



CG INSIGHTS

# Quarterly perspectives from the CG team

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cgam



## CONTENTS

**Macro outlook: In the long run we are all bankrupt**

P.03

**Bond Markets: The race for global capital**

P.05

**Credit Markets: Artificial diversification**

P.07

**Equity update: The soft underbelly of the US equity market**

P.09

**Recent changes to multi-asset portfolio positioning**

P.11

**Asset valuations and investor behaviour summary**

P.12

# In the long run we are all bankrupt

At heart, Keynesian economics is very simple: the government should spend more to make up shortfalls in aggregate demand (for instance, in times of recession) and spend less when times are good. Politicians have been very good at doing the former and very bad at doing the latter.

This is particularly notable today in the US where business investment is very high, thanks to the AI investment boom, and where the personal savings rate is low.

This gives us plenty to worry about. First, should any of those three branches of society – government, business and households – choose or be forced to reduce their spending, it is not obvious that the rest of society can take up the slack. This leaves the economy vulnerable to a downturn.

Secondly, as we write in our section on global bond markets, this huge imbalance between desired savings and desired investment is driving up borrowing costs around the world. Combined with high government deficits, it is giving rise to concerns over the solvency of governments. Bond markets are jittery everywhere and, just now, are particularly concerned about France.

Thirdly, the nature of government investment is troubling. In fact, most spending isn't investment at all. Government spending is increasingly made up of fiscal transfers from young to old and rich to poor. The proportion spent on true investment has been falling. Investment raises the trend growth rate of the economy. Deficit-financed spending does the opposite. We won't rehearse the arguments here, but the main reasons are fiscal dominance and an increasing fiscal burden from debt interest expense.

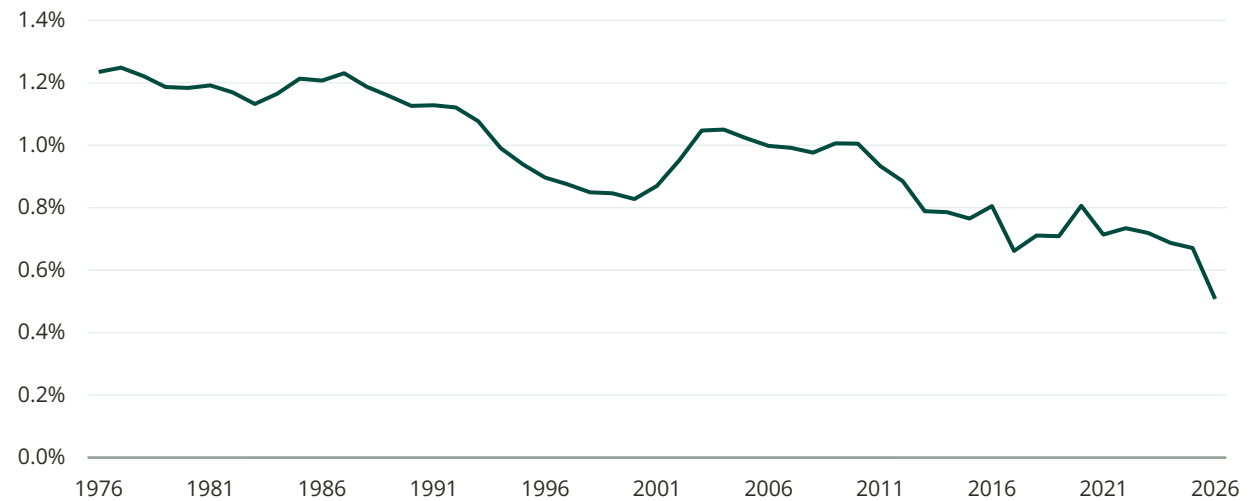
Finally, corporate investment needs to find its “goldilocks” level. Too cold and the productive capacity of the economy doesn't grow and growth stagnates. Too hot and capital is misallocated, will not produce reasonable returns and result in losses on credit and equity investors. It is impossible to be certain, but we are pretty confident that the AI boom falls in the latter camp.<sup>1</sup>

If we are right, and the AI boom proves unsustainable, a downturn in corporate spending would likely be accompanied by a fall in equity markets – given that a large proportion of equity earnings derive directly or indirectly from AI – which in turn would probably cause the savings rate to rise dramatically and lead to an economic downturn. From its starting position of a 6% budget deficit, we don't think the government can come to the economy's rescue.

