



TAKING STOCK: NEPC ASSET ALLOCATION ROUNDTABLE, THE 2025 EDITION

By NEPC Research

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Asset allocation is integral to the success of any investment portfolio, and it is among the most important decisions an investor will make. In this discussion, we pull back the curtain to offer you a behind-the-scenes glimpse of the issues and themes at the forefront of the meetings of the NEPC Asset Allocation Team.

THE PARTICIPANTS:

Jennifer Appel, CFA, Principal, Senior Investment Director

Robert Goldthorpe, ASA, Investment Director

Christopher Hudson, Senior Investment Associate

Phillip Nelson, CFA, Partner, Director of Asset Allocation

James Reichert, CFA, Partner, Senior Director of Portfolio Strategy

Michael Zampitella, CMT, Investment Director, OCIO

Aparajita Bubna, Managing Editor, facilitated this roundtable

What are your thoughts on the current economy?

Jennifer: We are in an environment where continued high spending is supporting growth, and markets have been looking at that favorably, even if sentiment is poor which most surveys and metrics suggest. It has been easy to anchor to the negatives, whether it's the government shutdown or tariffs or higher prices. However, the economy doesn't seem to be slowing down. Corporate earnings have been solid and then there's an easier monetary policy backdrop that can support spending and markets moving forward.

Phillip: I think an interesting point is that outside of AI, there are some recessionary conditions for the more traditional segments of the economy, for instance, the manufacturing and industrial sectors. But it seems there's a bit of an upswing, and there's a surprising number of healthy earnings and economic data points despite people feeling uncomfortable with the current state of affairs.

Michael: Sentiment has soured despite the fact that we're on firm footing. Many are focused on low job postings and low job turnover, but the data has been solid. I think there's still this wealth effect at play. And we've seen an economy that's able to stomach higher inflation and higher rates, and now we're getting some easing on monetary policy. So, all in all, even though you know there are concerns, the economy is strong.

Jennifer: There is definitely a different consumer story for lower-income households, and I think that

K-shape profile holds true for the economy as a whole, especially related to the traditional manufacturing or industrial sectors versus the new technology-related ones.

Phillip: It reinforces that the majority of consumer spending, which is the main driver of the U.S. economy, is increasingly concentrated in a smaller wealth cohort than 20 years ago. If real estate and stock markets are healthy, the wealth effect results in higher spending and that's largely what's keeping the economy on an upward trajectory.

James: Yes, that's been the case since the end of the COVID pandemic. The one thing I might caution us to look at is the balance of the economy that's in the part of the K that's pointed up versus the part of the K that's pointed down. The downward part of the K is increasingly struggling with higher costs of living. The upper portion of the K, while it's supporting the economy, is predicated on those folks having jobs; we haven't seen a dramatic change in employment, but more layoffs of higher-wage earners challenges their ability to continue consuming.

It's been a roller coaster of a year. In your opinion, what's been the biggest surprise so far in 2025 for markets?

Michael: A big surprise has been geopolitical events but also the lack of a lasting impact on markets. But oil in particular has been a surprise—it has been below \$65 for most of the year—and that caught me off guard in a year of many surprises.

Jennifer: Adding to that, I think the ability of the market to look past many of the surprises or climb that wall of worry has been surprising. Maybe it is the buy-the-dip mentality that we talk about, but I was thinking back to many moments, for instance, DeepSeek's announcement earlier this year on the capabilities of its cost-efficient artificial intelligence models. We had tariffs coming in far above expectations, significant uncertainty around policy, declines in the dollar...and the market's been able to look past it all.

Michael: On that point, Chinese equities, which are in the eye of the hurricane of tariffs have continued to climb higher as well.

Phillip: It's a case study for why we should be looking past the headlines, which we often try to do. The markets shrugging off tariffs, new policies, geopolitical conflicts brings us back to what's driving stock markets: tremendous growth of free cash flow coming out of a select number of names, and a secular backdrop of growth in artificial intelligence. At the end of the day, the market's saying that this is the most important piece out there. I don't think we want to be as flippant as to say that nothing else matters, but there's a component of the heavy AI spending that is enabling markets to almost ignore the other events that have popped up over the course of the year. The market dynamic is really fascinating right now. We can divide the year in two: the first three months, and then everything after the Trump administration's tariff announcements in early April, and just how quickly the market recovered.

