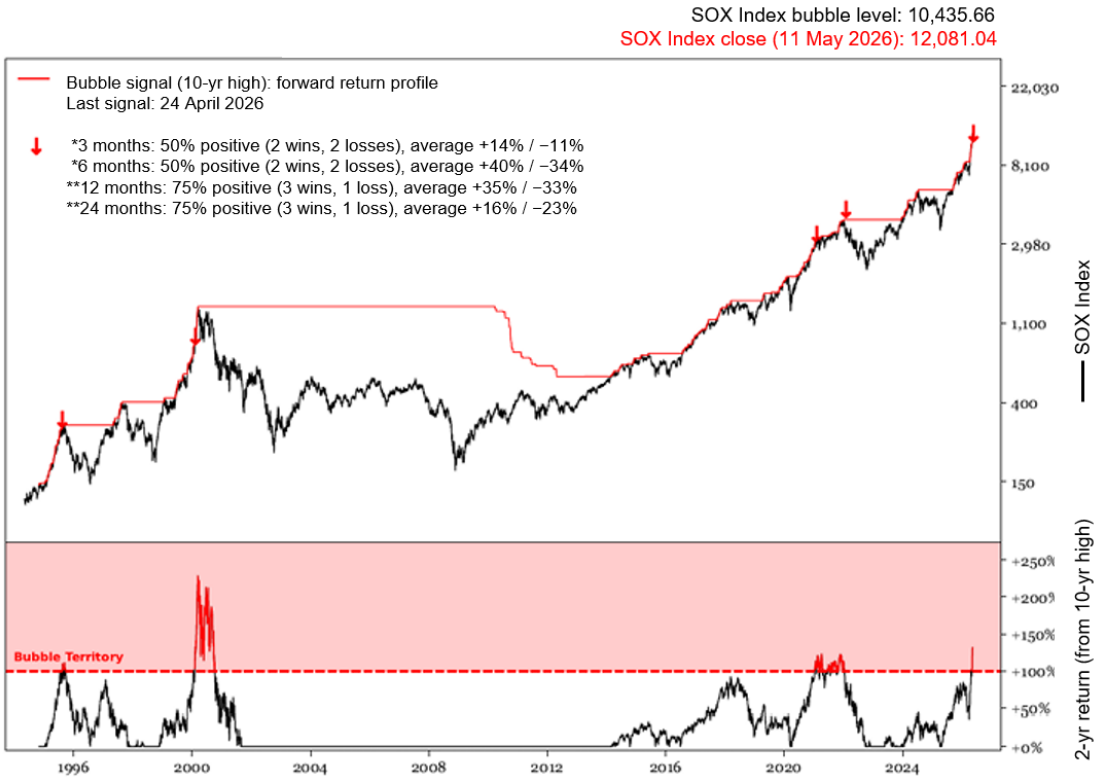
Sentiment–Despite ongoing debate about passive investing, the reality is that capital continues to flow into vehicles that price securities with limited discrimination at the stock level. This has contributed to increasingly pronounced cycles driven by momentum and positioning.

Patterns of cumulative buying, followed by crowded selloffs and elevated volatility, are likely to persist. The growing use of leveraged ETFs and margin financing among retail investors further amplifies these dynamics.

Current observations include:

- South Korean equities have risen approximately 157% over the past year (as at 19 May 2026), with retail margin lending at all-time highs.
- Semiconductor stocks have increased by roughly 130% over the same period—historically a signal often associated with late-cycle dynamics (Chart 5).

Chart 5: SOX Index bubble indicator



This chart tracks the SOX (semiconductor) index and highlights periods when the market reaches extreme levels relative to its own history, referred to here as a "bubble signal". The bubble signal is triggered when the index reaches a new 10-year high and exceeds a model-based threshold (the red line). These points are marked with red arrows on the chart.

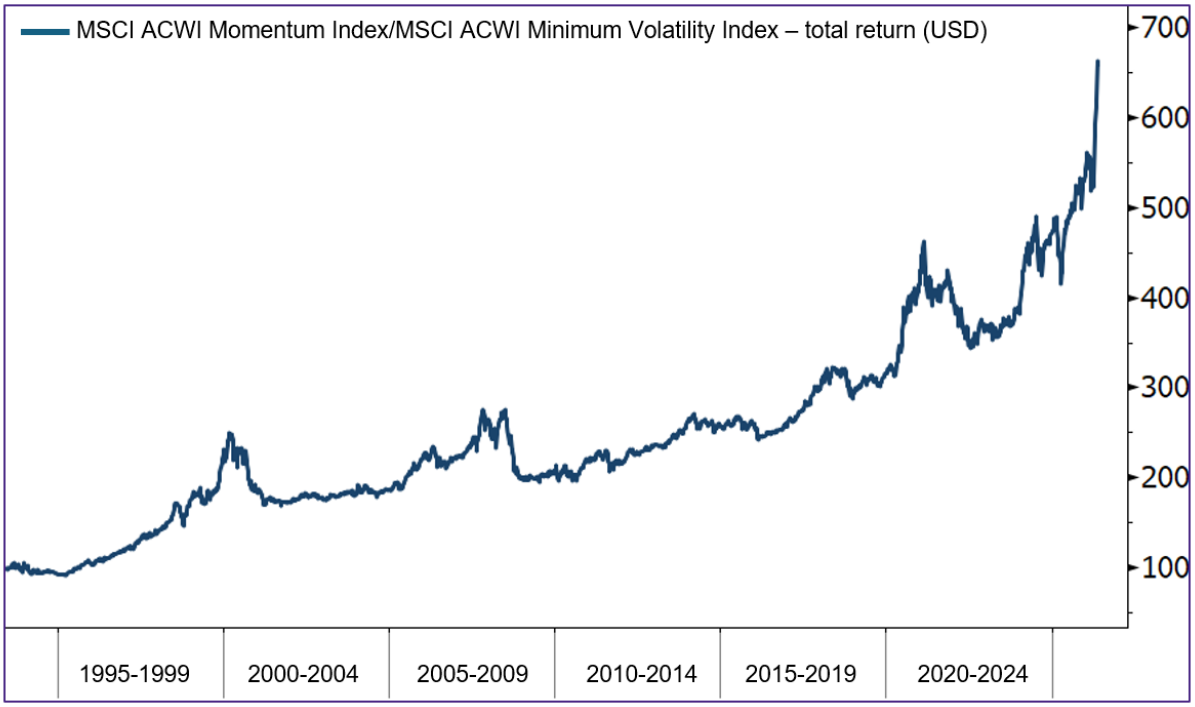
*Short-term outcomes (3–6 months) have been mixed, with roughly 50% positive returns.

