

The K-Shaped A.I. Revolution

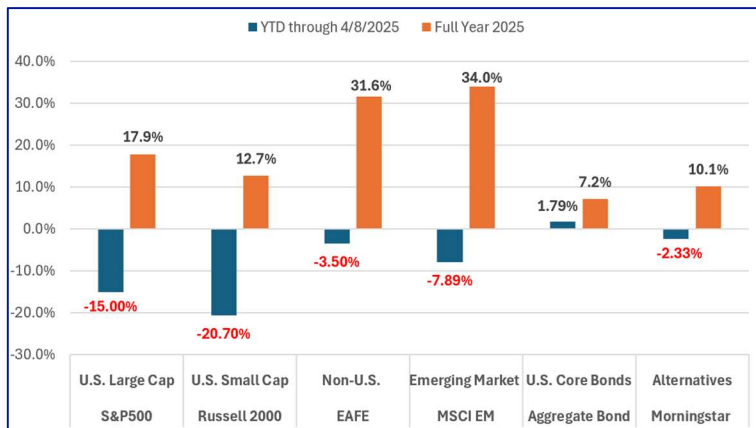


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Investors are walking tall after a rewarding 2025. But it **wasn't easy**. Recent all-time highs and nine months' passing can help us forget the mini-crash last Spring when stocks dropped 10% in two days. The chart below shows the strong returns from major categories for the calendar year (orange bars) and where they stood year-to-date on April 8 (the blue bars) – which was the bottom of a nasty correction triggered by shockingly high tariff proposals.

U.S. Large Cap stocks, at one point down 15.0% for the year (and down 18.9% from their January high), rallied to finish the year up 17.9%. Small Caps rebounded from a 20% decline to gain almost 13% for the year. U.S. stocks were not the biggest stock market story of the year as **non-U.S. stocks drubbed their U.S. peers**, advancing over 31%. Grabbing the first-place trophy, Emerging Market stocks, despite the tariff and trade war winds, leaped 34%.



During the market decline, Bonds did what we hope they do, posting positive returns. For the year, with interest rates declining somewhat, and a resilient economy rewarding investors in corporate debt, **Core Bonds gained 7.2%**, their best return in several years.

A diversified portfolio of Alternative Investments provided a consistent source of returns, finishing the year around

+10%. Sub-sector returns were varied, however. Private Credit held strong, with many funds posting high single digit or even low double-digit returns. Trend Following Strategies struggled with the speed of market moves in the first half of the year but rode strong trends in commodities, currencies, stocks and bonds in the later half. Private Equity overall was somewhat muted, while Venture Capital had some big winners in an otherwise broadly calm year.

We can't talk about 2025 without mentioning another headline grabber - Gold – both the real, shiny Gold - and the new, modern Gold. The price of **Gold rose 65%** in 2025 – it's strongest annual return since The Knack's "My Sharona" topped the charts in 1979. (*Ma, ma, myyy Sharona.*) On the other hand, Bitcoin, often referred to as "digital gold", suffered a nasty correction (over 30%) in the fourth quarter and declined 7% for the year. We remain open minded to Bitcoin, but we think it continues to belie the assertion by its backers that it is a "store of value" or a safe alternative to fiat currencies.

Looking beyond investment performance, 2025 will be defined by a few letters – The **"K" shaped nature of the economy**, and the dawn of the **Artificial Intelligence (A.I.)** era. A 2025-themed Wordle puzzle might look like this:

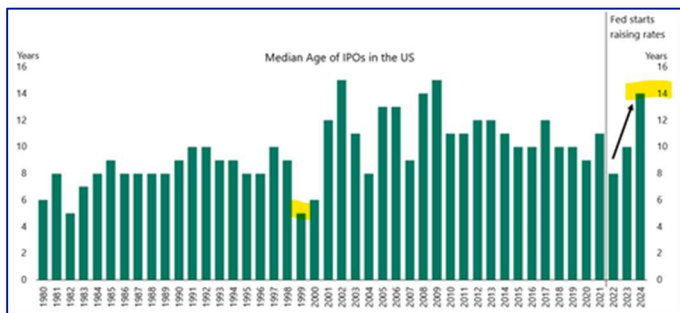


When the calendar flips, we think it's productive for investors to reflect on what they learned each year. Often, it's something new, other times we are just reminded of a lesson we already knew. 2025 was a banner year in that regard.

