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InvestorView

INSIGHTS AT THE INTERSECTION OF WEALTH, FAMILY, AND VALUES

THE GREAT FRACTURING

From Globalization to Regionalization

Winter 2026

InvestorView

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Dear clients and friends,

Happy New Year! As we usher in 2026 and kick off Semiquincentennial celebrations in the U.S., we are also taking time to reflect on the previous year. 2025 was a year of market volatility, rapid technological innovation, and policy uncertainty.

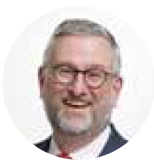
Paradigm shifts are rarely evident while they're still happening, but the perfect economic storm of the COVID-19 pandemic, the Russian invasion of Ukraine, and shifting U.S. trade policy seems to be ushering in an era of less globalization and more regionalization. In our feature article, Partner and Chief Investment Strategist Scott Clemons explores what this might imply for the global economy, inflation, investment opportunities, and portfolio construction.

We also sat down for a Q&A with Partner and Chief Investment Officer (CIO) Justin Reed and Principal and Deputy CIO Ilene Spitzer. They offer an in-depth analysis of the economy, markets, and investments entering the year, sharing insights on the risks and opportunities influencing the investment environment in the months ahead. Meanwhile, Partner and Portfolio Manager Neil Hohmann, Ph.D., highlights five fixed income trends he and his team will be watching in 2026.

Finally, Senior Wealth Planner Karin Prangley and Wealth Planner Matt Thornburg explain how to take advantage of the benefits of the qualified small business stock exemption – made more appealing by recent legislation.

Please do not hesitate to reach out if you would like to discuss any of the topics covered in this issue in more depth. We wish you a successful and rewarding start to the year ahead.

Best,



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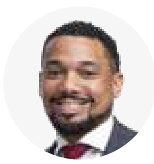

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THE GREAT FRACTURING

From Globalization to Regionalization

Scott Clemons
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"We now stand at an inflection point where the global economy is fracturing into regional blocs defined by geography, security alliances, and shared values. Understanding this transformation is essential for navigating the decade ahead."

When the definitive history of the global economy at the turn of the 21st century is written, the 30 years between 1990 and 2020 will stand out as an unprecedented, and possibly unwarranted, *pax economica*. For three decades, globalization defined the economic paradigm. From the fall of the Berlin Wall in 1989 through the 2010s, the world economy became increasingly integrated, interconnected, and interdependent. Global trade as a percentage of world gross domestic product (GDP) rose from roughly 39% in 1990 to a peak of 61% in 2008, before settling around 58% by 2019. China's accession to the World Trade Organization (WTO) in 2001 accelerated this integration, with the country's share of global exports surging from 4% to nearly 15% by 2020. Supply chains stretched across continents, optimized for efficiency rather than resilience. Capital flowed freely across borders, seeking the highest returns in an increasingly borderless financial system. The proliferation of free trade agreements – from the North American Free Trade Agreement (NAFTA) to the EU's single market expansion – reflected a broad consensus that lowering barriers would lift all boats.

This era delivered remarkable outcomes: hundreds of millions lifted from poverty, particularly in emerging Asia; declining prices for consumer goods in developed markets; and unprecedented corporate profit margins as companies accessed low-cost labor and production and met the needs of expanding markets. Yet the seeds of fragmentation were always present. The 2008 global financial crisis (GFC) exposed vulnerabilities in interconnected financial systems. Rising inequality within nations fueled populist movements skeptical of trade. And geopolitical tensions, particularly between the U.S. and China, introduced security considerations that trumped pure economic efficiency.

The sustainability of this period of economic globalization and growth is now seriously in question. The COVID-19 pandemic laid bare the brittleness of just-in-time supply chains, raising the appeal of just-in-case inventory management. Russia's invasion of Ukraine in 2022 showed that kinetic war in Europe was a modern reality, not just a historical artifact. And the Trump administration has demonstrated that tariffs are economic tools to be used against friend and foe alike.

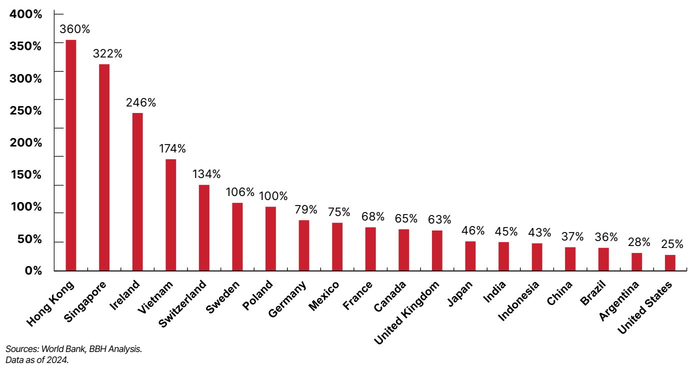
Globalization is not going away, although the character and paths of trade are shifting. We now stand at an inflection point where the global economy is fracturing into regional blocs defined by geography, security alliances, and shared values. Understanding this transformation is essential for navigating the decade ahead.

Economic implications

The shift toward regionalization carries profound implications for global economic growth, and the effects are likely to be predominantly negative in the aggregate, though distributed unevenly across regions and sectors. The fundamental economic logic is straightforward: Globalization allowed countries to exploit comparative advantage, achieve specialization, and scale economies that boosted productivity and output. Fragmentation reverses these gains, at least in part.

Early evidence of this is already emerging. In a study conducted before the U.S. imposition of tariffs, the International Monetary Fund (IMF) estimated that fragmenting the global economy into competing blocs could reduce global GDP by up to 7% in the long run, with losses concentrated in smaller, trade-dependent economies.[1] The U.S. is relatively insulated from this at the macroeconomic level, simply because trade is not a large part of the overall American economy. Smaller (and especially emerging) economies that rely heavily on trade bear greater economic risk.

Total trade (exports and imports) as a % of GDP



Some of the figures in the nearby graph exceed 100% because they take into account exports plus imports, whereas the calculation of GDP nets the figures (exports minus imports). This gross calculation of total trade demonstrates the heightened exposure of smaller intermediary countries (Hong Kong and Singapore), the global draw of a tax haven such as Ireland, and the appeal of lower-cost manufacturing economies such as Vietnam and Mexico. The U.S. appears at the far end of the graph, with total trade accounting for only 25% of GDP. Indeed, in this study conducted by the World Bank, only Ethiopia, Sudan, and Haiti had a lower exposure to global trade than the U.S. The U.S. really is an economic island.

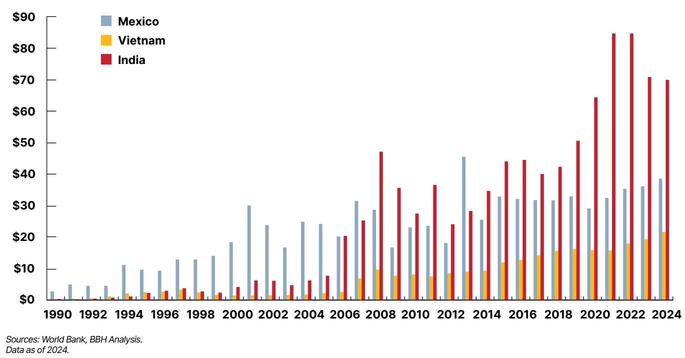
Or at least an economic peninsula, as no nation is completely immune from the shifting flows of trade. Even for the U.S., the reshoring and "friend-shoring" of manufacturing capacity comes with significant costs. Manufacturing labor costs in Vietnam or Mexico are three to five times lower than in China, but still 10 to 15 times lower than in the U.S. or Western Europe. Companies relocating production closer to home markets therefore may face structurally higher cost bases. Taiwan Semiconductor's chip plant in Arizona, for instance, is estimated to cost 30% to 40% more to build and operate than comparable facilities in Taiwan or South Korea.

The duplication of research and development (R&D) efforts across regional blocs represents another growth headwind. The semiconductor industry exemplifies this inefficiency: China is reportedly investing over $150 billion in developing domestic chip capabilities to reduce dependence on Western technology, while the U.S. has committed $52 billion through the Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act, and the EU has pledged €43 billion to the same ends. These parallel investments fragment R&D talent and capital that could otherwise be deployed more efficiently in a unified global market. The result is duplicative efforts, slower innovation cycles, and higher costs per unit of innovation output.

The unpredictability of trade policy is itself a constraint on investment and growth. Since the initial announcement of tariffs on Liberation Day in April 2025, tariffs have been suspended, postponed, reduced, raised, and waived – sometimes from day to day. It is impossible for companies to make long-term capital decisions on facilities and equipment in such an uncertain environment. Academic research suggests that policy uncertainty can reduce business investment by 5% to 10% in affected sectors, as companies delay capital expenditures until the regulatory environment clarifies. The proliferation of export controls, particularly on advanced technologies like artificial intelligence (AI) chips and quantum computing components, further constrains the efficient allocation of resources.

Regionalization is not, however, uniformly negative for growth. Certain economies are positioned to capture disproportionate benefits as "connector" nations within regional blocs. For example, Mexico's nearshoring boom has been remarkable: Foreign direct investment surged to a record of $39 billion in 2024, with manufacturing investment more than doubling from 2020 levels. Vietnam has similarly benefited, with its manufacturing output growing at 8% to 10% annually as companies diversify away from China. India, with its combination of scale, democratic institutions, and alignment with Western security interests, is attracting investment in everything from iPhone assembly to pharmaceutical production.

Annual foreign direct investment (FDI)
$ billions



[1] *Bolhuis, Marijn A., Jiaqian Chen and Benjamin Kett. The Costs of Geoeconomic Fragmentation, International Monetary Fund, June 2023.*

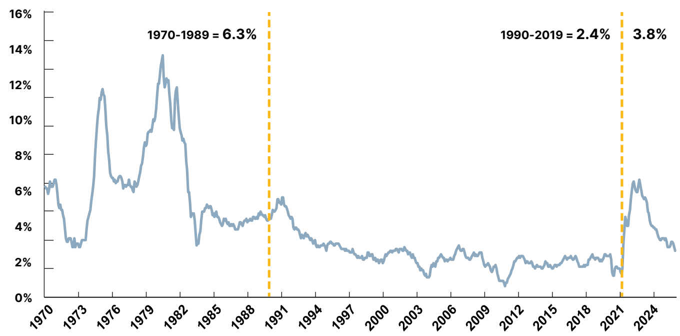
Regional integration may also spur focused innovation ecosystems. The EU's emphasis on green technology and industrial policy, backed by the €800 billion NextGenerationEU recovery fund, is creating concentrated expertise in wind energy, battery technology, and circular economy solutions. The U.S. is developing deeper capabilities in advanced semiconductors, biotechnology, and aerospace through a combination of public investment and private sector dynamism. These regional champions may generate localized productivity gains that partially offset broader efficiency losses.