**Longer-term outcomes (12–24 months) have been more frequently positive (around 75% of cases); however, losses, when they occur, can still be large (e.g. -30% in some periods).

Source: Renmac, 11 May 2026

- Momentum returns have been exceptionally strong, particularly relative to low volatility (Chart 6).

Chart 6: Performance of momentum stocks relative to low-volatility stocks



Source: Bloomberg 19 May 2026

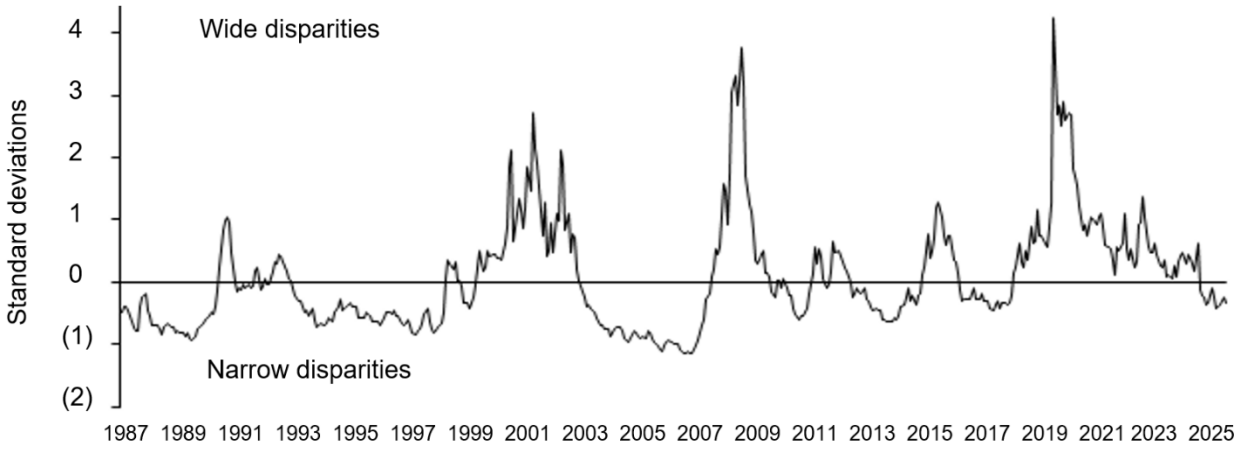
Our view: *The global growth backdrop remains relatively subdued outside a narrow set of themes (notably AI, defence and energy infrastructure). While positioning reflects this reality, it has become increasingly crowded and correlated. Although timing inflection points is difficult, the risk of a rotation away from momentum leadership is clearly rising.*

In summary, as quality investors, we believe returns are best maximised through investing in companies that deliver superior growth and sustained high returns on invested capital. However, there are periods when other parts of the market, often starting from lower valuations, can exhibit stronger relative performance—as has been the case over the past two-plus years for value firms.

Following the market rotations over the last couple of years, the environment is now characterised by:

1. Compressed valuation spreads, placing greater emphasis on earnings delivery as the driver of excess returns

Chart 7: Developed markets valuation spreads-top quintile compared to the market average (1987–April 2026)



Source: Empirical Research Partners Analysis, May 2026

2. Momentum returns that are elevated and approaching short-term extremes
3. Growth concentrated in a narrow set of themes, most notably AI-related capex
4. A new issuance cycle emerging, driven by the capital-intensive nature of this growth and the need for large-scale funding through public markets.

Our philosophy has experienced limited support in recent quarters, compounded by a few unfortunate stock-specific outcomes, which we expect will prove to be a matter of timing in many cases. That said, when assessed through the **LIVES** framework, the temptation to shift toward shorter-term, momentum-driven exposures—simply because they are performing better for now—is unlikely to align with our role as long-term stewards of client capital.

The key principles of our philosophy—attaining and sustaining high returns on capital, and paying attractive valuations for firms that typically deliver superior and more durable growth—are very much in place. Our current portfolio represents these outcomes, and given the recent valuation declines, the risk/reward appears even more favourable assuming a normalisation in return skew in the coming quarters.

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