<sup>1</sup> For a detailed description of our views please see: <https://wp-cgam-2025.s3.eu-west-2.amazonaws.com/media/2026/10/AI-Capex-Chris-Clothier.pdf>



## US Federal Investment as % of GDP



Source: American Association for the Advancement of Science

### Our Investment Judgement

1. Investors must prepare for a stagflationary world of low growth and high inflation
2. With all sections of society spending freely, any economic slowdown is likely to be more severe due to the lack of buffers
3. If a slowdown arises because the AI boom proves unsustainable it is likely to cause a sharp recession

# The race for global capital

The continued rise in real interest rates has reignited the debate around valuations in global bond markets. For some time, real interest rates had been very low. The reason, penned by Ben Bernanke in 2005, was a “global savings glut” – that is to say, an oversupply of savings and a lack of investment opportunities. This had an array of negative consequences: ample savings drove interest rates lower, and low interest rates created a low hurdle rate for investment, resulting in the misallocation of capital to sectors and projects with low productivity. These trends reinforced the low growth tendencies of the time.

This era has recently drawn to a close. At Jackson Hole, Kevin Warsh declared that the global savings glut had given way to a global investment surge. The dominant feature of capital markets is now not excess savings but

rather the rapidly increasing demand for loanable funds. This demand is visible across all three main sectors: governments are running persistent deficits; household savings ratios are very low; and the AI capex boom is rapidly increasing US corporates’ demand for borrowing.

This increased competition for capital is putting pressure on interest rates. Understandably, this has reignited the debate around the sustainability of the major economies’ fiscal policies in a higher-for-longer rates era. To the extent that – over time – higher interest rates are a symptom of higher trend growth rates, perhaps driven by AI productivity enhancements – then these higher rates are not detrimental.

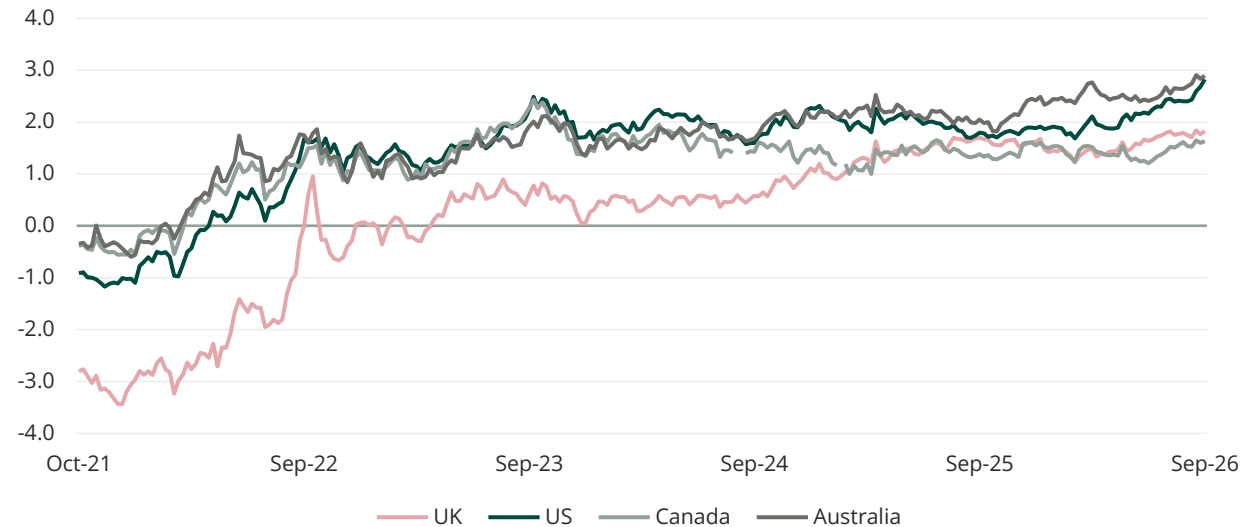
However, there are two foreseeable issues: first, even if AI does increase productivity, interest rates are being driven up by other factors as well – for example, by energy-driven inflation expectations and fiscal deficits. The second is that while AI investment is having a material impact on US economic performance, there is little evidence of a measurable impact elsewhere.

