



2026 HEDGE FUND INVESTMENT OUTLOOK

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INTRODUCTION

“We owe it, therefore, to candor and to the amicable relations existing between the United States and those [European] powers to declare that we should consider any attempt on their part to extend their system to any portion of this hemisphere as dangerous to our peace and safety.”

- *James Monroe, 1823 State of the Union Address*

“Under our new national security strategy, American dominance in the Western hemisphere will never be questioned again. Won’t happen.”

- *Donald Trump, Jan 3 2026 press conference*

Just over 200 years ago, President James Monroe articulated his vision for American statecraft in that the young United States would defend the newly independent nations of Central and South America from European colonialism. Under what would later be called the Monroe Doctrine, any attack on these countries would be considered an attack on the United States and dealt with as such. Subsequent presidents expanded this doctrine to justify American intervention across the Americas to support U.S. interests, often with the stated intention of precluding interference from European countries.

As 2026 opens, we see a reinvigoration and expansion of this thesis under the “Donroe Doctrine,” seemingly promising fire and fury to any foreign power or domestic government that seeks to profit in the Americas at the United States’ expense. Quite the corollary! While more cynical market observers anticipated that the United States would likely maintain a policy of ‘maximum pressure’ upon Venezuela into 2026, possibly none had predicted that former President Nicolas Maduro would be so quickly and explosively sidelined, and his successors so rapidly coerced into sending idle Venezuelan crude oil to U.S. refineries.

As our last annual letter noted, predicting politics is a fool’s game, as is attempting to predict its ultimate effects on markets. While there is much excitement over the prospect of Venezuela’s rich oil reserves causing steep price declines at the U.S. pump, most observers agree that it will take much investment and time to rebuild Venezuela’s aged extraction facilities, and oil prices have actually headed higher in the first few days of 2026 amid fears over Russian sanctions and Iranian output slowdowns. Why then do we even dwell upon the political if it seems to have so little impact upon the financial?

Sometimes, the political and the financial do appear to rhyme. As we also noted in our last letter, the idea that the U.S. stock market would once again see double digit gains in 2025 was by no means a given at the beginning of the year. We had noted that the rising chorus of tariffs and deregulation could lead to a renaissance in both U.S. manufacturing and in equity capital markets activity, but that the U.S. market also leaned dangerously heavily upon A.I. enthusiasm and continued rate cuts from the Federal Reserve. Despite these fears, including those that were at least partially realized over the year, the other consensus idea held at the end of 2024 won out. Specifically, with the ascendance of a forceful administration bent on reasserting American dominance, investors in U.S. equities seemed poised to benefit from explicit political support for continued market gains. DeepSeek’s threat to upend American AI dominance, the administration’s shocking “Liberation Day” tariff announcements, and slower-than-expected Fed cuts ultimately slowed but did not stop the double-digit ascendance of broad U.S. equity indexes for a third straight year. The S&P 500 rose by 17% over 2025, and the tech-heavy NASDAQ 100 jumped by an even more impressive 20%.

The bull case driving U.S. markets then appears to be the bull case now: U.S. corporate profits continue to be spectacularly strong (if concentrated among the largest, techiest players) and deregulation has indeed led to a rebirth of mergers, acquisitions, and IPO activity. If we are not quite yet in Isaac Asimov territory, rising spending among U.S. corporations for AI applications (and, perhaps ominously, rising talk of slowing hiring and other forms of “efficiencies”) appear to finally support the thesis of rising adoption of AI – and, by extension, rising revenues for the AI hyperscalers and their enablers.

The question entering into 2026, as it was entering into 2025 (if not also 2024): can the U.S. keep up its spectacular run of outperformance? By one important metric, its enviable record has already stalled: ex-US outperformed their U.S. domestic equivalents over 2025. Tariff announcements and all manner of political pressures on both the European Union and China weren’t enough to outweigh tailwinds in either market. tracking both markets saw gains of more than 30% over 2025, and the MSCI ACWI Index (which tracks the performance of several large developed and emerging markets) comfortably outperformed U.S. markets with a +22% return for the year. Geopolitics (and tariffs) be as they may, plenty of market observers continue to expect strong ex-US performance given relatively cheap valuations in both the Eurozone and China, and from the boost of wider fiscal stimulus in the former and AI enthusiasm with Chinese characteristics in the latter.