- Obviously, Politics was a story all year, especially the first 4-6 months with the Tariff Tantrum. Any investor

who worried too much about the policies coming out of Washington and got more conservative with their portfolio made a big mistake. Last year reminded us all to **leave politics out** of our investment process.

- 2025 was also a reminder that **change happens fast**. As our chart showed, markets flipped from down sharply to up sharply. Importantly, multi-year laggards like Bonds and Non-U.S. stocks posted their strongest relative returns in years. Nobody we know predicted the large performance gap between Gold and Bitcoin.
- **Nothing lasts forever**. Taking a little longer viewpoint, the story in Real Estate warrants a quick word. Outside of single-family homes in '07-'09, Real Estate was close to a can't lose, stable, core investment for over 35 years. Of the ten major sectors in the stock market, Real Estate had the worst returns in 2025 and is in last place over the past five years. Quite a fall.
- Finally, attentive investors begin 2026 with a newfound appreciation for the **importance of investing in Private Markets** and not limiting themselves to public equities. As this chart (from Apollo) shows, whereas the median age of companies that IPO'd in 1999 was only 8 years, in 2025, the median age of IPO companies was 14 years. Today, companies are staying private much longer and growing much larger prior to going public. There are now many private companies with valuations over \$100 Billion. Many of today's most promising Tech companies, including the company behind ChatGPT, are private.



While these are all important points, we think that **the big takeaways from 2025 are two timeless and fundamental classics** of investing. The first is best explained by the famous Yogi Berra quote:

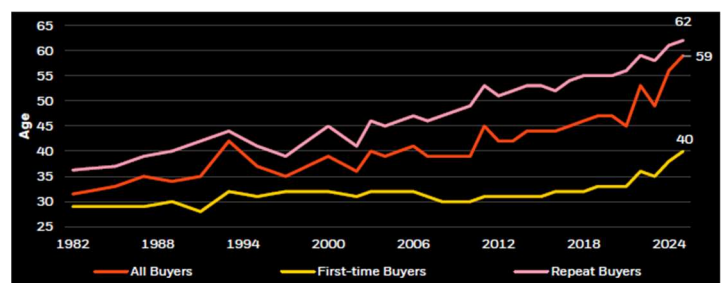
"It's tough to make predictions, especially about the future."

And secondly, after years of investment returns being dominated by a few large cap U.S. Tech stocks, we're reminded that **diversification still works**. In light of the speed and magnitude of the numerous investment

surprises last year, we're also reminded that market timing is extremely difficult to do successfully and consistently, so it's important to be diversified before big market moves.

Overall, the Economy ended '25 and begins '26 from a position of apparent strength. The last data available showed the U.S. economy growing at a 4.3% annualized after-inflation rate. The economy may be in a spot where it is not too strong to worry inflation hawks, but strong enough to allay concerns of a slowdown or recession. But summary and headline statistics don't paint the full picture – the **"K" shaped nature of the economy** means that it's almost as if there are "two" American economies with some participants doing great and others suffering.

The "K" metaphor describes how one segment of Americans is enjoying a nice upward sloping economic experience, while the other is not just losing ground, but losing hope as well. The main pain (or pleasure) depends largely on whether or not you own a lot of assets. Americans with generous stock portfolios and houses, are flush. Heck, even conservative investors with "cash in the bank" have benefited from higher interest rates on their savings. On the other hand, many younger Americans can't afford housing, are hurt by higher interest rates, and have not participated in the stock and housing market gains of the last 5-10-15 years. Regarding housing, consider this chart (from Blackrock), and the yellow line showing how **the median age of first-time home buyers** has risen from ~29 years old in 1982 to 40 years old today.