All of this adds to our sense of concern for the outlook for global interest rates. While higher yields on global bonds clearly improves their relative value, the increasing stock of debt foreseeably pushes up on long-term interest rates. Accordingly, we continue to favour short duration across all fixed income in our portfolios.

## Real interest rates are rising globally (10-year yield, %)

Note: Chart shows 10-year real yields on inflation-linked government bonds over the past five years.

Source: Bloomberg Finance LP



## Our Investment Judgement

1. The continued rise in global real rates increases their relative attractiveness against equities. Long-term yields on TIPS and index-linked gilts exceed the CAPE yield on the S&P 500. Accordingly, we continue to favour inflation-linked bonds as an asset class, and remain highly underweight risk assets.
2. We expect that the ongoing competition for borrowing will continue to drive up interest rates. We expect this to put pressure particularly on the long end of government yield curves, where supply concerns are exacerbated by elevated inflation expectations. Consequently, we maintain short duration in our inflation-linked (c. 5 years) and corporate (c. 3 years) bond portfolios.
3. To the extent that AI-driven capex delivers economic growth enhancements, we expect the US to see the largest benefit from this. As a consequence, our inflation-linked bond allocation is tilted towards TIPS (c. 28%), and USD remains our largest non-sterling currency exposure.

# Artificial Diversification

## *The rising concentration of AI exposure in passive credit markets*

In February, Alphabet issued sterling paper maturing in 100 years. A century is a long time for a sector undergoing rapid technological change, yet the transaction highlights two things i) how far into the future investors are willing to finance today's ambitions, and ii) how **exposure to the AI bet is spreading from equity to credit markets**.

J.P. Morgan estimates \$5.5tn of AI capex expenditure predominantly from hyperscalers by 2030, of which **only** 18% is expected to be met by organic cash flows. In response, hyperscalers are set to issue more debt this year than in the last five years combined. **Approximately \$2.1tn of this funding gap is expected to be absorbed by the corporate bond market over the next 4.5 years**, with the balance predominantly funded through off-

balance sheet alternative financing. **The scale, currency mix and pace of issuance is reshaping global credit markets**, increasing borrowing costs for these companies and forcing others to plan their financing needs around the sector. This has been felt most acutely by longer duration borrowers where issuance has been concentrated.

Substantial as these obligations are, we do not believe they imperil the businesses that stand behind them, nor is there clear evidence that this issuance has contributed to the sell-off in government bonds, but the risk is that they *are* swimming in the same savings pool and it is not getting any deeper. **Defaults are not required for bondholders to suffer material capital losses, particularly at longer maturities should credit spreads widen.**