The growth implications ultimately depend on how deep the fractures become and whether regional blocs maintain internal openness. If the U.S.-Mexico-Canada Agreement (USMCA; NAFTA's successor), the EU single market, and Asian trade pacts like the Regional Comprehensive Economic Partnership (RCEP) remain vibrant, with significant internal trade and investment flows, the damage to global growth may be contained to 1% to 2% of GDP over the long term. But if fragmentation extends to financial flows, data localization, and technology standards, the costs could approach the IMF's more pessimistic scenarios, with economic growth rates persistently 0.5 to 1.0 percentage points lower than they would have been under continued globalization.

The future of inflation

The shift from globalization to regionalization represents a fundamental regime change for inflation, one that threatens to end the "great moderation" of price pressures that characterized the 1990 to 2019 period. Disinflationary forces dominated the globalization era: Access to low-cost Chinese manufacturing, competitive labor markets spanning continents, and efficient global supply chains consistently pushed prices downward. Core inflation (excluding food and energy) in the U.S. averaged just 2.4% from 1990 through 2019, a sharp drop from an average of 6.3% in the preceding two decades. Indeed, readers with a long-enough memory will recall central bankers in some economies fretting about how to combat the threat of persistent deflation during this period.

U.S. core Consumer Price Index (ex-food and energy)
1970–2025 year-over-year % change



Sources: Bureau of Labor Statistics, BBH Analysis.
Data as of November 30, 2025.

There are, of course, many drivers of inflation, of which the relative openness of economies is but one.

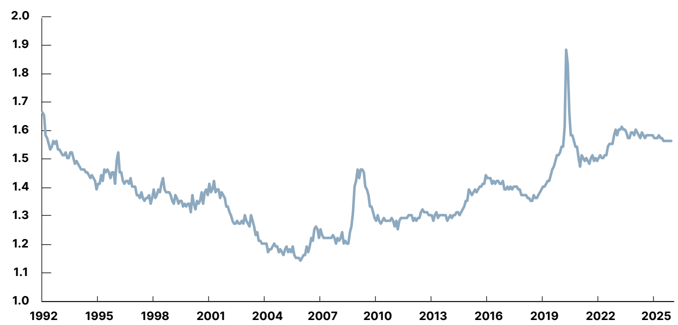
Regionalization

Regionalization threatens to reverse many of these disinflationary dynamics. The most direct inflationary impact comes from reshoring and friend-shoring production to higher-cost locations. When Apple diversifies iPhone production from China to India and Vietnam, labor costs rise substantially. Chinese manufacturing wages, while no longer the cheapest, benefit from unmatched infrastructure, supplier ecosystems, and worker productivity developed over decades. Moving production fragments these advantages. Studies of companies reshoring to the U.S. suggest manufacturing cost increases of 15% to 30%, depending on the product category and degree of automation possible. While not all of these costs pass through to consumer prices, as companies absorb some of the added burden through margin compression, the inflationary bias is clear.

Supply chain reconfiguration

Supply chain reconfiguration also sacrifices the inventory efficiencies that dampened inflation volatility. Just-in-time manufacturing systems minimized working capital and storage costs, allowing companies to operate with inventory-to-sales ratios that declined steadily from 1992 through 2007, before rising slightly from 2007 through 2019. Inventories spiked sharply in the early months of the pandemic, as supply chains were disrupted or even shut off. As the effect of the pandemic waned, inventory-to-sales ratios settled back from elevated levels, but remain higher today than they have been for most of the past 30 years.

U.S. manufacturing inventory-to-sales ratio



Sources: US Census Bureau, BBH Analysis.
Data as of December 31, 2025.

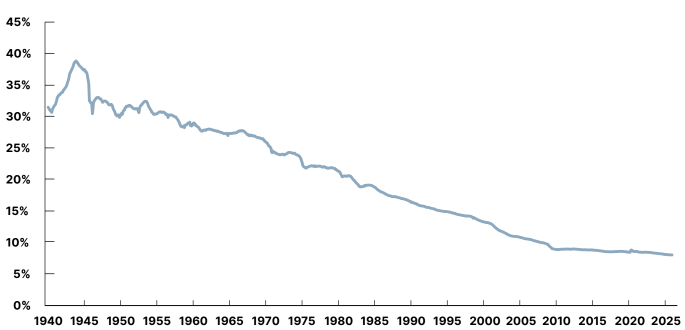
Fractured or regionalized supply chains prioritize resilience over efficiency, requiring companies to hold larger buffer stocks, maintain redundant supplier relationships, and accept higher carrying costs. These changes are already visible: Even accounting for the pandemic, U.S. manufacturing inventories relative to sales have increased approximately 15% since 2019, representing hundreds of billions in capital that could otherwise earn returns elsewhere. Higher capital intensity translates to higher structural costs and prices.

Energy markets illustrate these inflationary pressures particularly vividly. The global trade in liquefied natural gas created price convergence across markets, with arbitrage mechanisms limiting price divergence. In 2019, natural gas prices in the U.S., Europe, and Asia traded within a relatively narrow band, adjusting for transportation costs. But Europe's post-2022 pivot away from Russian pipeline gas toward liquefied natural gas and renewable sources fragmented the market. European natural gas prices spiked to more than 10 times U.S. prices at peaks, and while prices have moderated, structural divergences persist. Europe now pays three to four times U.S. prices, with this energy cost differential feeding through to manufacturing costs, transportation expenses, and ultimately consumer prices. Similar dynamics are emerging in critical minerals and rare earth elements, where countries are developing domestic supply chains at significant cost premiums to global market prices.

Labor market dynamics

Labor market dynamics create an additional potential source of inflation. Globalization suppressed wage growth in developed economies by expanding the effective labor supply available to multinational corporations. Manufacturing workers in Detroit competed not just with peers in Tennessee but with workers in Monterrey and Shenzhen. Regionalization might tighten labor markets by reducing this competitive pressure, although there is scant evidence of this as of yet. From a peak of close to 40% of the workforce in the post-World War II years, manufacturing jobs declined in a near-straight line for decades as globalization, automation, and a shift toward an information and service economy reshaped the job market. There was a slight – almost imperceptible – uptick in manufacturing jobs in 2020 and 2021, but the downward trend resumed quickly as the pandemic disruptions faded. As of December 2025, manufacturing jobs accounted for a record low of 8% of the U.S. labor force.

Manufacturing jobs as % of total U.S. labor force



Sources: Bureau of Labor Statistics, BBH Analysis.
Data as of December 31, 2025.

Fiscal implications

The fiscal implications of regionalization are also inflationary as policy adjusts to a new era. Industrial policy – subsidies for domestic production, tariff revenues recycled into the economy, and infrastructure investments – represents a meaningful fiscal expansion. The combination of the U.S. Inflation Reduction Act (IRA), CHIPS Act, and infrastructure spending exceeds $2 trillion over a decade. The EU's various green and digital transition funds total similar amounts. While spread over time, this represents sustained fiscal stimulus concentrated in specific sectors, adding demand to potentially supply-constrained markets. When governments subsidize semiconductor fabs or battery plants, they're directing capital toward industries facing labor and equipment shortages, bidding up prices for specialized inputs.

Several countervailing forces, however, may moderate these inflationary pressures:

- Technological advancement, in particular, continues apace, with AI, machine learning, automation, and robotics potentially offsetting higher labor costs in reshored facilities. As an example, consider the disinflationary implications of something as simple as a Zoom call – less business travel, fewer hotel nights, fewer restaurant meals. Tesla's highly automated factories in Texas and Germany demonstrate that advanced manufacturing can achieve competitive costs even in high-wage environments. The International Federation of Robotics reports industrial robot installations have accelerated significantly, with density in manufacturing approaching 150 robots per 10,000 workers globally, up from fewer than 100 in 2016. This automation can dampen the inflationary impact of geographic shifts in production.
- Competition within regional blocs may remain intense. The EU market of 450 million consumers, the USMCA zone with over 500 million, and Asia's integrated supply chains encompassing billions of consumers still offer scale for competitive dynamics. If regionalization means trading with 25 neighboring countries rather than 150 globally, efficiency losses may be manageable. Intraregional trade in goods within these blocs often exceeds 50% of total trade, suggesting substantial existing integration to build upon.

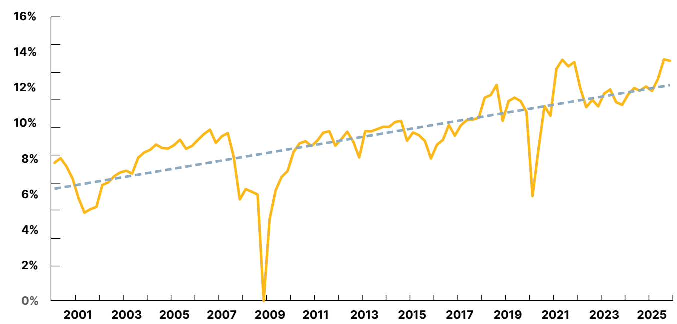
The net effect likely represents a sustained upward, albeit modest, shift in the inflation regime, rather than runaway price growth. Central banks may find neutral real interest rates are higher in a regionalized world, with inflation settling into a 2.5% to 3.5% range in developed economies rather than the sub-2% rates that prevailed during peak globalization. This represents a measurable regime shift, but not a return to the disabling inflation of the 1970s. The key risk is that supply shocks – geopolitical disruptions, climate events, or technology failures – will generate larger price swings than in the globalized era, as diversified sourcing and arbitrage mechanisms are less available to act as economic shock absorbers and smooth disruptions.

Financial markets in a fractured world

Just as business owners and operators are readjusting to a more regionalized world, so, too, must investors take into account a shifting financial landscape. The fracturing of the global economy into regional blocs has implications for financial markets, affecting everything from equity valuations and sector performance to the structure of competition, currency dynamics, and risk premia. Investors must recalibrate their frameworks for a world where geopolitical considerations increasingly override pure financial optimization.