James: The biggest surprise is the speed of the market's recovery and everybody's continued fear of missing the next big thing. And the next big thing might be really big...like AI. There is a strong case for it, and it will hopefully result in productivity gains. It just seems that the euphoria around it spurs a lot of investment and, maybe, over-exuberance that has helped fuel this rally with seemingly unending legs.

As we've gone through the year, you realize it's not just the hyperscalers...it's all the pieces that go into making a data center, it's all the energy companies, so you end up with many stories around this AI-themed productivity boom that will eventually come. Until there is some comeuppance in the market—maybe a widespread job loss—you're going to have a fair number of people who are afraid of missing out and will continue to support the market.

Phillip: The biggest surprise to me is just how sanguine everyone is...I've never seen a bull market that everyone hates on so much. It's hard to call anything a bubble when you are lacking real exuberance; there's pockets of it, but you still hear this fear out there of what's coming next, what's the next shoe to drop that is holding the market back from reaching fully frothy levels.

Speaking of the other shoe, what is the biggest threat to the U.S. economy?

James: We are on sound footing outside of an unexpected shock to our labor force that will impact people's ability to consume. Job losses are a threat to the U.S. economy, especially displacement of jobs caused by AI such that people cannot be retrained quickly enough to be re-hired.

Phillip: It is hard to see what would cause the economy to slow down. If anything, I fear the economy will start to overheat as we move into a cycle of rate cuts with the Fed and, given the tax and spending provisions, there will be fiscal stimulus flowing through the economy for the next 18 months. These strong stimulative features, in a period where the stock market is hitting record highs with a massive boom in the technology space, make the risk of the economy overheating more prevalent; but I think that's a tail risk and not a base case for us.

Michael: What if the threat is ignoring the non-AI economy? We have the government taking stakes in semiconductor companies and the administration's focus on technology may be hiding some of that underlying weakness. We talk about a K-shape economy, so maybe taking the eye off the ball and focusing too much on this small subset of companies could be a threat.

Phillip: Applying that more broadly, the equity stake the government has taken in some companies is stoking uncertainty around regulatory shifts—be it tariffs, policies or equity ownership in other companies—that could unbalance the economy. Like any complex machine, if you push too far, it's going to start to break down. So far, we've seen the market's reaction when tariffs were viewed to have gone too far, and there was a pullback.

Michael: Yes, we have seen the market's ability to stomach some of those risks in the short term, but there could be a certain point where enough is enough, and these things start to add up and snowball.

Robert: I would say a misstep by the Fed. It is heavily dependent on data, and the quality of that data has been deteriorating based on the response rates and the rate at which they impute or interpolate values. As a result, the Fed may be led down the wrong path. I think that's the biggest threat.

Phillip: I think a big risk is the natural constraints of the infrastructure buildout for AI. How quickly can you erect power plants? How long does it take to set up data centers? And when you're putting trillions of dollars to work, what constraints start to come up? In that buildout, demand for power is clearly going to be a big issue at some point, especially in the United States.

James: I don't think that's a 2026 problem yet because we're still in the euphoria stage of spending trillions of dollars and are just starting the buildout. But at some point, in the next 18 months, we might run into a potential weather or technology event...it might not even be an exogenous event but a matter of overall supply and demand factors. I do think that will happen but not next year; for now, we're going to keep spending money on this.

Jennifer: Spending on AI is a big tailwind for growth today, and if that reverses it will be deeply negative for GDP.

Robert: I don't think that's a risk...you've got the public and private sectors working together in unison to build this infrastructure up, so when it's all-hands-on-deck, it will usually get done. I would be more concerned with the hyperscaler companies. They've got high operational margins and, until recently, don't have any assets. Now they're going to look more like utilities or companies that have to pour money into infrastructure like data centers or new chips. What happens to these companies when investors realize these companies no longer look like or behave like hyperscalers anymore or if AI doesn't get the return on capital?