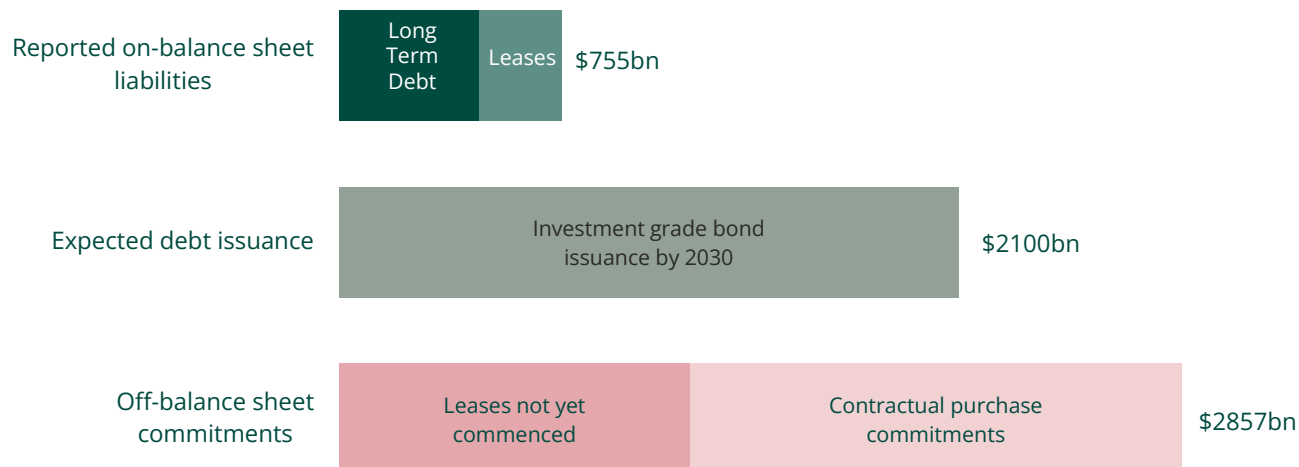
More concerning to us is the rapidly rising off-balance liabilities. In the case of Alphabet, it has added ~\$493bn of contractual commitments in the last quarter alone. We estimate from company filings that there are a further ~\$2.9tn of off-balance sheet liabilities contractually committed by hyperscalers.

**AI-linked debt could ultimately rise from 6.3% to 20% of the US investment grade index by 2030.** As these commitments put pressure on the reportedly pristine balance sheets of hyperscalers, investors seeking diversification through passive corporate bonds indices will find there are **few places to hide** from the risks of rising concentration or disappointing returns in the capex war for market dominance.

**Chart takeaway:** Contractual liabilities and debt will rise rapidly for Amazon, Alphabet Meta, Microsoft, Oracle and Nvidia

Source: CGAM Analysis, Company Accounts, KKR, J.P. Morgan

## Hyperscaler contractual commitments by 2030 (\$bn)



## Our Investment Judgement

1. Growing exposure to the same investment cycle is spreading into credit markets, reducing the diversification investors might expect from an allocation to the index. Our credit exposure avoids this trend with an overweight to transport, utilities and other asset backed sectors.
2. We favour short-duration investment-grade bonds. Our longer-dated exposure requires stronger justification through valuation, inflation protection or early repayment of principal.

# The Soft Underbelly of the US Equity Market

Foreign capital is pouring into US equities. Overseas investors bought a record \$942 billion of US equities and investment funds in the twelve months to July, the **highest since records began in 1985**, and foreign ownership of the US equity market has risen from 5.6% in 1994 to around 18% today. A clear display of American exceptionalism.

However, as fiscal uncertainty and economic nationalism draws capital closer to home, the **reliance on the foreign buying of US equities is a potential source of fragility**.

Japan, the largest foreign holder of US assets, is an example of how this might materialise. Decades of negligible and, at times, negative, domestic interest rates encouraged Japanese savings abroad. Much ink has been spilt on the

concerns about Japanese investors leaving the treasury market on the back of changing monetary conditions (with the Bank of Japan policy rate at 1.25%) and 10-year JGB yields >3%. Yet, it is their role in the equity market that is often overlooked. **Japanese investors own roughly \$1.4 trillion of US equities**. The value of these holdings is \$400bn *more* than they hold in the treasury market.