Equity market implications begin with profitability. The profit margin of the S&P 500 large-cap index reached a record level of 13.5% in the latter half of 2025. As the nearby graph demonstrates, this upward trend has been in place for some time as the composition of the U.S. public equity market continues to shift toward higher-margin technology and information services sectors. Globalization contributes to this technology success story, offering companies access to low-cost inputs, efficient supply chains, and the ability to minimize tax obligations through cross-border structures. Regionalization threatens to pressure these margins. Companies facing higher production costs, increased inventory requirements, and duplicative infrastructure investments will struggle to maintain current profitability without offsetting productivity gains or pricing power (see the previous discussion of inflation).

S&P 500 operating margin



Sources: Standard & Poor's, BBH Analysis.
Data as of December 31, 2025.

Profit margins are clearly cyclical. The damage wrought to profitability by the GFC and the pandemic are evident in the sharp downward spikes in the graph. And yet following an economic dislocation, margins tend to revert rather quickly to a mean, a testament to the remarkable resilience of this economy and market. Margins at present are about 150 basis points (bps)[2] higher than the trendline, implying that a reversion to a (still-impressive) mean would take profits down about 10% to 15% from current levels. With the S&P 500 already priced at 22.5 times consensus expectations for

[2] *One basis point is equal to 1/100th of 1%, or 0.01%.*

2026, there isn't much valuation room for a downgrade to earnings expectations.

It is, however, increasingly difficult to talk about or even analyze "the market" as if it is a single thing. The concentration of large-cap technology companies skews any calculation of average return, profitability, margins, or valuation. Sector performance will diverge even more dramatically in a more regionalized world. Traditional winners from globalization – technology companies with distributed supply chains, consumer goods manufacturers relying on low-cost production, and multinational conglomerates optimized for global efficiency – face increasing headwinds. Conversely, several sectors emerge as potential beneficiaries. Defense contractors are benefiting from sustained budget increases as countries prioritize military capabilities, with global defense spending rising toward $2.5 trillion annually. Infrastructure and construction companies benefit from the massive investments in regionalized production capacity. Energy companies, particularly those in regions with cost advantages like U.S. natural gas producers, enjoy structurally favorable pricing power in fragmented markets. Logistics and supply chain companies that can navigate complexity and manage regional distribution networks become increasingly valuable.

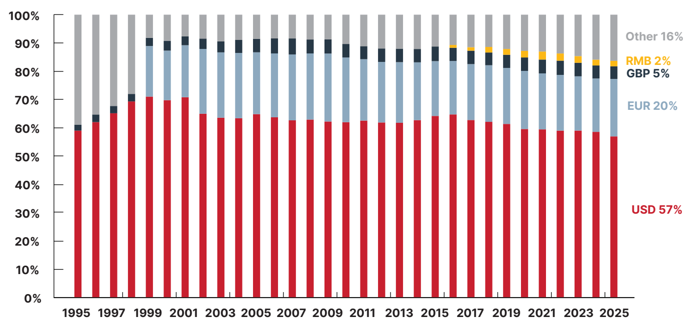
The technology sector presents a more complex picture. While disrupted supply chains and export restrictions challenge hardware manufacturers, the software and services segments may prove more resilient. Cloud computing, cybersecurity, and AI platforms can serve regional markets without the same degree of physical friction. Indeed, the proliferation of regional data centers and digital infrastructure spending may even benefit these segments. However, the fragmentation of technology standards – China's developing parallel ecosystems in everything from telecommunications (5G) to payment systems – will constrain addressable markets and create stranded investments in incompatible technologies.

Small- and mid-cap stocks may be better positioned in a regionalized paradigm. Historically, smaller companies with domestic focus have been less sensitive to global trade dynamics and currency fluctuations. The Russell 2000 index, heavy with domestic-oriented businesses, may enjoy a sustained rerating relative to the multinational-heavy S&P 500. Similarly, international diversification strategies require reconsideration. The traditional argument for international equity exposure is that global diversification reduces risk while broadening an investor's opportunity set. But if regional blocs move more independently, with divergent monetary policies, fiscal approaches, and regulatory frameworks, the correlation benefits change. Some diversification benefits may actually increase if regional economies decouple, while geopolitical risk premiums rise. The correlations and linkages of the last 30 years need to be reconsidered.

Fixed income markets face their own adjustments. Higher structural inflation implies higher long-term bond yields, and investors demand compensation for the erosion of purchasing power. The 30-year U.S. Treasury yield averaged roughly 2.5% from 2015 through 2020, reflecting low inflation expectations and substantial foreign demand for Treasuries, particularly from China and Japan. In a regionalized world with inflation settling above 3%, these yields likely need to trade 3.5% to 4.5% or higher to offer positive real returns – and indeed, the market already seems to be pricing this in. This represents a fundamental regime change for bond investors after a four-decade bull market in fixed income.

Foreign central bank appetite for U.S. Treasuries may also moderate as countries prioritize domestic financial market development and reduce dollar dependency – though the dollar's reserve currency status provides considerable inertia. Although it has lost some ground over the past decade, the dollar remains the global reserve currency, accounting for 57% of all central bank foreign exchange reserves in the world. The euro remains a distant second, with a 20% share. Despite China's looming presence on the global economic stage, the renminbi is a mere 2% of global reserves. The dollar stands tall for now, but regionalization would likely reduce demand for dollars, with implications for interest rates and currency values alike.

Composition of global foreign exchange reserves



Sources: International Monetary Fund, BBH Analysis.
Data as of June 30, 2025.

Emerging markets require particular discernment in a regionalized framework. Not all emerging economies will fare equally. Those positioned as connectors within regional blocs – Mexico in North America, Poland in Europe, Vietnam and India in Asia – may enjoy sustained economic growth, along with the corporate profitability and equity market appreciation that follow over time. Countries caught between competing blocs or lacking clear alignment face greater challenges. Portfolio allocation in this new world should increasingly focus on regional trade patterns, infrastructure connectivity, and alignment with major economic blocs, rather than traditional emerging market beta.

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Risk premiums across asset classes likely need to rise to reflect greater geopolitical uncertainty. The equity risk premium – the expected return on stocks above safe bonds – compressed during the globalization era as geopolitical risk, or at least the perception thereof, diminished. A return to higher risk premiums would imply lower valuation multiples for equities and wider credit spreads in corporate bonds. The practical implication is that investors should adjust expected returns for traditional asset classes downward and reconsider their needs for liquidity in an environment of heightened volatility.

Finally, alternative investments and private markets may gain appeal in a regionalized world. Private equity and venture capital can be deployed with regional focus, supporting the buildout of localized production ecosystems. Real assets – infrastructure, commodities, real estate – offer inflation protection and tangible value in an environment of greater price volatility. Commodities, in particular, may experience a sustained bull market as regionalization drives duplicative demand for critical minerals, energy resources, and agricultural commodities previously traded in globally integrated markets. Gold and other traditional safe havens may also benefit as hedges against geopolitical risk and currency uncertainty.

Beyond economics and markets

It remains to be seen if this pivot toward regionalization is truly a paradigm shift or merely a transitory reflection of the perfect storm of a global pandemic, the Russian invasion of Ukraine, and a neo-mercantilist U.S. trade policy. While the economic impacts of regionalization on growth, inflation, and financial markets are already becoming evident, the transformation, if sustained, extends into dimensions that fundamentally alter how investors must evaluate opportunities and risks. Portfolio managers need to pay particular attention to three areas: corporate strategy disruption, emerging market differentiation, and the challenge of navigating transition risks.

The era of the truly global corporation optimized for worldwide efficiency is drawing to a close, or at least shifting to a new state in which geography matters more than it has for the past generation. For decades, multinational companies built integrated supply chains spanning continents, consolidated back-office functions in lowest-cost locations, and managed global operations from centralized headquarters. This model is breaking down. Companies now face pressure to maintain parallel operations across regional blocs, duplicating functions that were previously consolidated. A semiconductor company might need separate design teams for U.S. and Chinese markets due to export restrictions. A software firm must build redundant data centers to comply with data localization requirements in Europe, Asia, and North America. An automotive manufacturer possibly needs separate supply chains for USMCA, EU, and Asian production rather than sourcing globally optimal components.

This fragmentation imposes real costs but also creates winners and losers among corporate strategies. Regional champions – companies with deep expertise and dominant positions within a specific geographic bloc – may outperform traditional multinationals struggling to manage complexity across competing regions. European industrial companies focused on serving the EU market with minimal extra-regional exposure avoid the costs of navigating U.S.-China tensions. American defense contractors benefit from allied nations' increased military spending without needing to compete in Chinese markets. Conversely, companies whose business models depend on global scale – think cloud computing platforms requiring worldwide server networks or pharmaceutical companies amortizing R&D costs across global markets – face strategic challenges. Yesterday's competitive advantage may be tomorrow's competitive disadvantage as addressable markets shrink and regulatory requirements diverge.

For investors, this suggests careful analysis of corporate geographic exposure and strategic positioning. Companies with balanced regional portfolios may appear diversified but actually face maximum complexity costs. Firms concentrated in growing regions with clear competitive advantages may prove more attractive. Stranded assets become a real concern: Manufacturing facilities, distribution networks, and technology investments in the "wrong" geographic locations lose value as trade barriers rise and regional preferences shift. The traditional investment approach of favoring global multinationals for their diversification may need recalibration toward companies with focused regional strategies or those genuinely capable of managing multiregional complexity profitably.