2026 has already given us quite a bit to think about in its early innings. Consensus seems to hold that the global economy will continue to grow thanks to A.I. improvements and deregulation. It remains an open question whether cheaply valued ex-US equities will continue their recent spate of outperformance or whether U.S. equities, be it through tried-and-true productivity enhancements or some as-of-yet unforeseen application of the Donroe Doctrine, regain their dominant position. It is beyond the scope of a market outlook to comment upon how A.I. employment usurpation, affordability concerns, or societal thunderclouds might affect our lives in the months to come. All we can continue to do is observe that hedge fund managers have a variety of tools at their disposal to profit both from rays of sunshine and rainier days.

EQUITY LONG/SHORT

U.S. EQUITY LONG/SHORT

Those who have studiously kept up with our letters may start to notice a familiar set of refrains regarding the U.S. economy over the last few years. Short-term fears over tariffs, unsustainable AI capital expenditures, or sweeping federal layoffs were not enough to distract from the long-term bull case that has underpinned U.S. equities since 2023. Namely, U.S. equities rallied over 2025 off the back of rate cuts, a resilient U.S. economy, and evidence of heightened adoption for AI applications. While these themes are familiar, however, the story for U.S. stocks (especially relative to stocks in other markets) hasn't remained entirely the same.

Specifically, 2025 marked a break in the narrative that there was no alternative to investing in the mega-cap U.S. equities that had dominated previously. As mentioned, though those U.S. dominated by mega-cap tech stocks generated double digit returns, they trailed both European and Asian (specifically Chinese) markets over 2025. Some of this is due to the steep drawdown suffered in the first half of the year, when fears over DeepSeek's erosion of American AI dominance fed directly into panic over highly punitive tariffs announced at the beginning of April. Part of this relative underperformance could simply be due to investor fatigue – while there remain plenty of fundamental reasons to be excited about the U.S. market, valuations of U.S. equities continue to look much richer than European or Asian markets going into 2026.

As we move into 2026, the shifts made throughout 2025 have oriented the portfolio toward managers with long exposure to leading U.S. companies known for strong cash flows and resilient product portfolios, and we continue to believe selective investments in both the Magnificent 7 and similar companies should prove additive to investor portfolios over 2026. Active management is important here. Fears of an explicit, broad-ranging AI bubble seem somewhat alarmist given evidence of rising adoption of AI tools by both consumers and enterprises, and managers point to the use of free cash flows rather than unfunded debt spending by the hyperscalers as a positive comparison to the go-go days of 1999. Still, there will undoubtedly be those companies that go over their skis in AI spending that will make compelling targets for our short sellers. Additionally, while the resilience of the U.S. economy and pace of rate cuts over 2025 helped buoy smaller-cap companies, their price appreciation in aggregate disappointed relative to the large caps. The Russell 2000, which tracks the performance of U.S. small caps, rose +12.8% for the year, trailing its larger-cap-focused equivalents. Dispersion in this market should prove quite strong, especially given the lower-end U.S. consumer faces many issues with the affordability of their daily staples (especially given the U.S. Fed's apparent abandonment of the goal of bringing U.S. inflation to or below 2%).

CONVICTION:

HIGH

U.S. Long/Short

MODERATE

Sector Specialists

Europe Long/Short

LOW

Asia Long/Short



EUROPEAN EQUITY LONG/SHORT

Few save the most ardent European supporters would have guessed that 2025 would prove a banner year for European equities. Both the Euro Stoxx 50 index and FTSE 100 Index, which track the largest companies in continental Europe and the United Kingdom respectively, rocketed over 35% over the calendar year. The geopolitical perception of European leaders being trapped between the Russian Scylla (via drones and missiles) on the one end and the Trumpian Charybdis (through tariffs and demands for self-reliance) on the other proved an unexpected boon for European equities. Namely, as European leaders stepped up to meet heightened NATO defense spending targets and Germany opened its long-fastened purse strings to fiscal stimulus, European financials and defense contractors skyrocketed in value. While it was not just Europe's largest banks and defense companies that rallied, these were certainly some of the continent's greatest winners over the year and have entered 2026 on strong footing.