While the "K" nature of the economy is largely linked to the wealth effect (those with appreciating assets doing better than those without), it's also linked to the job market. One of the most obvious data points - recent college grads are having a tough time finding jobs – the **unemployment rate for recent college grads is 8.8%**, a level only seen twice since 2000: during the Global Financial Crisis and Covid.

A key factor potentially driving the jobs market may be the increasing importance of A.I. Even though it's been around for years, it seems that 2025 may go down in history as the year that A.I. was truly born – in lay terms...more people

stopped “Googling it” and started “Asking ChatGPT”. But A.I. is much more than ChatGPT and is being utilized more and more by businesses. Talks of AI-related **job cuts or hiring freezes have become common headlines** lately. Here are some key headlines from the front lines:

- Walmart employs 2.1 million workers. They plan to freeze headcount for several years.
- Verizon is cutting over 13,000 jobs.
- Amazon is cutting 14,000 jobs.

Between the growing use of A.I. and the growth in robotics, even those with jobs are feeling the pressure, more so on the lower end of the wage spectrum. This chart shows wage growth for the four different quartiles of earners. While the “service economy” boomed, the bottom quartile of earners (the tan/yellow line) enjoyed the strongest wage gains for many years leading up to and including during the pandemic. Recently, their wage gains have crashed and are trailing significantly behind the rest of the income spectrum. With asset prices up and with inflation and higher interest rates hurting this group more than others, the top and bottom of the “K” grows wider apart.



As we look to the next few months, the **Federal Reserve will be a big story in 2026**, as the current Chair, Jerome Powell, will be replaced this Spring. The President wants a Fed Chair who will lower rates more than Mr. Powell and his colleagues have been willing to do so far. While lower rates should help the lower income households on the wrong part of the “K” and could also loosen up the housing market, financial markets could get spooked if the President installs a pushover who will lower rates too much that it leads to a surge in inflation. An inflation spike, or even just the fear of one, could lead to higher bond interest rates and sharply lower stock and bond prices.

Even in the face of this uncertainty, nearly every research source we trust predicts that short-term rates will decline about 0.50% this year, and a little more (0.25%) next year. Barring a recession or sharp economic slowdown, it’s hard to see short-term rates falling below 3.0% and bond yields under 3.75% - 4.0%. After what’s felt like decades of “extreme” rates – either too high or too low – a return to more “normal” levels like this would be a welcome change.

While we think the “K” and the “A.I.” themes from 2025 are destined to continue in 2026, we also expect there to be big differences between 2025 and 2026. For one, even though it is a mid-term election year, a lot of **political and policy uncertainty will be lower**. Considering how violently disruptive the tariff announcements were in the first third of last year, that’s not a wild prediction - This year simply must be quieter on tariffs. (Except that the Supreme Court has yet to rule on the legality of the Administration’s tariffs.) Elsewhere, tax policies are much more certain. The passage of the OBBBA last summer assured that, and it will also help stimulate the economy in the first half via an estimated **\$60 Billion of tax refunds** this Spring.

Perhaps the biggest change for 2026 that we can look forward to with a high degree of confidence is that we **expect the A.I. story to broaden out**. The next leg to the Technology theme is less likely to be about Technology companies, and more about which companies will leverage A.I. and Robotics to improve their competitiveness and profitability. To wit, here’s a sampling of Goldman Sach’s 2026 A.I. “Focus List” of companies that could benefit from increased efficiency and more productivity:

- **Financial Services** – JP Morgan, Bank of New York
- **Retail** – Amazon, Walmart, Target, Home Depot
- **Transportation** – UPS, FedEx
- **Restaurants** – Chipotle, Starbucks, Wendy’s

It’s not just these name brands of large companies that may benefit. Smaller companies can as well. And it’s reasonable to expect that Private Equity investors will leverage A.I. to improve the operations of the companies they control in their portfolios. Overall, the A.I. opportunity may be so large that it’s hard to grasp. Blackrock calculated that 55% of the costs in U.S. corporations is spent on labor (salaries). If business can reduce the cost of labor by just 9%, earnings would jump 31%. If that were to happen, they estimate the total value of A.I. related efficiencies at **\$110 Trillion Dollars**, most of which would be realized by the companies themselves and a smaller portion by the A.I. Technology providers. This won’t happen overnight though; when it comes to A.I., we’re reminded of another quote, this from Bill Gates:

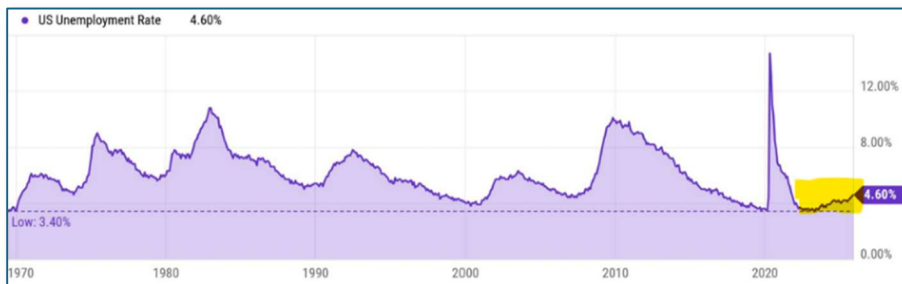
We overestimate the change that will occur the next two years and underestimate the change that will occur the next ten.

In addition to the Federal Reserve, many forecast that **other Central Banks are more likely to lower rates** than raise. This would be a positive development and further supports a reasonably optimistic outlook. And “look out

above” if inflation surprises to the downside and the Fed can lower rates more than the market expects (which we think is unlikely but at least possible). The stock and bond markets could rally very strongly in 2026 if that happens.

So, there are a lot of factors to feel good about as we start 2026. But as usual, there are also many risks worth cataloguing and being mindful of.

- According to Bloomberg, nearly every analyst on Wall Street is bullish for 2026. **Positioning is crowded.** It won't take much – an earning miss from NVIDIA or Microsoft, or a surprise policy error by the Fed or the White House, could trigger a quick and severe sell off in U.S. stocks.
- We are **concerned about the employment situation.** While the tension between the business and labor market has produced a kind of “No hiring and no firing” equilibrium, the unemployment rate is rising.



This chart of the unemployment rate going back to the 1970's shows that, compared to previous cycles when the rate quickly spiked sharply higher, unemployment today is **rising at an unusually gradual rate**. Is this time different? So far, it appears so. Will it continue? That's the question. The advent of A.I. and Robotics, and the increasing cost of healthcare insurance, has every business leader asking the age-old question – *Do I really need to pay a human to do this?* Some forecast unemployment reaching **6%** later this year as firms "harvest" A.I. productivity gains through "workforce

optimization". It's hard to see unemployment that high without a recession, which would be bad for stocks.

- **Valuations**, especially in Large Cap U.S. stocks like the S&P 500, are clearly high - there's simply no "margin for error" when stocks are priced to perfection.

So, while we start the year with valid concerns, we find ourselves embracing our default condition – **cautious optimism**. On balance, the positive tailwinds this year (lower interest rates, broader A.I. adoption, economic resilience, robust profit margins) seem much more predictable while the potential negative catalysts are simply "possible" or theoretical. While uncomfortable, innovation and change are constant - the economy and markets have endured dislocations before. We think attractive yields in the bond market, continued opportunities in Alternative Investments, and perhaps most importantly – the broadening out of stock market performance beyond the largest and most well-known U.S.

companies – is a **great environment for investors**. But we're not expecting a perfectly smooth ride. With the current consensus so overwhelmingly in agreement, leverage increasing the fragility of markets, and with U.S. Large Cap stock market valuations so elevated, we're likely to experience some short-term volatility this year, especially compared to the smooth rally the last 8 months.

K A I Z E N

Don't beat yourself up if you didn't get the Wordle puzzle at the beginning. For one, its six letters (longer than the standard five) and secondly, it's a Japanese term, not exactly common English. Kaizen is a business philosophy focused on **continuous improvement**. To us, this applies to both the A.I. forces driving today's economy, and if we're right, intelligently constructed and carefully diversified investor portfolios in 2026 as well.

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