Phillip: I think these companies—the top technology names in the country—are being efficient with how they're allocating capital, where they're not necessarily bringing the data centers onto their balance sheets; they're looking for partners in the private equity space. You're bringing in a pool of capital with regulatory backing, supported by business leaders...so, it's hard to see how there's a speed bump to some of the AI spend over the next 12-to-18 months. We're struggling to find the threat out there and I just don't see one.

Christopher: I agree with Rob... it's hard to bet against innovation or on the U.S. when all efforts are directed towards a solitary goal. My concern would be AI's impact on the labor market and job displacement over the long term. As James pointed out, the speed at which we retrain employees and transition them to different sectors in the economy will be critical. Phillip: What's the analogy for where we are now in the tech spend cycle...are we at 1995 or is it 1999? To me, it feels more mid-to-early 90s despite valuation levels being a bit high.

James: I'm not so sure about that. Let's say you're issuing lower quality bonds to build these data centers, and then this debt is potentially going into leveraged portfolios...you can almost get a whiff of the subprime credit crisis that was brewing pre-2008. There's a lot of money chasing after AI, with the idea that cash flows have nowhere to go but up. But inside of that story, we have some speculative stuff that does look frothy.

How is the U.S. dollar impacting asset allocation decisions?

James: The dollar has been weak this year for reasons that we expected and some we didn't. We'd been on a really strong dollar rally for most of the last decade. Coming into 2025, we expected a slight decline with the tariff announcements, and the dollar hasn't recovered since. There have been fits and starts here and there. We're on more solid footing relative to other developed markets and that could potentially result in dollar strength.

As we go into 2026, relative to other pain points around the globe, having more dollar exposure for our investors, who are predominantly U.S. dollar domiciled, makes sense for a number of reasons.

One, there is a lot of innovation going on here in the United States and U.S. companies are taking up an increasingly larger share of the global indexes. Having exposure to U.S. markets is going to be beneficial in a higher-growth AI-dominant economy.

Jennifer: We received many questions this year on whether the dollar is still a safe haven currency and the world's reserve currency. Transaction volumes suggest that's still very much the case. There hasn't been a big move away from the dollar when you look at the data, and I think that's an important piece that headlines can sometimes misconstrue.

Michael: The dollar index bottomed around 97 in July, bottomed again in September around the same level. It looks like it's found its level and is perhaps building towards some strength.

In terms of impact on our asset allocation, ultimately it could be a headwind for some of the non-U.S. equities going into next year.

What are your views on the Fed and monetary policy?

Phillip: Interest rates will be lower by June 2026 when we have a new Fed chair. It is clear there's a bias to cutting interest rates from the Fed at the moment. Do we move into a 3%-3.5% range for the fed funds rate over the next 12 months? That's quite possible and supportive for equity markets. The worry is, absent an economic dislocation or job losses, if the Fed brings the fed funds rate below 3% over the next 12 months, the market could interpret that as too much, too soon, and you could see a push back. But as we've seen before, the Fed cares a great deal about market stability.

Robert: Also, as we adjust to a slightly higher inflationary environment, maybe the Fed's adopted target of 2% inflation gets replaced with a 2.5%-3% rate.

Michael: One other nugget is the end to quantitative tightening. So, right now we have a lot of liquidity as it is, and this could be another injection of liquidity into the economy.

What is your view on emerging markets?

Jennifer: Overall, there are a couple of large names at the top of the index that have done exceptionally well, but the overall market beta is more challenging. Personally, I'd probably want to be more underweight to emerging markets because the macro story for China today isn't compelling, whether it's consumption or housing or deflationary pressures. While the headline GDP numbers look fine, the concern is the composition of that GDP, which is export heavy. That pressures long-term economic sustainability when you think about the geopolitical backdrop today. With the absence of stimulus, it's hard to be overweight in this space.