Despite this rally in shares, European corporates remain surprisingly undervalued by most metrics relative to their analogues across the Atlantic, and managers continue to find excellently positioned companies in specialty industries whose share prices look cheap relative to similar American peers based solely on their geography. While passive investors might need to be cautious over slowing rate cuts and concerns over Europe's energy security impacting the performance of broad-based , we value managers for being able to hedge against these uncertainties and look for those shorting opportunities among companies that still face punishing tariffs from the U.S. or rising competition from cheaper Chinese alternatives.

SECTOR SPECIALISTS

We continue to value those sector specialists with a special edge in industries with high dispersion opportunities and operational complexities which reward experts over generalists.

Energy-focused managers have been some of the most successful investments over 2025, and we continue to view the space as an especially rewarding area to trust a sector specialist rather than a generalist. In traditional energy markets, we continue to anticipate that the U.S. administration's focus on domestic energy dominance regardless of underlying cash flows or profitability should provide plenty of dispersion candidates among traditional oil and gas exploration companies, refiners, and distributors. The quickly shifting dynamics of supply and demand for these commodities amid OPEC deliberations, let alone Russian and American missile and drone strikes, necessitate quick and skillful trading among our experts. While renewable energy markets appear politically fraught amid the U.S. administration's explicit skepticism over solar and especially wind's utility, we continue to find value in managers that are able to navigate the sprawling and complex market for industrial metals, finished turbines and panels, and even nuclear reactor components that underpin renewable energy markets. It is additionally important to invest with those managers who understand how these markets are intrinsically entwined, both for good and for ill, with enthusiasm for data center construction in pursuit of AI productivity gains.

As we move into 2026, we continue to have increased interest with managers that explicitly focus on technology within our book. Technology stocks, though undoubtedly expensive relative to other parts of the market by most metrics, continue to show stunning upside potential with the fast pace of AI-related innovations.

While it is tempting to believe that one can simply invest in a mega-cap tech focused index and benefit from the performance of the index's largest players, one must not forget the major dispersion that has been observed among the artists formerly known as the Magnificent 7. Alphabet, whose core search business was written off by market observers as a ChatGPT casualty in early 2025, rocketed +65.4% over the year thanks to its dominance in AI-driven advertising and model development; Amazon, formerly a champion of the cloud computing arena, rose just 5.2% thanks to fears over its high capital expenditures and its increasingly assertive retail competitors. There is not just value, then, in investing in a manager able to discern the smaller winners and losers of fast-paced technology changes, but even those relative winners and losers at the top of the food chain.

ASIA EQUITY LONG/SHORT

Asian markets broadly performed at a blistering pace over 2025. Smaller markets like Korea and Taiwan, whose market are dominated by major tech companies like Samsung and Taiwan Semiconductor, leapt enormously due to their top constituents' connection to the ongoing AI revolution. Yet even larger and more diversified markets like China and Japan saw sizable, double-digit gains over 2025. The drivers of either market overlapped in some cases – both China and Japan are home to a number of tech-forward companies who play integral parts in the ongoing AI buildout – but differed importantly. China, for example, benefitted more from the resilience of its innovative, if not cutthroat, exporters and the dynamism of its homegrown rivals to the Silicon Valley titans. Japan, on the other hand, resembled more the bull case we see in some of the major European economies where the first signs of fiscal stimulus and monetary tightening in decades, as well as growing acceptance of the demands of corporate governance-focused activists, are contributing to better shareholder returns than those seen in many years.

The dynamism and relative dispersion of these markets make for an attractive investment opportunity. We will monitor managers in this space and make investments where we find additive and accretive players for our existing portfolio.

CREDIT/EVENT

PERFORMING CREDIT

Heading into 2026, the portfolio reflects a modest reduction in exposure to performing credit (where our managers look for long and short opportunities in investment-grade and non-distressed high yield credit). Though credit broadly has been one of our most fruitful areas in recent years, the opportunity set looks less compelling today given the length at which credit spreads both domestically and abroad have remained historically tight. The option-adjusted spread of the ICE BofA US Corporate Index, which tracks spreads across investment grade markets, is at its lowest level in nearly 30 years, while similar measures for high-yield corporate spreads hover close to their tightest level in twenty years. Only the riskiest areas of the high-yield bond and leveraged loan markets, which are those most likely to verge into stressed or distressed territory, provide any meaningful cushion from a spread perspective.

On the one hand, this provides some attractive carry opportunities for managers to invest in the credit of companies with strong fundamentals; if, however, rising default rates in both the U.S. and Europe portend to trouble in the future, tight credit spreads provide little room for error from a pure buy and hold perspective. While there may be some attractive shorting opportunities in this environment, managers must proceed cautiously given the high level of current yield (and thus, ongoing losses on a short perspective) paid by many better performing credits.

