

Who's afraid of the blue wave?

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The recent US midterm elections ended with a clear Democratic majority, bringing geopolitics, energy prices, and the conditions for AI investment into sharper focus. Tensions in the Middle East could increase again in the near term. At the same time, the AI buildout is likely to enter a longer cycle, but with continued double-digit growth in data center capacity and more attractive valuations. Against this backdrop, we see the current market phase as a reset and recommend viewing the correction as an opportunity to diversify portfolios across asset classes. In our view, the longer-term case for equities is much stronger for broader diversification than for a higher cash allocation.

The US midterm elections have significantly reshaped the political landscape. The Democrats have recorded their strongest nationwide gain in votes since the 1970s and now control the House of Representatives and the Senate. Blue is the Democrats' color, and the clear result can be described as a blue wave. Many election observers also see the result as a rebuke to President Trump from the American electorate. Higher living costs, in particular, appear to have strongly influenced the vote.

With the elections now over and markets having reacted strongly, it is worth looking ahead. As I wrote a few weeks ago, the elections are unlikely to cause lasting disruption to the solid US economy. But adjustments are possible in some areas.

The first issue, and probably the most urgent, is the geopolitical situation in the Middle East. Near-term escalation risks appear elevated ahead of early January 2027, when the new congressional majority could potentially restrict the president's room for maneuver. Energy prices could therefore fluctuate more sharply in the coming weeks, with negative consequences for equity markets and economic activity. In Europe in particular, it is important to note that gas reserves are very low and winter is approaching. Higher prices or even supply disruptions could threaten the cyclical recovery, especially as elevated inflation continues to severely limit the European Central Bank's room for maneuver.

However, it is equally possible that President Trump will continue to rely on blockades of Iranian exports to try to force an agreement with Tehran. Over the medium term, appetite for a prolonged conflict is likely to be limited in both political

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camps. High living costs are an important issue for both Republican and Democratic voters, and both parties are likely to want to address it as quickly as possible.

Markets are even more focused on the outlook for the continued expansion of artificial intelligence (AI) infrastructure. They fear that stricter rules under a Democratic majority, along with tighter requirements for data centers, AI applications, and AI models, will slow the infrastructure buildout. This is particularly significant because expectations for AI investment had already cooled before the elections. Concerns about insufficient monetization, rising competition, and the potential cannibalization of existing businesses have weighed on markets for weeks. Given these headwinds, we think it is realistic to expect the investment trajectory to flatten. But that does not mean the buildout will collapse. Our base case is a longer, more drawn-out cycle.

Even with additional hurdles, we continue to expect double-digit growth in global data center capacity over the coming years. With valuation multiples in this sector significantly lower, the recent correction is likely to create opportunities, particularly in companies with robust, established business models that both drive the infrastructure buildout and can benefit directly from it. For investors who have so far invested little in AI, the current correction is likely to represent a buying opportunity, in our view.

Europe is also worth considering in this context. Since European companies contribute relatively little to the AI buildout, the market outlook depends heavily on how quickly companies can use AI productively. According to estimates from US investment bank Morgan Stanley, around one-third of European companies now report a tangible return on their AI investments. This is a significant increase from around one-fifth last year.

Banks, technology hardware manufacturers, and diversified financial companies stand out positively in this context. Among the leading adopters in these industries, expected earnings per share rose 15% over the past 12 months. This increase is around 4pps above that of their respective sectors, ultimately a clear indication that AI investments can pay off and that selectively diversifying into European equities could be worthwhile.

Finally, bond markets have reacted positively to the blue wave. The market expects greater fiscal discipline and believes that a slower but more stable AI buildout could reduce financing pressure. A lower risk of escalation in the Iran conflict could also lead to lower energy prices over the medium term. Both could ease pressure on bond markets and support a broader bond market recovery.

We think these hopes are realistic only to a limited extent. We are particularly skeptical about the case for greater fiscal discipline. Spending priorities may shift under the Democrats, but we do not think this necessarily means lower spending. Another debt ceiling debate also looms in the spring and could become heated given the new balance of power.

What does all this mean for investment strategy? We see the current market phase more as a reset than the end of the cycle. Markets have reassessed many risks in recent days, from AI euphoria and geopolitics to monetary and fiscal policy, while fundamentals still appear solid. Investors should therefore use the current correction to reposition their portfolios and improve diversification where needed.

We favor quality US stocks that benefit from the AI trend, European companies with demonstrable benefits from AI, and selected bonds that could benefit from a potential easing in energy prices and issuance volumes. Over the next two years, a well-diversified portfolio is also likely to contribute more to preserving and growing wealth than cash or liquid assets.

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