Emerging markets require even greater discernment in a regionalized world, as these economies will experience vastly different trajectories based on their positioning within or between major economic blocs. The traditional approach of treating emerging markets as a homogeneous asset class – bundling countries from Brazil to Thailand into a single portfolio allocation – becomes increasingly obsolete. Instead, investors must differentiate between three categories of emerging economies, each with distinct risk-return profiles:

- **A first category consists of "connector countries" strategically positioned within major regional blocs.** Mexico, as the prime beneficiary of North American nearshoring, has seen manufacturing investment surge as companies relocate production closer to U.S. markets. Vietnam occupies a similar position within Asian supply chains, and India, with its combination of scale, democratic institutions, and strategic alignment with Western interests, is positioning itself as a manufacturing alternative to China in sectors from smartphones to pharmaceuticals. Poland serves this role within the EU, attracting investment as companies establish European production footprint. These connector countries benefit from sustained capital inflows, technology transfer, and employment growth, making them attractive markets for foreign direct investment (FDI) despite near-term volatility.
- **A second category comprises countries caught between competing blocs or lacking clear alignment.** Many African nations, Central Asian republics, and some Southeast Asian economies face pressure to choose between Chinese Belt and Road infrastructure financing and Western-led development models. These countries may struggle to attract sustained FDI as companies hesitate to commit capital in locations where geopolitical winds could shift. Their debt sustainability comes under pressure as access to diversified international funding becomes more difficult. Turkey exemplifies the challenges: Positioned between Europe, Russia, and the Middle East, the country faces currency volatility and capital flight as investors price in geopolitical uncertainty. For portfolio managers, these markets require higher risk premiums and shorter time horizons, with careful monitoring of political developments that could shift regional alignments.
- **A third category includes countries firmly aligned with blocs but lacking the infrastructure, institutions, or strategic positioning to become major manufacturing hubs.** These economies may still grow through commodity exports, domestic consumption, or services, but they won't capture the same manufacturing investment flows as connector countries. Their equity markets may offer opportunities, but investors should temper expectations about the pace of development and recognize that regionalization provides less of a tailwind than for strategically positioned peers.

Finally, investors must navigate the profound challenge of transition risks – the reality that the shift from globalized to regionalized economic order may prove more turbulent and costly than the destination itself. The timing and pace of fragmentation remain deeply uncertain.

A gradual transition, playing out over 10 to 15 years, allows companies and economies to adjust incrementally. Supply chains relocate methodically, with old facilities depreciated before new ones are built. Workers retrain as manufacturing patterns shift. This scenario, while still costly, spreads adjustment burdens over time and allows capital to be reallocated efficiently. Investors can position portfolios gradually, rotating toward sectors and geographies benefiting from regionalization while reducing exposure to those facing headwinds.

An abrupt transition, triggered by geopolitical crisis, sudden policy shifts, or cascading supply chain failures, imposes far higher costs. Companies scramble to relocate production, accepting suboptimal locations and paying premium prices for construction and equipment. Critical shortages emerge in products whose supply chains cannot adjust quickly. Financial markets experience sharp dislocations as investors reprice assets. The 2020 to 2022 period offered a preview: Pandemic-related supply shocks, followed by the Ukraine conflict's energy disruptions, demonstrated how quickly integrated systems can fracture and how painful rapid adjustment proves.

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Path dependency complicates these scenarios. Decisions made today – where to build factories, which markets to prioritize, which regional alliances to cultivate – lock in structures that persist for decades. A semiconductor fabrication plant takes three to four years and $10 billion to $20 billion to build. Once constructed, it operates for 15 to 20 years, making the location decision essentially irreversible. Trade agreements, once established, create constituencies that resist change even if economic conditions shift. Infrastructure investments connect specific regions and make alternative routing costly. Investors must therefore consider not just current positioning, but also the durability of regional structures being built today.

Moreover, the risk of overshooting looms. Just as globalization may have extended too far – creating brittle supply chains prioritizing efficiency over all else – regionalization could go too far in the opposite direction. Excessive fragmentation that duplicates capacity, fragments research efforts, and erodes remaining scale economies would impose costs exceeding any security or resilience benefits. History suggests that policy pendulums often swing past optimal points before correcting. The challenge for investors is identifying when regionalization moves from rational adjustment to counterproductive extreme, and positioning accordingly. This likely means maintaining some exposure to truly global businesses and being prepared to increase that exposure if fragmentation clearly overshoots.

The transition also creates potential for policy reversal. A change in political leadership in major economies could rapidly shift trajectories. Climate change imperatives might force renewed global cooperation on clean energy technology, creating islands of integration within otherwise fragmented systems. Breakthrough technologies – like transformative AI capabilities, fusion energy, and quantum computing – could transcend geographic boundaries and restore elements of global integration. The probability of such reversals is impossible to quantify, but their potential impact on portfolios is substantial.

Navigating the new economy

The three-decade era of aggressive globalization is giving way to a more fractured and regionalized economic order. This transformation is neither sudden nor complete, but the direction is clear and consequential. The implications span the full spectrum of economic and financial dynamics:

- Slower aggregate growth as efficiency gains from specialization and scale are sacrificed for resilience and security
- Higher structural inflation as production relocates to more expensive venues and supply chains prioritize redundancy over cost minimization
- Financial markets that must adjust to compressed profit margins, elevated risk premiums, and greater volatility

Yet this shift is not uniformly negative. Regional integration within blocs like the USMCA, EU, and East Asian trade networks can preserve many benefits of openness while providing security and alignment among trusted partners. Certain economies – the connectors and logistics hubs within regions – will capture outsized benefits. Technological innovation, particularly in automation and AI, may offset some of the cost increases from geographic shifts in production. And for investors, new opportunities emerge in sectors like defense, infrastructure, logistics, and localized technology ecosystems.

The key to navigating this transition, whether as policymakers or investors, is to recognize that we’re experiencing a regime change rather than a temporary disruption. The forces driving regionalization – geopolitical competition, security considerations, and domestic political pressures – are likely to persist for years if not decades. The assumption that efficiency and cost minimization will trump all other considerations, which undergirded investment and corporate strategy for a generation, no longer holds. Instead, resilience, security of supply, and political alignment now rival traditional economic factors in importance.

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> Successfully navigating this transition requires moving beyond traditional frameworks that assume stable, globalized markets toward dynamic assessment of regional positioning, corporate adaptability, and the timing of structural change.

The regionalization of the global economy represents a regime change on par with the opening of China, the creation of the euro, or the collapse of the Soviet Union – transformative events that redefined investment opportunity sets for decades. Successfully navigating this transition requires moving beyond traditional frameworks that assume stable, globalized markets toward dynamic assessment of regional positioning, corporate adaptability, and the timing of structural change. Investors who cling to generalizations formed during an era of globalization will find their portfolios increasingly misaligned with economic reality. Those who understand and adapt to this new era of economic opportunity will thrive.

The Economy, Markets, and Investments at Q1 2026

Justin Reed
Partner and Chief Investment Officer

Ilene Spitzer
Principal and Deputy Chief Investment Officer

2025 was an eventful year, from policy shifts and geopolitical tensions to rapid artificial intelligence (AI) innovation and growth in the private credit universe. We recently sat down with Chief Investment Officer (CIO) Justin Reed and Deputy CIO Ilene Spitzer to explore how these forces and more will shape the investment landscape as we enter 2026.

What drove markets in 2025, and what do you see as key risks today?

Justin Reed: After advancing 26.3% in 2023 and 25% in 2024, the S&P 500 rose 17.9% in 2025, largely driven by a combination of macro and company-specific (micro) factors. On the macro side, after keeping the fed funds rate steady during the first half of 2025, the Federal Reserve (Fed) restarted its interest rate-cutting cycle with three rate cuts for a total of 75 basis points (bps).[1] This shift toward a more dovish monetary policy provided a supportive backdrop for business growth and investment, helping to boost equities – particularly as declining interest rates fueled the rally in the S&P 500. As such, the prospect of lower borrowing costs (the 30-day average Secured Overnight Financing Rate [SOFR] rate has declined by 74 bps to 3.8%, the lowest since December 2022) has helped boost future earnings per share (EPS) growth estimates and provided support to high valuations given the inverse relationship between interest rates and valuation multiples.

In terms of business growth, despite concerns that tariffs could cause a recession, quite the opposite occurred as consumer spending remained resilient and capital expenditures (capex) related to AI boosted growth. The initial reading by the Bureau of Economic Analysis (BEA) estimated real U.S. gross domestic product (GDP) growth reached 4.3% on an annualized basis in third quarter 2025, marking the highest growth rate in over two years and an acceleration from the 3.8% real GDP growth generated in second quarter 2025.

Digging more into the micro, despite downward earnings revisions during the first half of the year and heightened growth slowdown concerns due to tariffs, company fundamentals ultimately surprised to the upside. The S&P 500 is now estimated to generate earnings growth of 11.5% in 2025, up from 8.7% estimated in June 2025, and 14.9% in 2026. This is largely driven by the sharp increase in hyperscaler capital spending and multibillion-dollar agreements signed between key AI developers and semiconductor manufacturers, which disproportionately benefited the Magnificent Seven (Mag 7)[2] within large-cap equities and speculative growth stocks within small-cap equities.

Approximately 42% of the S&P 500's 17.9% return can be attributed to the performance of the Mag 7, reflecting the ongoing trend of heightened market return concentration observed in recent years. As such, the communication services and technology sectors were the best performing sectors in the S&P 500, returning 33.4% and 24% in 2025, respectively.

Moving onto risks, U.S. large-cap equities are expensive across a series of valuation measures. Whether you look at price to earnings (P/E), dividend yield, or price to cash flow, the S&P 500 trades at least in the top quintile of historical valuations going back 30 years. With a forward P/E ratio of 22x as of December 31, 2025, the S&P 500 sits just under two standard deviations above its 30-year historical average of 16.8x.

The market rally that began on April 9, 2025, following the policy pivot by the Trump administration, was driven in large part by AI exuberance. For example, Nvidia saw its share price double from its April lows and became the world's first $5 trillion company. The period also saw a remarkable rotation into speculative growth and highly shorted companies following the first quarter. This was a year in which high-quality companies, not only across U.S. equities but international equities as well, did not keep up with lower-quality companies on a price basis.

[1] One basis point is equal to 1/100th of 1%, or 0.01%.
[2] Magnificent Seven (Mag 7): Apple, Microsoft, Alphabet (Google), Amazon, Nvidia, Meta, and Tesla.

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– Justin Reed

Ilene Spitzer: Following up on that, one of the risks that we are monitoring closely is the historic level of concentration within the S&P 500. Historically, the S&P 500 is considered concentrated when the top 10 stocks reach 23.4% of the index; today, that number is 40.7%. In other words, 2% of the names in the benchmark represent 40.7% of the overall exposure, while the Mag 7 represents 34.9%. To us, the outlook for the S&P 500 is strongly tied to the outlook for the AI giants. Our equity portfolio is less concentrated in the top 10 names and more attractive from a forward fundamental standpoint compared with the S&P 500. We have constructed client portfolios that are more diversified than the benchmark – owning businesses across geographies, sectors, and the market cap spectrum. In 2025, we generated alpha by owning international stocks, for example. International equities benefited from a declining U.S. dollar and from phenomenal returns for defense-related companies on an expected increase in defense spending by NATO countries.