STRESSED/DISTRESSED CREDIT

Stressed and distressed credit continues to provide attractive opportunities for managers investing both in the United States and in Europe. U.S.-focused managers have flagged that while default rates have remained relatively low (though at a rising pace) in the high-yield bond market, leveraged loan defaults remained at relatively elevated levels for the third consecutive year. The gap between high-yield bond and leveraged loan defaults closed slightly over the year, but leveraged loans in particular remain under pressure thanks to the higher-for-longer environment of U.S. rates. Rate cuts in 2026 may provide some relief to those corporate borrowers using floating-rate debt, but managers have observed that the amount of loans trading at stressed and distressed levels elevated to a two-year high by the end of the year. Even outside of outright defaults and restructurings, this environment provides plenty of opportunities for our stressed and distressed credit experts.

Though the overall quantity of debt trading at distressed levels remains relatively low in European credit markets, the picture is roughly similar across the Atlantic in that the leveraged loan market appears to be in worse shape than that of the traditional high-yield bond market. Though rate cuts from the ECB and Bank of England have provided some relief, the pace of these cuts may slow over 2026 with stubborn inflation, and the rising level of distressed debt in the European loan market could lead to stormier days ahead. In this environment, our European distressed and restructuring experts have a wide opportunity set in which to operate.

CONVICTION:

HIGH
Stressed/Distressed Credit
Event Equity

MODERATE
Merger Arbitrage

LOW
Performing Credit

EVENT EQUITY & MERGER ARBITRAGE

Though the threat of tariffs and broader geopolitical instability slowed the anticipated tidal wave of event equity activity in the first half of 2025, by the end of the year many observers celebrated the triumphant return of mergers, acquisitions, and other special situations in equity markets. The value of M&A deals in the United States climbed to levels not seen since the heady days of 2021 as the new administration steadily overturned the previous administration's skepticism with megadeals. While IPO activity did not recover to the go-go-days of 2021, the number and value of IPOs in the United States too climbed significantly in 2025 relative to previous years. Although the most hyped deals happened within the realm of artificial intelligence and its various inputs, the likes of old economy industrials and traditional entertainment names too picked up their pace of marriages, divorces, and divestments.

We expect this environment to continue into 2026, as it appears increasingly clear that regulatory scrutiny will be sufficiently light to allow for continued exuberance. That said, we prioritize those managers that take a selective approach to deals – including understanding the increasingly important dimension that political connections make in successfully completing transactions – over those who cast a wide net on the space. Additionally, we prioritize those managers able to take advantage of capital efficiency driven divestments, or those able to short less logical IPOs and other spinoffs, than those who focus exclusively on casting a wide net on the M&A market.

Broadly speaking, we find that there will be plenty of dry powder for our special situations focused managers in 2026 and have modestly increased our exposure going into the year.

RELATIVE VALUE

As part of our cautious rotation into strategies with higher upside potential like event driven and long-short equities, we have modestly reduced our exposure to relative value managers going into 2026. Although performance has largely met expectations, there is a shift toward managers positioned with more favorable tailwinds.

We remain constructive on the opportunity set in structured credit, but less so given the aforementioned spread tightening across both investment-grade and high-yield markets. There remain plenty of relative value opportunities in this market given the dispersion of home price appreciation across geographies in the United States and selectively attractive credits in the troubled office commercial mortgage market.

Fixed income relative value managers remain part of our toolkit given their ability to profit from central bank policy divergence (especially with heightened pressure on the Fed to cut rates coming against slowing cuts in the Eurozone and the potential for hikes in Japan) and other areas of market volatility. In particular, we value those managers that are able to navigate the increasingly complex “dollar debasement” trade, wherein the chances of a depreciation of the dollar in favor of baskets of other reserve currencies, gold, or even crypto rise amid unrestrained fiscal spending in the U.S.

Convertible bond arbitrage has been a mainstay allocation in our portfolios, and we continue to prioritize managers able to benefit of the renaissance in corporate capital markets activity. In particular, arbitrage activity should remain elevated given rising issuance from data center builders and other beneficiaries of the AI revolution.