Phillip: To your point, the policy decisions that are currently being made by the Chinese government seem to be stuck in the playbook of the last three decades. Many would like to see a bigger push to support the consumer, and pivot the economy away from an expanding manufacturing sector.

Jennifer: China just released its updated five-year plan for 2026-2030 with more of a focus on being technologically self-reliant and upgrading its industrial capacity. It runs a bit counter to the consumer spending story that many were buying into emerging markets for. So, there's not really any proof in the pudding of an economy in transition.

Robert: Besides diversification and tracking error risk to global benchmarks, what's the reason to continue owning emerging markets?

James: I hear a lot of negativities around emerging markets. To me, it is not a monolith. Obviously, China is the biggest piece of it and the country has some challenges. But I would counter that it's also an exceptionally large country with tremendous potential for innovation and growth. We haven't heard a lot about it lately, but DeepSeek turned the AI world upside down for a minute. Given the breadth of the Chinese market and its population, getting exposure to the second largest economy in the world is important because it will create a playing field where managers can find really good names.

It is good to remember that EM is not just China; it's a lot more than that. Some of the biggest pieces of the AI story are in EM. To answer your question, Rob, I think EM provides real diversification, and fertile ground for people to generate excess returns by finding those winning companies of the future.

Jennifer: James, you make a great case for active EM; I'm less sold on the broad passive beta exposure because you do have to own all the stuff that's not exciting.

Michael: Some years ago, we used to hear China was not investable. Over the past year, emerging markets have outperformed the S&P 500 despite the volatility around tariffs and headlines, so I do believe they have a place in portfolios.

What is your most important recommendation to investors?

Jennifer: Especially in the current environment, just having a rebalancing policy—no matter the cadence or the methodology—and sticking to it are important. It's not an exciting answer, but when you see momentum in markets, having that disciplined policy in place to harvest gains along the way is a prudent strategy, and it can make a big difference over the long run.

Phillip: To belabor the point...staying invested and not getting overly negative is a challenge we are all grappling with in this world of above average valuations. Staying invested or staying at market weight for equities doesn't always feel great, but we are really encouraging investors to do that.

Michael: To that point, new highs, especially in equities, tend to be scary because we're entering a level that we haven't seen before, but my recommendation would be to stay invested using a disciplined and diverse approach.

Phillip: One other strategic point is to ensure you have sufficient liquidity and high-quality fixed income in your portfolio. When markets are doing well consistently, we tend to forget about the potential for drawdowns, and having liquidity to rebalance or support cash flow needs constitutes a core principle.

What do you see as the biggest market drivers of 2026?

James: BTS tour!

Phillip: The biggest driver for markets next year is the degree to which easing financial, regulatory, and monetary conditions propel more M&A activity, cheaper financing for the smaller-large companies in the United States, and help the rest of the economy catch up to the mega-cap technology names.

Jennifer: The overall policy backdrop looks favorable for 2026. There were many provisions in the tax

bill that were front loaded. That's something that can be stimulative in the near term, and especially if there's more of a push towards deregulation, M&A and greater lending activity.

Michael: I'll mention midterm elections because we're going to start hearing about them more and more. Currently, Republicans control both the House and the Senate. We could see some seats flip and potentially some gridlock down in DC. It's a little early for most people, but we'll see some headlines next year.

Robert: The biggest market driver will be the early adopters of AI that lie outside of the AI companies that are the hyperscalers and the Magnificent 7-type firms. These downstream companies can utilize AI infrastructure and leverage it in their own businesses without the same level of capital expenditure as the top technology companies. They will start to show up in 2026, and they might outshine those top companies that are putting so much money to work.

We believe diversifying portfolios with different asset classes are important, but what is your top performing asset class for 2026?

Phillip: U.S. mid-cap stocks.

James: Long bezzle.

Jennifer: Diversified public real assets.

Robert: The S&P 490, that's the S&P 500 excluding the top 10 names.

Michael: Commodities.

Christopher: Infrastructure.

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