It is important to note that following periods of market concentration in the top 10 index constituents, the other 490 stocks outperformed the top 10 91% of the time over the following five-year period. This could have positive implications for our portfolio and for active management in general.

Coming back to other risks, we continue to monitor the impact of tariffs on equity markets. In 2024, the average tariff rate on goods imported to the U.S. was 2.4%. Today, the Yale Budget Lab estimates that the effective tariff rate on U.S. imports is about 17%, the highest rate since the 1930s.[3] So far, inflation data has remained muted, although November and December numbers were skewed by the federal government shutdown.

There’s been much discussion about the K-shaped economy and divergence in economic realities between top earners and lower earners. We’re closely watching consumer sentiment and spending as well as inventory rebuild by businesses, which tariffs may affect more going forward.

We are also closely monitoring the risk of stagflation. We are increasingly concerned that lower interest rates and continuing trade tensions may lead to higher inflation in the near term. We are also on the lookout for slowing growth, in part due to consumer spending headwinds, particularly for low- and middle-income earners. When combined, these market dynamics suggest a risk of stagflation, which could create monetary policy challenges for the Fed.

[3] *Source: The Budget Lab as of November 17, 2025.*

What is your outlook on AI?

JR: At a very high level, we are cautiously optimistic about AI. There is a principle called Amara's Law that suggests people tend to overestimate the short-term impact of technological innovation and underestimate its long-term impact. We think this principle is applicable to what we're witnessing today, and as a result, we view AI as both an opportunity and a risk within client portfolios.

One of the key risks we are monitoring relates to the level of capex of the hyperscalers – think companies like Alphabet and Meta that are spending heavily on data centers in support of AI initiatives. This year, we expect the hyperscalers to spend roughly $400 billion in capex. Notably, there are limited revenues associated with those expenditures today. In isolation, that is concerning. Many will remember large capex in the lead-up to the tech bubble. The source of that capex is important, though. In the tech bubble, many of the companies that had large capex spend were funding that from debt. Today, most of the hyperscalers are funding their spending from cash flow. We think that helps to mitigate some of the capex spending risk.

We study history to inform our positioning, and we have done the same with AI. While no two innovation cycles are the same, we do believe that there are lessons to be learned from the past.

Thinking about the internet in the lead-up to, during, and after the tech bubble, there were three key layers:

- Infrastructure (companies like Cisco and Intel)
- Platform (companies like Alphabet and Microsoft)
- Application (companies like Meta and Netflix)

In the current AI innovation cycle, the infrastructure layer is composed of companies like Nvidia, Taiwan Semiconductor Manufacturing, and ASML. The platform layer is more nascent, including companies like OpenAI, Anthropic, Alphabet, and Meta. The application layer is nascent, but currently includes companies like Cursor, an AI-powered code editor, or Harvey, an AI application for the legal services industry. We have exposure to these types of companies through our venture capital (VC) program.

Over the long term, our view is that we are likely to witness something similar to the internet innovation cycle where the platform and application layers experience the strongest returns. There were success stories in the infrastructure layer (companies like Cisco), but there was an overbuilding cycle that led to less-attractive returns in aggregate relative to the companies built upon that infrastructure.

We are careful not to overload our AI exposures now, as most of the companies available for investment are in the infrastructure layer and, to a lesser extent, the platform layer. We think our clients benefit from focusing on those opportunities where we gain AI optionality, leaving some dry powder to "dollar-cost average" into future AI opportunities in the coming years.

So, what does this mean for portfolio positioning?

IS: In client portfolios, we are slightly underweight indices in the AI infrastructure and platform layer within public equities. That said, we are focused on sizing up our AI platform and AI application layer exposures over the next few years, across both public and private equities. For clients who can invest in the asset class, we think VC exposure will facilitate meaningful long-term optionality to AI.

"As with any technological innovation, there will be winners and losers. We want to invest in those companies that can harness the technology and stay away from those companies that are unwilling or unable to incorporate it successfully."

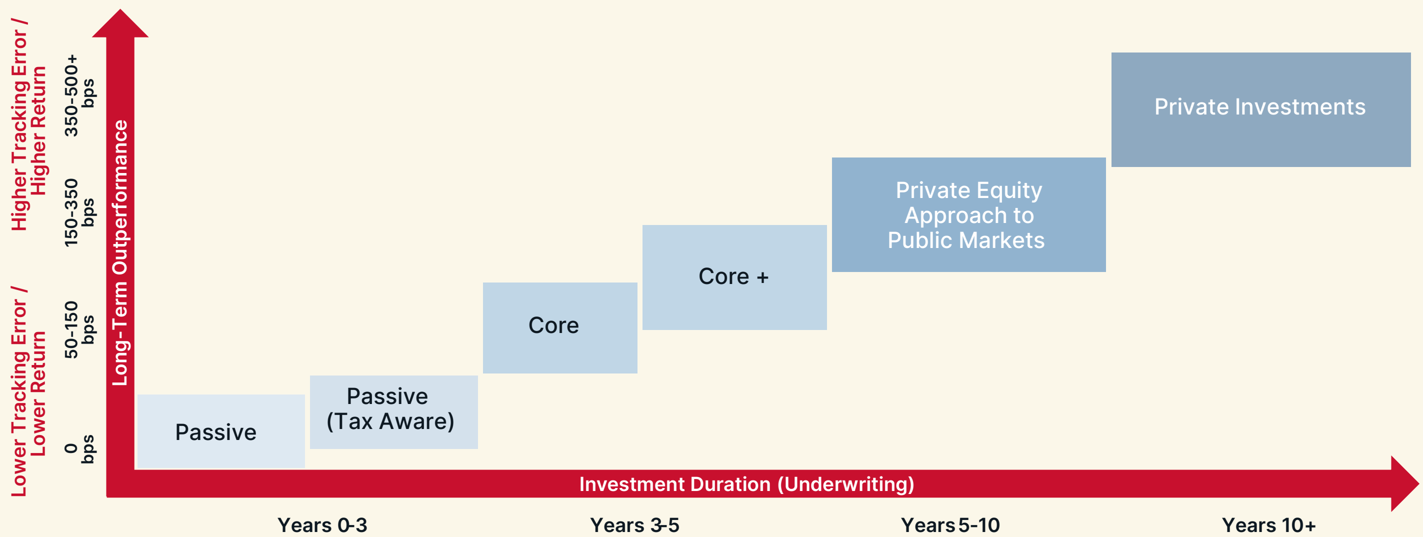
– Ilene Spitzer

We also evaluate our AI exposure by assessing how our underlying portfolio companies are harnessing AI to become more efficient and productive. Some of them are even moving into using AI to grow revenues instead of just enhancing margins. As with any technological innovation, there will be winners and losers. We want to invest in those companies that can harness the technology and stay away from those companies that are unwilling or unable to incorporate it successfully.

We are focused on gaining additional exposure through what we call AI derivatives. We are doing a lot of work on power needs, which we consider to be one of the biggest gaps in the value chain. We recently onboarded a public equity strategy whose largest position is a collection of several utility companies that are benefiting from increased power demand.

What is your view on passive investment options?

JR: We view passive investment options as just one of several tools we can use to help our clients meet their goals and objectives. The appropriateness of an investment for a given client depends on many factors, including tax sensitivity, time horizon, and tolerance for deviations from benchmark performance, often referred to as "tracking error." For the most benchmark-aware clients with a shorter time horizon, passive investment options can help them stay invested over the long term. For our taxable clients, we encourage the use of our proprietary tax-managed equity strategy, which provides



Source: BBH.
For illustrative purposes only.

"Stock owner" mindset **"Business owner" mindset**

Client's Goal	Liquidity	Liquidity	Conservative Growth	Conservative Growth	Growth	Accelerated Growth
Implementation	Passive	Passive (Tax Aware)	Core	Core +	Private Equity Approach To Public Markets	Private Investments (Private Equity & Venture Capital)
Return Focus	Index	Index	Relative	Relative/Absolute	Absolute	Absolute
Tracking Error	–	Low	Low-Medium	Medium	High	Very High (all privates)
Active Share	–	Low	Low-Medium	Medium	High	Very High (all privates)
Alpha Potential	–	Low	Low-Medium	Medium	High	Very High
Tax Efficiency	High	Very High	Low-Medium	Medium	High	Very High
Model Options	No	Yes	Yes	Yes	No	No
Investment Duration	n/a	n/a	1-3 Years	3-5 Years	5-10 Years	10+ Years

additional tax optimization benefits compared with investing in a passive exchange-traded fund (ETF) that tracks an index.

Beyond passive, we have active management options that differ in a number of dimensions. Our Core and Core+ strategies include investment managers who look to outperform over three to seven years, and our alpha managers, who take a private equity (PE) approach to public markets, tend to underwrite to a holding period of seven to 15 years and are more absolute return-focused. Over any short time period, alpha manager returns are likely to differ meaningfully from indices – both underperformance and outperformance can be significant (i.e., up or down 20%) in a single year.

Investing is about *time in* the markets, not *timing* the markets. That is why it is critical that we guide our clients toward investment solutions that best meet their risk tolerance, tracking error expectations, and return objectives. Keeping clients invested is our goal.

Passive investment offerings also warrant investment diligence. There are now more ETFs than stocks, and investment selection is still key. Our team spends a lot of time curating the best passive options, focusing on variables such as fees, construction, liquidity, and tracking error, among other variables.

Finally, we would be remiss if we did not say that clients should be careful about giving up on active management in today's environment. With historic levels of market concentration and the S&P 500 trading close to all-time highs and valuations, we think active management will help to preserve capital over the medium term.

Private credit, and direct lending in particular, has received increasing attention in the press. How are you thinking about private credit today?

IS: Let's start off with a reminder about what private credit is – borrowing that occurs outside of the traditional banking system, creating securities that are not traded in public markets. Direct lending, a common form of private credit, refers to privately negotiated loans between a borrower and a nonbank lender. Since the global financial crisis (GFC) in 2008, the private credit universe has seen exponential growth, as changing capital requirements for banks created a void that financial firms stepped in to fill.