CONVICTION:

MODERATE

Convertible Bond
Arbitrage
Structured Credit

LOW

Fixed Income Relative
Value



GLOBAL MACRO

Whether or not our previous predictions are exactly right, completely false, or somewhere in between, market volatility is likely to remain elevated on both the upside and downside. Macro managers have found ample opportunities in trading baskets of developed and emerging market equities, steepeners and flatteners on various sovereign treasury curves, and even in the stressed and distressed credit of emerging market sovereigns and corporates.

In a world where markets can shift massively due to the proscriptions of a central committee or due to the declarations of a Truth Social post, we continue to emphasize discretionary managers who have the ability to step in to dial up risk when other participants flee and reduce risk when others dive in. Systematic managers are less of a focus given their difficulty in readjusting their exposures in heavily gyrating markets.

CONVICTION:

HIGH

Fundamental Macro Strategies

LOW

Systematic Macro Strategies



2026 INVESTMENT OUTLOOK

Strategy	Outlook	Conviction
Equity Long/Short	We maintain our high conviction in U.S. Long/Short amid a robust opportunity set. Many of the leading drivers of global market performance continue to emanate from the US, such as AI, semiconductors, digital infrastructure, and power build out. The US economy remains resilient for now. Inflation in the U.S. remains subdued with core inflation pointing to benign levels in the 2-3% range. However, we have yet to see the full impact of increased tariffs on the economy and inflation. U.S. equity valuations continue to climb with the market multiple well above average which creates opportunities on the short side. We have shifted our conviction in Europe Long/Short to moderate. However, even with a strong year of European equity outperformance, many European equities remain cheap relative to valuations in the US.	<p>HIGH U.S. Long/Short</p> <p>MODERATE Sector Specialists Europe Long/Short</p> <p>LOW Asia Long/Short</p>
Event Driven	We retain our high conviction in stressed and distressed credit. The combination of higher-for-longer interest rates and sector-specific dislocations has created a compelling environment for proactive managers. We expect defaults and especially distressed exchanges to remain elevated for the foreseeable future and managers with restructuring expertise will be able to take advantage. We maintain a high conviction in event-equity strategies, supported by a continued rise in corporate actions and shareholder activism. Management teams are increasingly deploying buybacks, spin-offs, asset sales, and strategic reviews to unlock value. We have also raised our conviction to moderate for merger arbitrage strategies as deal activity resumes. Deal spreads remain reasonable, supported by open financing markets and reduced regulatory headwinds, which together improve the overall certainty of deal completion. Spreads for performing credit are near all-time tights. While the carry from elevated interest rates provides a tailwind, there isn't enough convexity left in performing credit to compensate for the uncertainty in the world.	<p>HIGH Stressed/Distressed Credit Event Equity</p> <p>MODERATE Merger Arbitrage</p> <p>LOW Performing Credit</p>
Relative Value	Conviction remains moderate for both Convertible Bond Arbitrage and Structured Credit. Convertible bond issuance remains robust offering investors attractive income potential with additional upside from equity-linked appreciation and early refinancing activity. Relative Value strategies continue to benefit from elevated volatility, with our focus on selective positioning in fixed income relative value and structured credit to capture short-term dislocations and structural inefficiencies. Interest rate volatility remains high, supported by rising fiscal deficits, shifting term premiums, and concerns over the U.S. dollar's reserve status, which has enhanced cross-market opportunities. In credit, tight spreads have tempered the opportunity for relative value trades; however, weakening fundamentals may lead to decompression trades.	<p>MODERATE Convertible Bond Arbitrage Structured Credit</p> <p>LOW Fixed Income Relative Value</p>
Global Macro	Amid rising geopolitical tensions and diverging global policy stances, the current macroeconomic landscape is increasingly favorable for Global Macro strategies. Diverging central bank actions are generating opportunities across rates, currencies, and cross-border markets. We consider Global Macro managers with tactical expertise in developed markets to capitalize on both structural shifts and short-term dislocations. In Emerging Markets, supportive fiscal reforms, undervalued currencies, and a weakening U.S. dollar create a compelling investment backdrop. While EM carries heightened volatility and liquidity risks, its uncorrelated return profile and active opportunity set support a constructive outlook.	<p>HIGH Fundamental Macro Strategies</p> <p>LOW Systematic Macro Strategies</p>

Source: 50 South Capital. The opinions expressed are as of December 2025 and are subject to change at any time without notice.

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