The government is placing increasing pressure on domestic investors to allocate more to Japan. Corporate reform remains a priority, with capital returns in the equity market at record highs. On top of this, in July, Prime Minister Takaichi and Finance Minister Katayama addressed parliament and stated that the government intends to implement measures encouraging the GPIF and local households to **substantially**

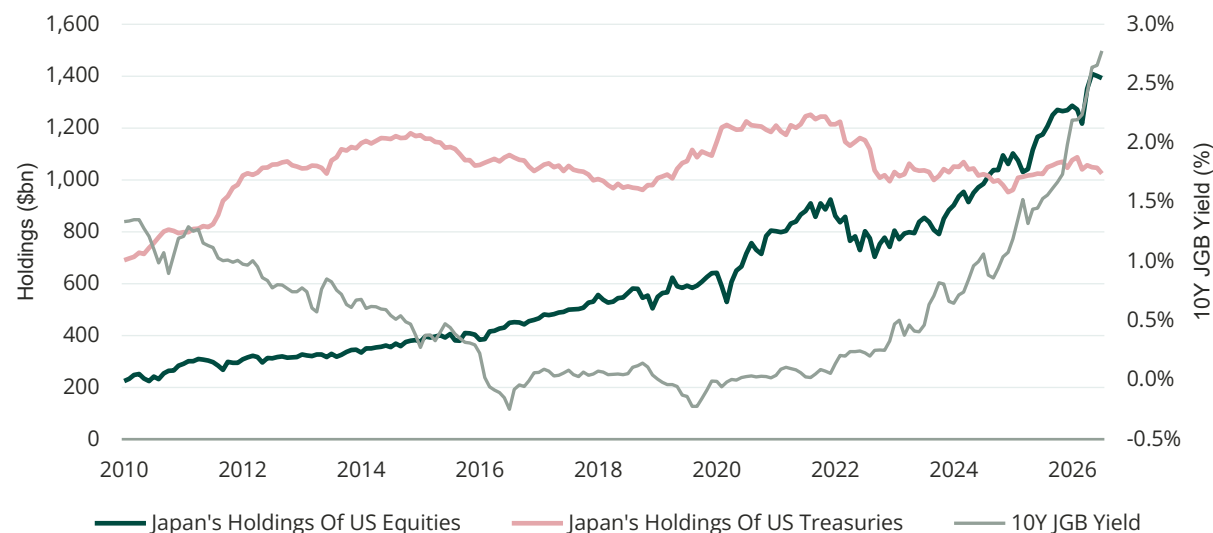
increase their holdings of Japanese financial assets. Hence, the next marginal dollar of Japanese capital is becoming increasingly contested.

There does not have to be a dramatic repatriation of Japanese savings for the consequences to be tangible for the US equity market. In a world of higher interest rates, greater fiscal demands and growing pressure for domestic investment, a change in marginal allocation would weaken the foreign bid on which expensive US equity markets have increasingly depended. **The risk is not so much that foreign investors sell America, but that they simply stop buying quite so much of it.**

## Japan's ownership of US equities has increased dramatic whilst domestic yields have started to normalise

Note: Chart shows Japanese holdings in the US equity and treasury market (LHS) alongside the 10-year JGB yield (RHS).

Source: Bloomberg Finance LP, Federal Reserve Bank of New York, US Department of the Treasury



## Our Investment Judgement

1. US equities are increasingly reliant on foreign buying, with record inflows and foreign ownership now around 18% of the market. Foreign investors tend to be *less sticky* and leaves the market at risk should opportunities arise (or are mandated to allocate) closer to home.
2. Government pressure on the institutions and households to increase holdings of domestic financial assets, alongside ongoing corporate reform and record capital returns, supports Japanese equities while contesting the next marginal yen that would have flowed into US assets. We maintain our overweight to Japan and underweight to the US.
3. With CAPE at levels only previously seen in the dotcom bubble, and multiple areas of concern including AI capex spending, the potential unwind of the carry trade and fiscal uncertainty, we remain cautious on equities. We therefore equities only constitute 14% of the portfolio.