Investors are attracted to private credit as a source of income, portfolio diversification, and the ability to receive a yield premium over more traditional fixed income markets. Like most opportunities, as the number of players in the space has increased, we've seen spreads compress, particularly in the most plain area of the market: PE-sponsored direct lending.

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Investing is about *time in* the markets, not timing the markets. That is why it is critical that we guide our clients toward investment solutions that best meet their risk tolerance, tracking error expectations, and return objectives.

– Justin Reed

More recently, negative headlines have surfaced around the implosion of First Brands and Tricolor. Both companies had utilized private credit markets as a source of capital. The story of First Brands highlights the importance of thorough due diligence. Many private credit firms turned First Brands away, citing a number of signs they viewed as suspicious, including:

- The company's willingness to raise such expensive debt despite reporting high cash balances
- A lack of clarity around why the company needed a $200 million loan given high cash balances
- The company's consistently late payments to its suppliers
- The company's headquarters being only a single floor of a Cleveland office building – unusual for a $5 billion revenue company
- The existence of numerous lawsuits against the founder, including allegations of fraud by several lenders

Given the tremendous growth in private credit and less attractive opportunity set (which in our opinion leads some managers to lend to less attractive companies), we have been cautious about adding strategies in traditional direct lending. Instead, we have focused on less frothy parts of the private credit universe, including real estate lending and alternative credit.

Taking a step back, whether it is public equity, PE, traditional fixed income, or private credit, we look to partner with managers that know what they own and why they own it. While underwriting mistakes happen, thorough vetting of investment opportunities can go a long way in avoiding fraudulent situations and preserving capital. We have been opportunistic in our private credit offering, only partnering with established groups with strong histories of strict underwriting standards.

Final question: Any key themes for your outlook for 2026 and beyond?

JR: Let's start with a geographical lens: We are neutral on U.S. equities, meaning that we are encouraging our clients to stay close to strategic targets and to rebalance if they are overweight after several strong years of relative performance, excluding 2025.

One of the things we are keeping a close eye on in the U.S. is the so-called K-shaped economy, which suggests that higher-income earners and select companies will do well, while lower-income earners and broader sectors will lag. The top 10% of households, as measured by income, account for roughly 60% of all consumer spending. Those same households control almost 85% of U.S. wealth.

The divergence of the K-shaped economy is illustrated in the nearby chart, which compares the S&P 500 – typically benefiting higher-income individuals – to consumer confidence, a measure that more broadly represents sentiment among lower-income consumers. It suggests a story of diverging fortunes, which bears monitoring over the next year and beyond.

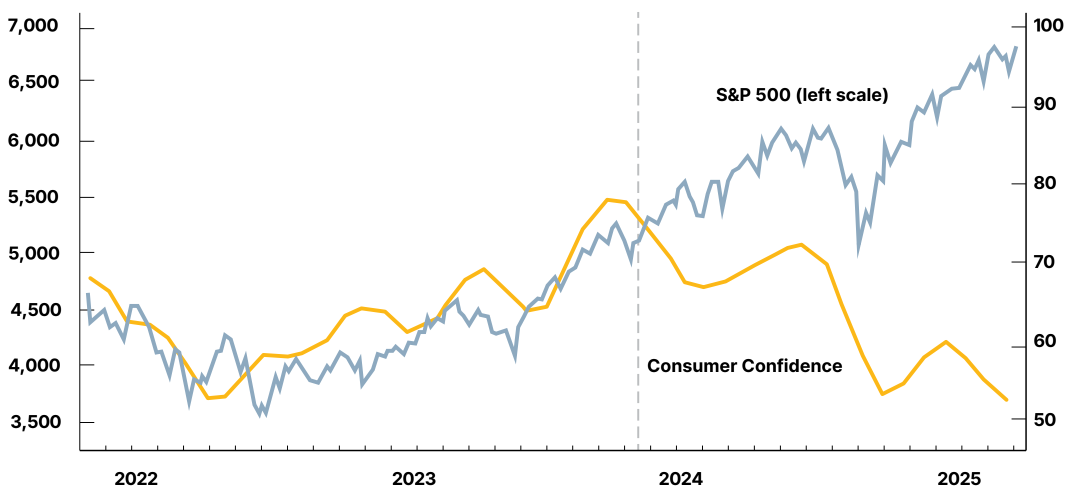
Can the top 10% of the socioeconomic spectrum continue to support nearly half of all spending?[4] We are monitoring the health of the upper-income consumer closely. If the stock market suffers declines, and the wealth effect diminishes, the U.S. economy is left vulnerable.

We continue to be very constructive on international equities, specifically in Europe and emerging markets. This positioning benefited client portfolios in 2025, and we expect it has the potential to continue in the year ahead. While U.S. equities, as measured by the S&P 500, are trading close to all-time high valuations, international and emerging markets are trading just slightly above their long-term average valuations.

For our U.S. clients, we also highlight the geopolitical environment, where all signs point to President Trump nominating a dovish Fed chair in 2026 who will be focused on lowering rates. We think this likely leads to additional U.S. dollar depreciation, especially when the dollar is trading at a 37% premium to the euro and 40% premium to the Japanese yen, based on purchasing power parity (PPP). Within Europe, we continue to have meaningful exposure to defense companies, which also benefited client portfolios in 2025. We expect the trend of renationalization and decoupling from a reliance on the U.S. for defense to continue.

For clients with an overweight to equity vs. fixed income, we recommend rebalancing back to the appropriate asset class allocation. A client who invested in a traditional 60/40 equity/fixed income portfolio in 2019 and did not rebalance would now have an 80/20 portfolio due to the run-up in stock prices and muted returns in fixed income since then. We encourage clients to rebalance soon if they have not done so already.

A glimpse at the K-shaped U.S. expansion
S&P 500 vs. Consumer Confidence Index



Past performance is no guarantee of future results.
Consumer confidence is represented by the University of Michigan Survey of Consumer Sentiment.
Source: LSEG Data & Analytics and AllianceBernstein (AB).

[4] *Source: Moody's Analytics.*

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We continue to encourage clients to extend to defend: We believe locking in higher rates now will benefit results in the coming years, as reinvestment risk is a greater concern than interest rate risk at this point in the cycle.

– Ilene Spitzer

IS: Coming back to equity market valuations, we are particularly constructive on independent return strategies. These are strategies that tend to generate equity-like returns with low correlation to broader equity and fixed income markets. We have added several of these strategies over the past couple of years and are focused on adding more to the platform this year. We think that the addition of these strategies to client portfolios will help preserve capital in any equity market correction while still providing growth potential.

Turning to AI, we are cautiously optimistic about mega-cap tech. As we mentioned earlier, the hyperscalers have largely funded capex through cash flow instead of debt. Our analysis of these companies leads us to believe that most of the recent price appreciation is a result of fundamental growth (e.g., revenue and EPS growth) and strong balance sheets, instead of multiple expansion.

We are being thoughtful about playing AI derivatives. There is some correlation to the AI trade that has us thinking more deeply about portfolio construction and preservation of capital. As we mentioned, in the long term we are very constructive on AI, but if we do experience a meaningful disappointment on the AI front in the next year or so, that may translate into more areas than many investors realize.

For example, many investors have diversified into energy power via utilities and real estate, which have historically delivered portfolio diversification. Now imagine a world in which AI use cases and revenue fail to materialize as expected – what happens to power demand, and what happens to the value of all those data centers? What happens to all the office real estate owned by hyperscalers?

Switching to monetary policy, the fed funds futures curve is pricing in two rate cuts in 2026, while the Fed is projecting just one cut. We think this mismatch in rate cut expectations can be a source of equity market volatility in 2026, given the impact of rates on valuation multiples. Despite this mismatch, the common denominator is at least one rate cut. As a result, we expect short-duration rates to be lower in 2026 and for the yield curve to steepen further. This should be a tailwind to longer-duration, rate-sensitive assets like PE, real assets, U.S. large-cap companies (mainly growth companies), and smaller-cap companies (mainly pro-cyclicals and consumer-focused companies). We continue to encourage clients to extend to defend: We believe locking in higher rates now will benefit results in the coming years, as reinvestment risk is a greater concern than interest rate risk at this point in the cycle.

In 2025, mergers and acquisitions (M&A) meaningfully increased (compared to 2024), and we also witnessed a strong IPO market. We expect this environment to continue, particularly in a lower interest rate environment. In such an environment, we would expect more distributions from PE and VC firms, as well as an interesting environment for event-driven independent return strategies. Accordingly, we continue to be constructive on PE (and VC) focused on return generation through value-add initiatives and proprietary deal sourcing (as opposed to leverage).

At the end of the day, we are always trying to look around corners to take advantage of opportunities and mitigate risk in client portfolios. We will continue to do this in 2026 and beyond.

Justin and Ilene, thank you for your time.

To learn more about our Investment Research Group's positioning, reach out to your BBH relationship manager. ■

Five Fixed Income Trends We're Watching in 2026

Neil Hohmann, Ph.D.
Partner and Portfolio Manager

Fixed income markets are evolving rapidly, and understanding the forces shaping them is critical for investors. Here, Partner Neil Hohmann, Ph.D., highlights five key fixed income trends we're watching in 2026, covering credit cycles, yield opportunities, policy uncertainty, and private credit dynamics.

1 *Where do you think we are in the "credit cycle?" What do you think are the critical factors for performing through this segment of the cycle?*

Credit cycles are generally the convolution of multiple types of market waves, particularly credit and liquidity movements. One can argue we're toward the tail end of both (they are frequently correlated).

For credit, weakening jobs numbers, plateauing corporate earnings, persistent inflation, and unclear Federal Reserve direction suggest investment grade and high-yield credit may weaken from today's levels. Fixed income investors are more cautious and selective in this weakening macroeconomic environment, widening spreads and lifting volatility.

To help insure our clients against developing cycles, we diligently follow our tested investment process – owning only credits durable to the worst macros and industry distress we can anticipate and buying only at attractive valuations that give us a hefty margin of safety[1] in income against potential market price declines.

2 *Where can investors attain higher yields with a relatively high degree of safety?*

As a medium-sized manager, we can invest meaningfully in credits for investors that may have less issuance, are less familiar to markets, and may be experiencing substantial issuance growth. These favorable technicals for investors provide us consistent opportunities for value in sectors like structured credit (such as asset-backed securities [ABS], commercial mortgage-backed securities [CMBS], and collateralized loan obligations [CLOs]) and less-frequented corporate credit sectors (such as business development companies [BDCs], insurers, and Yankee banks). In smaller or overlooked credit sectors, our investors may simply benefit from the absence of the large fixed income managers.

