Diversify away from the obvious

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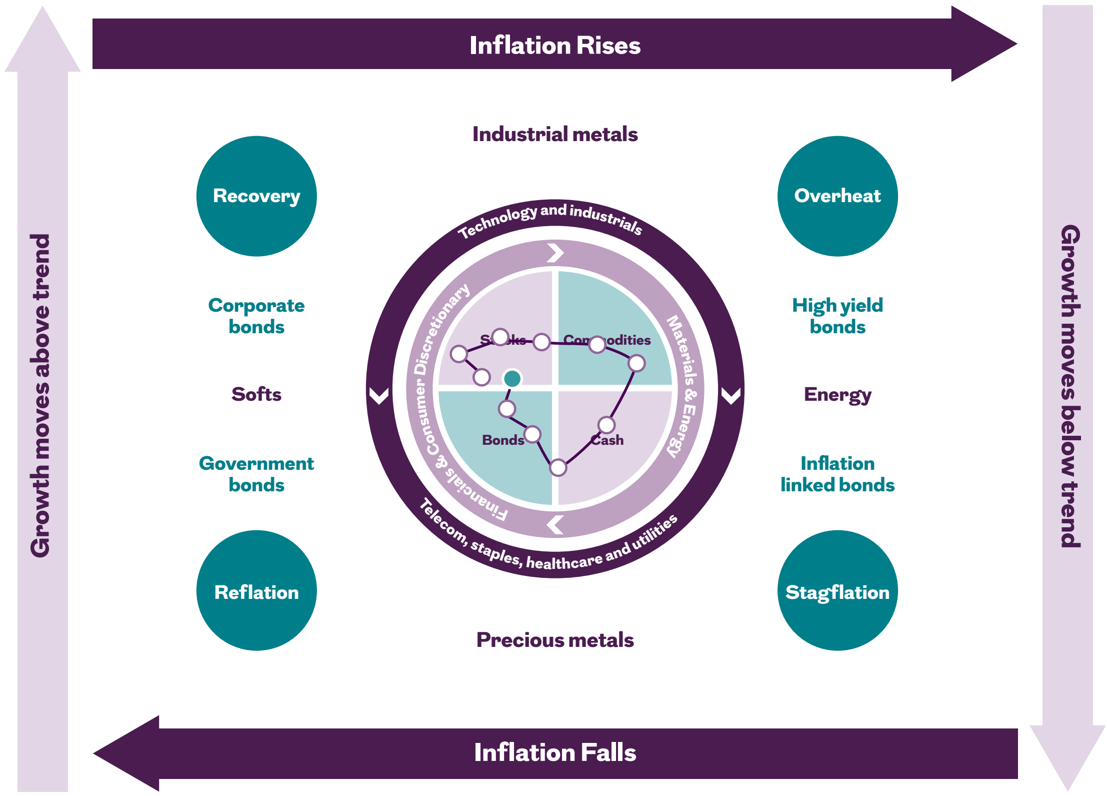
Diversify away from the obvious hot spots to seek value and improve portfolio resilience

The world economy is enjoying moderate, if patchy, growth with relatively low inflation when compared to recent years. This is the Recovery phase of the Investment Clock that has historically seen the best stock market returns (see Chart 1 overleaf). America's trade wars and sudden policy swings grab the attention, but in the background central banks have been steadily cutting interest rates and this bodes well for growth in 2026. Governments are heavily indebted, but the corporate sector is in good health with technology-related earnings particularly strong.

Stretched valuations on Wall Street and in parts of the global credit market raise the risk of disappointment should things turn out differently. We're tactically positive on global equities, including the US technology sector, but our broadly diversified and active approach to asset allocation balances exposure to the obvious hot spots with value plays in government bond markets, UK real assets and commodities.

Business cycle indicators have been moving rapidly in recent months. It's not beyond the realms of possibility that growth and inflation both end up stronger than expected in 2026. This would move the Clock into commodity-friendly Overheat. A shift from monetary easing to monetary tightening would strengthen the parallel with the later stages of the dotcom bubble of the late 1990s.

Chart 1: Investment Clock is in Recovery, but moving fast



Source: Royal London Asset Management. As at November 2025. For illustrative purposes only. Trail shows monthly readings based on global growth and inflation indicators.

Lessons from the past

History never repeats itself, but sometimes it sure does rhyme. Technology companies are once again engaged in an arms race to become the biggest and best with investors cheering them on. Traditionally cash-generative businesses are suddenly having to raise capital to fund eye-watering investments in artificial intelligence infrastructure. Wall Street is willing to provide cheap finance via generous stock market valuations and opaque private debt structures. We saw the same in the late 1990s, though the telecommunications and media sectors offer a better comparator for today's technology giants than the frothy internet start-ups, most of which had never turned a profit.

Is this a boom or a bubble? History suggests probably a bit of both. Artificial intelligence is undoubtedly a game changer. But as a comparison, few could dispute the transformative impact of the internet on business over the last quarter century and yet equity investors lost half their money in the three-year bear market after the bubble burst. Losses in the technology, media and telecommunication sectors were larger. For now, we remain tactically positive on US equities and technology, but with US stock valuations at their highest level since 1999/2000 and credit spreads tight, we think it makes sense to diversify more broadly, and we've further reduced our strategic exposure to US equities.

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Looking at the bigger picture

Outside of technology, the world economy faces some serious challenges. Country-specific risk under the second Trump presidency has risen significantly, posing a challenge to the dollar. War continues to rage on Europe's eastern flank. Government debt levels are high the world over. The surge in the price of gold suggests investor disquiet isn't far below the surface. This all speaks to diversification to reduce risk.

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Diversification in practice

We believe that value and resilience can be improved by adding government bonds, UK real assets and commodities to a global portfolio. In late 2021, 10-year gilts were yielding 0%, with index linked gilts offering a real yield of minus 2%. We were paying to lend money to governments with the risk of capital losses if and when yields normalised. The 2022 bond market crash was a major reset. Now real yields are closer to plus 2%. This makes life harder for finance ministers, but government bonds are paying their way once more and could provide portfolio resilience in a deflationary shock.

UK equities remain good value, with cycle-adjusted valuations around half the level of the US market. The FTSE's low exposure to growth sectors could make it resilient in a tech shake out. Indeed, the UK was one of the best performing major stock markets in 2022.

Real assets also have a place. Commercial property has recovered from the interest rate shock of 2022 and the asset class offers a decent yield with steady total returns. UK property was hit hard in the financial crisis of 2008 but it's worth remembering that it sailed through the dotcom crash, posting good returns in each year of the bear market.

Lastly, we continue to allocate to commodities, including gold, as a hedge against unexpected inflation and geopolitical risk. One thing you can say for sure about AI is that it's resource hungry.

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