## WHAT'S CHANGED

# Recent Changes to Multi-Asset Portfolio Positioning



### PORTFOLIO CATEGORY

#### **MANAGED LIQUIDITY RESERVE (29%)**

### ASSET CLASSES

Cash, Treasury Bills & Short Duration Government Bonds  
Short investment grade credit  
Preference shares

### CHANGES IN PORTFOLIO POSITIONING

- The managed liquidity reserve has remained the same weight over the quarter
- Corporate bonds increased from 10% to 12% as we continued to allocate to very short, investment grade bonds, shortening the duration in this part of the portfolio

### PORTFOLIO CATEGORY

#### **↑ INDEX LINKED BONDS (49%)**

### ASSET CLASSES

Sovereign inflation linked bonds  
UK, US and other developed markets

### CHANGES IN PORTFOLIO POSITIONING

- Allocation to index linked bonds has increased by 1% over the period
- UK index linked gilts increased to 21% of the portfolio we favour the the belly of the yield curve, with a duration of 4.7 years
- US index linked bonds have remained at 28% of the portfolio and the duration of the TIPS portfolio remained short at 4.4 years
- We have kept duration short given continuing concerns about deteriorating fundamentals

### PORTFOLIO CATEGORY

#### **↓ RISK ASSETS (22%)**

### ASSET CLASSES

Investment Trusts  
ETFs  
Non-investment grade credit  
Gold

### CHANGES IN PORTFOLIO POSITIONING

- Risk assets were reduced over the quarter by 1% with realisations from significant holdings from the alternatives such as Sequia Economic Infrastructure and BH Macro following discount contraction
- Conventional equities remained at 14%

Data refers to Capital Gearing Trust

## MANAGER UPDATE

# Asset Valuations and Investor Behavior Summary

| PORTFOLIO CATEGORY         | UK            | US           | JAPAN        | EUROPE       | CG VIEW                                                                                                                                                                                          |
|----------------------------|---------------|--------------|--------------|--------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| INVESTMENT TRUST DISCOUNTS | ATTRACTIVE    |              |              |              | The year has seen Increasing corporate activity for both conventional and alternative trusts which provide a favourable backdrop for our strategy                                                |
| EQUITY MARKETS             | FAIR          | UNATTRACTIVE | FAIR         | FAIR         | CAPE: UK (21), US (40), Japan (28), Europe (27)<br>US equity markets valuations remain at extreme levels                                                                                         |
| SHORT GOVERNMENT BONDS     | ATTRACTIVE    | FAIR         | UNATTRACTIVE | UNATTRACTIVE | Short duration UK government bonds are attractive, as are currently pricing interest rate expectations which in our view are not deliverable                                                     |
| INDEX LINKED BONDS         | ATTRACTIVE    | ATTRACTIVE   | UNATTRACTIVE | UNATTRACTIVE | Although deteriorating fundamentals give us concern about the long-end of the yield curve, short dated US and UK index-linked bonds remain attractive                                            |
| CURRENCY                   | BASE CURRENCY | FAIR         | FAIR         | UNATTRACTIVE | The Euro faces headwinds from trade competitiveness against both China and Japan. With the path for the Yen looks unclear after recent market intervention.                                      |
| CREDIT                     | FAIR          | UNATTRACTIVE |              |              | Credit spreads remain historically narrow, however, there are selective opportunities in very short Investment Grade credit                                                                      |
| INVESTOR BEHAVIOUR         | FAIR          | UNATTRACTIVE | ATTRACTIVE   | FAIR         | US valuations remain near record highs, despite geopolitical uncertainty, rising deficits and a deteriorating economic outlook. In Japan, we remain constructive on the ongoing corporate reform |

Source: Bloomberg LLP Finance



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