[1] *A margin of safety exists when the additional yield offers, in BBH's view, compensation for the potential credit, liquidity and inherent price volatility of that type of security and it is therefore more likely to outperform an equivalent maturity Treasury instrument over a three- to five-year horizon.*

3 *How do you see policy uncertainties affecting fixed income markets?*

We are in a period of greater policy uncertainty than we have been in some time – on rates, inflation, trade, immigration, and geopolitics. Yet the added uncertainty does not appear to be priced into the relatively low compensation available today in bond and loan markets. That just underscores the importance of defensive investing and process diligence. Our bottom-up process has organically resulted today in a greater-than-typical level of cash and reserves and a shorter credit duration profile across portfolios, both of which position us well to take advantage of the elevated risk of turbulence in these markets.

4 *What are you most excited about in this space as we kick off the year?*

We're excited about the continuing general availability of opportunities in these more overlooked segments (specifically, nontraditional ABS and CMBS, insurance, BDC, and loans).

Our tried-and-true investment process has allowed us to organically build reserves and shorten credit tenures to position us to take advantage of market turbulence. We expect more frequent episodes of market volatility that our process exploits and that have delivered competitive performance for investors in the past.

5 *How should investors navigate the actual and headline risks associated with private credit?*

This is straightforward. Invest with long-seasoned private credit managers that have stuck to their underwriting standards and not altered their business models to accommodate newer market structures and outsized growth.

In addition, invest in private credit fixed income structures that allow investors to take advantage of the substantial compensation opportunities but also help investors avoid direct losses in owning private credit outright. For example, BBH has historically been the most prevalent investor in unsecured corporate bonds of BDCs, which exhibit minimal debt leverage (about 1x) vs. the finance sector and where, based on our experience, no lender – bond or bank – has ever lost money over the 40-year history of the market. Nonetheless, rating for rating, they exhibit among the most attractive compensation we see in the investment grade bond market. We liken this to selling "pickaxes to the gold miners."

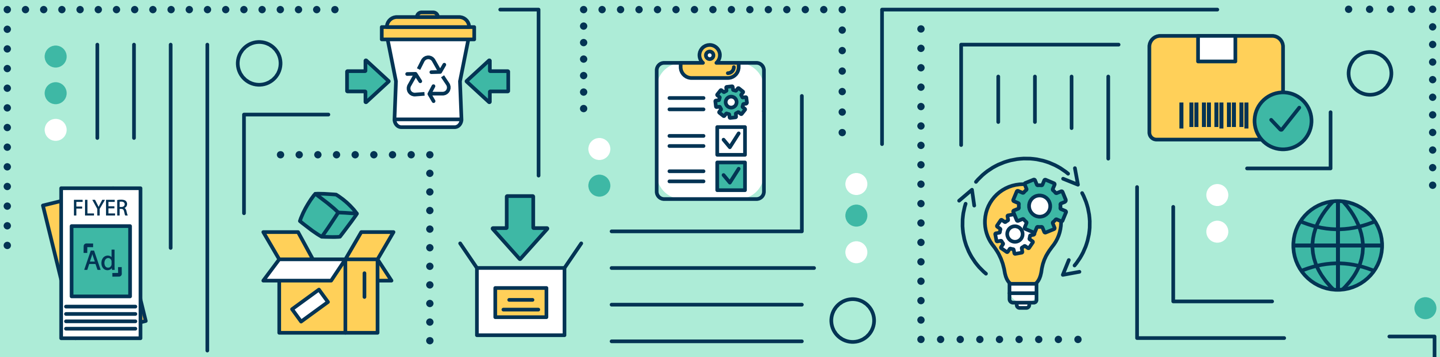
To learn more about fixed income trends and investing strategies, reach out to the BBH fixed income team or your BBH relationship team. ■

Past performance does not guarantee future results.

Investing in the bond market is subject to certain risks including market, interest rate, issuer, credit, maturity, call and inflation risk.

Asset-backed securities (ABS) are subject to risks due to defaults by the borrowers; failure of the issuer or servicer to perform; the variability in cash flows due to amortization or acceleration features; changes in interest rates which may influence the prepayments of the underlying securities; misrepresentation of asset quality, value or inadequate controls over disbursements and receipts; and the ABS being structured in ways that give certain investors less credit risk protection than others.

Below-investment grade bonds are subject to a high level of credit and market risks.



Selling Your Business Tax-Free

THE MAGIC OF QUALIFIED SMALL BUSINESS STOCK

Karin Prangley
Senior Wealth Planner

Matt Thornburg
Wealth Planner

Who wouldn't love to sell their business, or a successful angel investment or portfolio company, partially or totally income tax-free? If selling tax-free sounds good, it is time to learn about qualified small business stock (QSBS), especially since recent legislation makes the benefits of QSBS better than ever.

What is Qualified Small Business Stock?

Congress enacted the QSBS exemption in 1993 to encourage investment in certain small businesses, and in 2025, Congress greatly expanded the QSBS benefits with the One Big Beautiful Bill Act (OBBBA). Since 1993, QSBS has saved founders and investors billions of tax dollars. With advance planning, plenty of successful founders and investors have had large exits totally income tax-free.

The QSBS provisions in the tax code create essentially five requirements for powerful tax savings. In short, QSBS applies to shares originally issued from a U.S. C corporation that has less than $50 million ($75 million if the shares were acquired after July 4, 2025) of assets at the time of the investment. Shares from limited liability companies (LLCs), S corporations, and partnerships do not qualify – although read on, as some of these entities can be converted to qualify. QSBS-eligible companies include firms in sectors like technology and manufacturing, but not those in sectors like hospitality, professional services, finance, and agriculture. Capital gains from the sale of QSBS are partly or wholly exempt from federal taxes and from most state income taxes as well. This capital gains exclusion does have some limits, but before we share these limits, let's flesh out the five requirements for eligibility for the QSBS exemption.

The 2025 OBBBA legislation creates some new rules that make qualifying for QSBS easier and better, but these new rules only apply to shares that were acquired after July 4, 2025. We'll refer to the new rules by specifying what applies to "new shares" but also detail what rules apply to shares acquired on or before July 4, 2025, by referring to the rules for "older shares." The five requirements include:

Shares must be held for at least five years for older shares or three years for newer shares

For older shares, the owner must hold the shares for at least five years from the date they are acquired to the date they are sold to receive QSBS treatment. For newer shares, QSBS tax savings phase in at 50% after holding three years, 75% at four years, and fully at five years.

In some common situations, the holding period of stock from two companies or two owners could be combined. Specifically, if shares are converted or exchanged into other stock in a tax-free transaction, the owner's holding period of stock received includes the holding period during which the owner held the converted or exchanged stock. For shares received by gift or inheritance, the holding period of the recipient includes the holding period of the donor or decedent.

Shares must be acquired directly from the company, not on the secondary market

To get QSBS benefits, the shares must have been acquired after 1993 directly from a domestic C corporation or its underwriter in exchange for money, property, or services. In other words, shares purchased on the secondary market are not QSBS.

There are rules in place to prevent corporations from simply redeeming shares and reissuing stock at original issuance to qualify it as QSBS. As such, if certain redemptions occur within a specific time period before the selling shareholder received their shares, QSBS treatment may be unavailable.

Suppose the selling shareholder acquired the stock by gift or inheritance from someone who purchased their shares directly from the company. As long as the original shareholder who made the gift or left the inheritance received the QSBS directly from the company, the shares are deemed to have been acquired at original issuance.

The business's gross assets cannot exceed $50 million for older shares or $75 million for newer shares

Herein lies the first "S" in QSBS – small. As stated, Congress' goal in enacting the QSBS exclusion was to encourage investment in small businesses, and applicable tax rules essentially define small for older shares as having no more than $50 million of **assets on the balance sheet** from the company's inception until immediately after the shareholder receives the QSBS.[1] For newer shares, the company may have up to $75 million[2] of **assets on the balance sheet** at the time the shares were issued and still qualify. The amount of assets the business has after the shareholder invests is irrelevant. The valuation of the company (inclusive of certain important intangibles like its special brand, etc.) is also irrelevant. **Limiting the definition of "small" to just a view of the company's assets on the balance sheet means that many asset-light businesses like technology companies can qualify for QSBS even if they are highly valued.**

[1] Calculated per the adjusted basis rules of the QSBS provisions of the tax code. This value certainly includes investment, checking, and savings accounts of the business and some (but not all) intangible assets. These rules can lead to a calculation of value that is potentially significantly different than fair market value. The calculation of value also includes a proportionate amount of the assets of the company's subsidiaries.

[2] The $75 million net asset limit is adjusted for inflation beginning in 2027.

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Since 1993, QSBS has saved founders and investors billions of tax dollars. With advance planning, plenty of successful founders and investors have had large exits totally income tax-free.

The company must be involved in a qualified active trade or business

QSBS treatment is only available if the business uses a majority of its assets in connection with an active trade or business. Specifically, at least 80% of business assets must be used in the active conduct of business in any field, *except* for the following:

- The performance of services in health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, or financial/brokerage services
- Banking, insurance, financing, leasing, investing, or similar businesses
- Farming
- Production or extraction of oil, gas, or other natural deposits
- Hotels, motels, restaurants, or similar businesses
- Any business where the principal asset is the reputation or skill of one or more employees

Stock within these excluded industries cannot qualify as QSBS. Research, experimental, and startup activities related to a future qualified trade or business generally qualify.[3]

It can be tricky if a business straddles a qualifying activity and a nonqualifying activity, such as technology and financial services (fintech) or manufacturing and healthcare. In these situations, to determine whether the business qualifies as QSBS or not, Internal Revenue Service (IRS) guidance indicates that the following factors should be considered:

- Where does the company derive most of its revenues – from the qualifying or nonqualifying activity? For example, are customers paying for a personal service (like healthcare, which would not qualify) or a manufactured product (like a medical device or tangible product, which would)?
- Are most of the company's employees involved in the qualifying activity or the nonqualifying activity?
- Is the company's uniqueness or success dependent on a qualifying or nonqualifying activity? For example, if the company's unique differentiating factor is its amazing technology platform, that would help lead to the conclusion that the company is predominantly a technology company that could qualify for QSBS.

Other factors to consider include:

- Are the qualifying and nonqualifying activities conducted in separate legal entities? If yes, do the entities file a single consolidated tax return?
- Are 80% or more of the company's assets used for the qualifying or nonqualifying activity?

Shareholders and founders of businesses in sectors like fintech or healthcare manufacturing that straddle a qualifying activity and a nonqualifying activity might consider seeking a tax or legal opinion that their shares qualify for QSBS from an expert such as an attorney or other tax advisor. Professional guidance may protect from penalties on any tax liability in the event the IRS disagrees with the position that the business's activity qualifies for QSBS treatment. There have been several IRS rulings recently whereby the IRS indicates that a fintech or insurtech company does indeed qualify for QSBS.

The shareholder must elect QSBS treatment on tax return

Although some QSBS qualifications are a bit more complex, the mechanics of making the QSBS election are relatively simple. A shareholder can make a QSBS election on Schedule D of their tax return in the year they report the sale of the shares. No election needs to be made or filed when the shares are acquired or at any time other than when reporting the ultimate sale of the QSBS.

[3] *The following assets also can be counted as used in connection with an active trade or business: assets held for reasonable working capital needs and those held for investment that are expected to be used within two years to finance research, experimentation, or additional reasonable working capital in a qualified trade or business. A business will fail the active trade or business test if it has too much portfolio stock or passive real estate. Specifically, no more than 10% of the value of the business's assets (net of liabilities) can consist of real estate not used in connection with an active trade or business or of stock or securities in other corporations that are not subsidiaries of the business and not held as working capital.*

Sufficient proof that the shares qualify as QSBS should be obtained from the business and retained for a minimum of three years following the filing of the relevant tax return in case the IRS audits or questions whether the stock qualified as QSBS. It is much harder to create a paper trail when/if the IRS questions the return – which would likely occur years after the company has been sold – than to be proactive and document QSBS qualification when the shares are acquired and during the entire holding period.

Limits and restrictions on QSBS

While QSBS is truly one of the greatest provisions of the tax code, it does have its limits. Under current law, the maximum amount a shareholder can exclude from taxable gain on the sale of QSBS is the greater of 10 times their basis in the shares or $10 million for older shares or $15 million for newer shares.

Many startup entrepreneurs, especially those in the tech sector, have invested a tremendous amount of time and talent into their businesses but have only invested limited financial or capital assets and have very little basis in their shares. In these common situations, the founder or shareholder could sell up to $10 million or $15 million of QSBS completely income tax-free.

Note that these rules and limits apply on a per-issuer (corporation) basis. In essence, the shareholder gets the greater of 10 times basis or $10 million or $15 million (subject to any additional caps such as those explained earlier for three or four years for newer shares or shares acquired before September 2010, explained below) for each company that meets the definition of a qualified small business.

For example, if the shareholder owns QSBS in three different companies, she can reap the tax benefits of the QSBS exclusion three separate times – excluding $30 million to $45 million or more of gain from her taxes.

Under current law, the $10 million (or 10 times basis) exclusion is cut if the shareholder acquired the shares before September 28, 2010. For shares acquired before February 18, 2009, up to 50% of the shareholder's total gain may be excluded from tax. Finally, if the shareholder acquired the shares between February 18, 2009, and September 27, 2010, up to 75% of their total gain may be excluded from tax.

Note that these caps work similar to the 50% exclusion for newer shares held for three years and the 75% exclusion for newer shares held for four years with a notable exception described below.

QSBS exclusion percentage for shares held five years, by acquisition date

Date Acquired	Exclusion
On or after July 5, 2025	$15 million (or 10 times basis)
September 28, 2010 – July 4, 2025	$10 million (or 10 times basis)
February 18, 2009 – September 27, 2010	75% of the $10 million (or 10 times basis) exclusion
On or before February 17, 2009	50% of the $10 million (or 10 times basis) exclusion

How do these caps really work? The 50% and 75% cap on QSBS is worse than it would seem at first blush. Take the 50% cap, for example – it is not as simple as applying the 20% long-term capital gains tax rate to 50% of the gain and a 0% rate to the other 50% of the gain, giving you a total blended rate of a modest 10%. Instead, the QSBS laws require that 50% of the gain is taxed at a higher 28% capital gains rate and also subject to the 3.8% net investment income tax (assuming the income threshold is reached), meaning that the tax rate for the 50% excluded from QSBS is 31.8%.

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Be cautious when seeking to obtain QSBS benefits. The QSBS rules are sparse and leave many open questions. Advice specific to a shareholder's unique situation is essential.

Frequently asked questions

If older shares have not been held for five years or newer shares have not been held for three years, but otherwise meet the QSBS requirements, are there any other opportunities to reduce or defer income tax on the sale of the shares?

Many people have heard of 1031 exchanges, where real property is exchanged tax-free for like-kind real property. There is a similar provision for QSBS under section 1045 of the Internal Revenue Code. This section allows a shareholder to exchange sale proceeds on QSBS for new QSBS in cases where one of the following is true:

- Sale proceeds on QSBS exceed applicable QSBS maximums
- Stock that does not meet the five-year holding period requirement

The tax code allows the deferral of gain from the sale of the old QSBS if the new QSBS is held for least six months and if the shareholder purchases the new QSBS within 60 days of the sale of the old QSBS. The shareholder does not need to reinvest the entire sale proceeds.

In the event of a rollover, both the tax basis and the holding period of the original QSBS transfer to the new QSBS. Thus, when the second QSBS is sold, it is easier to meet the five-year holding period, as the time the first and second QSBS is owned is aggregated.

As recommended by my advisors, I gave away a portion of the shares in my business to an irrevocable trust that will not be taxed in my estate. I own half the shares, and the trust owns half the shares. How will the QSBS exclusion be calculated between my and the trust's shares?

It depends whether the irrevocable trust is a separate taxpayer. Some trusts are grantor trusts, meaning that they are subject to income tax on the trust creator's income tax return. In this case, the shares held by the stockholder individually and in the trust will receive one QSBS exclusion, since the shares are aggregated for income tax purposes.

Non-grantor trusts, on the other hand, are wholly separate taxpayers and file their own income tax returns. The QSBS rules provide that each taxpayer gets its own QSBS exclusion at the greater of $10 million/$15 million or 10 times basis (subject to a 50% or 75% cap, if appropriate). As such, if the trust is a non-grantor trust (or is timely converted to a non-grantor trust), the QSBS shares owned by the stockholder and trust could each receive a QSBS exclusion. If a stockholder had three non-grantor trusts (and the trusts have different beneficiaries), there could be four QSBS exclusions totaling $40 million to $60 million of tax-free gain or more – three exclusions for the trust and one for the shareholder personally.

What about state income taxes? Are QSBS gains excluded from those as well?

Unless a stockholder lives in one of the four states that do not recognize QSBS treatment (Alabama, California, Mississippi, and Pennsylvania), a valid QSBS election should also allow the QSBS amount to be excluded from state income taxes. Massachusetts and Hawaii have QSBS requirements that do not mirror the federal requirements discussed. Be sure to obtain advice specific to your state of residence.

Can passthrough entities such as S corporations and LLCs convert to C corporations to become eligible for QSBS treatment?

Whether another type of entity can convert to a C corporation to get QSBS treatment depends on what kind of entity it is. If the business starts as an S corporation and later terminates the S election, thus making the corporation a C corporation, the stock held immediately after the termination will probably not be QSBS because it is not original issuance by a QSB – one requirement of which is C corporation status. But it is often possible to restructure an S corporation to a C corporation to obtain QSBS status, though it may not be an easy, quick fix.

If the business starts as an LLC, then the company could be converted into a C corporation to qualify for QSBS in several ways, with a tax-free reorganization or taxable conversion being the most common. In the event of such conversion, the holding period for QSBS eligibility begins on the date the C corporation shares are issued and not on the date the LLC was formed.

In addition, for older shares only, the 50% of the gain that gets QSBS treatment is a preference item for purposes of the alternative minimum tax, so 7% of the QSBS excluded gain is still subject to a 28% tax.

These rules are extremely dense, so some examples are necessary:

Example one

Assume Sam Founder sells $10 million of QSBS acquired in 2008, which is a year when a 50% cap applies. Next, let's assume Sam has practically $0 basis in his shares. Sam is only allowed to exclude 50%, or $5 million of gain on the sale of his shares. However, the other $5 million isn't subject to the 20% capital gains tax rate. Instead, it is subject to a higher 28% tax rate, plus the 3.8% net investment income tax, and 7% of the other $5 million that nearly avoids tax is also subject to the 28% tax rate. Ignoring state income tax, this leaves Sam with a tax bill of $1.688 million – basically, a 16.88% effective tax rate on the entire $10 million of sale proceeds.

Let's compare this tax rate with what Sam would have paid had he started his business as an LLC and sold his LLC interests. An LLC does not qualify for QSBS, but unlike a C corporation, an LLC does not tax the profits distributed to its owners twice, so, as an aside, Sam may have paid less tax using an LLC for the many years he ran the company before the sale, assuming the company was profitable. Upon sale, if Sam had an LLC instead, he would pay a 20% capital gains tax rate – $2 million of tax on the sale of his business for $10 million. The partial QSBS treatment (with tax of $1.688 million) in this hypothetical did not save Sam much money.

Example two

Let's now instead assume Sam sells newer shares for $20 million, which have a $0 basis, and continue to assume a 50% cap applies (for shares held for three years only).

Sam's maximum QSBS gain is $15 million. The first 50% of this gain, or $7.5 million, is taxed at the higher 28% rate. Then, the other 50% of QSBS gain of $7.5 million escapes tax entirely. The remaining $5 million is subject to the 20% long-term capital gains tax rate, and $12.5 million is subject to the 3.8% net investment income tax. Sam's total tax bill is $3.575 million.

Conclusion

One final word of advice: Be cautious when seeking to obtain QSBS benefits. The QSBS rules are sparse and leave many open questions. Advice specific to a shareholder's unique situation is essential.

Meeting the QSBS requirements is generally an all-or-nothing proposition. If the stock does not qualify as QSBS, the potentially generous provisions to exclude gain are wholly unavailable.

Our Values-Based Wealth Planning team is well-versed in these complexities and would be happy to discuss your personal situation with you and your advisors. ■

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