Twin Shocks: AI and Geopolitics

Notes from the Trading Desk - Q1 2026

Executive Summary

- **Q1 reflected a market navigating two disruptions** with AI driving a structural repricing and greater dispersion in credit, while the Iran conflict delivered a near-term shock, lifting oil prices and delaying expectations for interest rate cuts.
- **Uncertainty is higher, and outcomes have a wider distribution, making resilience and security selection critical**. Dispersion – especially in AI disruption-exposed sectors – is rising, reinforcing the need to focus on durable business models and disciplined credit selection.
- **We are selectively capitalizing on mispriced opportunities while remaining defensively positioned**. We are keeping overall levels of exposure below average but leaning into some specific opportunities in short-maturity credit and Canadian duration.

What We Saw This Quarter

Q1 was defined by two concurrent disruptions: a structural repricing tied to AI and an acute geopolitical shock stemming from Iran.

Financial markets were volatile throughout the quarter as investors continued to reassess what the AI buildout means for asset valuations. Investors also had to process the impact of outflows from private credit markets into the other parts of the credit ecosystem while simultaneously contending with a sudden geopolitical escalation in the Middle East.

In credit, the emergence of AI has translated into a need to underwrite a wider range of outcomes for many of the businesses we lend to. The dispersion between potential winners and losers in AI is significant, and we saw that uncertainty has begun to be more meaningfully reflected in spreads during the quarter.

Within Investment Grade credit, much of the market's focus centered on Technology and Software, with both sectors seeing credit spread widening in recent months. Technology felt the weight of new issuance to fund infrastructure, and Software faced more immediate concerns around disruption.

The effects of AI-driven uncertainty were particularly pronounced in private credit and the Broadly Syndicated Loan ("BSL") market. It makes sense that signs of stress would be more pronounced in more leveraged and software-focused areas of the credit markets.

Private credit is facing its first real stress test in this cycle. Note that we do not invest in private credit, although we pay close attention to that market, as developments in private debt can impact the high yield market, where we are active in some of our mandates.

On average, private credit portfolios have roughly twice the exposure to Software compared to public credit portfolios.[1] This has raised questions around the valuations of loans in private credit portfolios, underscored by the persistent discounts at which Business Development Companies (BDCs) are trading relative to their reported Net Asset Values.[2]

This has been best illustrated by the most prominent publicly traded BDC ETF, which has just experienced a 30% drawdown from its highs in August to the end of March.[3] Outflows have accelerated, and in several cases, funds have relied upon their maximum redemption thresholds to stem redemptions.[4] Investors are now being gated and have the potential to be more exposed down the road to the most difficult assets within these portfolios.

Within the BSL market, companies perceived to have elevated disruption risk are finding financing more difficult to secure. The pattern became clear during Q1, where these sectors and companies accounted for only ~10% of the overall BSL issuance pipeline, yet represented approximately 60% of deals that were ultimately pulled owing to a lack of investor appetite.[5]

Overlaying this evolving, structural theme was the geopolitical shock tied to the US-Israeli military campaign involving Iran. The resulting disruption to oil flows through the Strait of Hormuz led to a sharp increase in oil prices and broader volatility across risk assets. Although this created some pockets of credit spread widening and some volatile trading sessions, the more notable impact was on front-end interest rates, as markets reassessed the likely paths of central bank policy action.

At the start of the year, investors expected Canadian administered rates to be unchanged in 2026 and 2-3 cuts to occur in the US. By the end of the quarter, the market was pricing in over 2 hikes in Canada and no changes to administered rates by the Federal Reserve.[6]

What Changed & Why It Matters

The events of Q1 reinforced that markets are operating in a regime of greater uncertainty, where both structural and cyclical disruptions are widening the range of possible outcomes.

The combination of geopolitical instability and technological disruption is a continuation of a broader shift that actually began in 2025. The “old world order” of more stable macro and policy backdrops has given way to an environment characterized by more frequent shocks and less predictable outcomes.

In practical terms, this tells us that the distribution of potential outcomes has widened, with a greater probability of more “left tail outcomes.”

Within our asset class – public credit – dispersion across sectors, issuers, and geographies continues to increase. Simply put, the valuations for similarly priced securities are more varied, with what we view as some investments trading too rich and others trading too cheap. Although this is an environment with an abundance of opportunities, it also comes with a wider and more complex set of risk factors. Looking ahead, we do not think investors will be well served by passive, index-like credit strategies. We believe active management will be particularly important both to find and capture the opportunities the markets present, but also to ensure effective risk management.

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[1]Source: Morgan Stanley, ‘The Risks of Private Credit’s Software Exposure.’ March 2, 2026.
[2]BDC portfolios are often managed by Private Debt firms and there is often an overlap in the private portfolios and the BDC portfolios.
[3]Source: Bloomberg.
[4]Source: BarclaysLive, ‘Business Development Companies (BDCs): Declining in Flow Motion.’ April 6, 2026.
[5]Source: Bridgewater.
[6]Source: Bloomberg.

Positioning for the Quarter Ahead

We are aiming for balanced portfolio positioning while selectively deploying capital into areas where volatility has created attractive opportunities.

In our Q4 2025 newsletter, we suggested that 2026 would be a year of more volatility and that we would aim to position our portfolios in a balanced way that would enable us to be opportunistic. This remains the game plan today.
From a credit perspective, we have positioned our portfolios with lower overall credit exposure and a bias toward higher-quality issuers compared to our longer-term averages. This reflects both the increased uncertainty in the environment and the wider dispersion of outcomes across credits.

That said, recent volatility has created pockets of value. Sectors like Financials, Healthcare, and select REITs in the US and Europe have stood out to us as they have been underperforming over the last couple of quarters. The increase in front-end yields has made certain BB and crossover credits attractive for our less constrained mandates, with all-in yields significantly higher quarter-over-quarter.

With respect to AI, disruption risk is now a core component of our underwriting process. Across sectors, our analysts are actively stress-testing investment theses and engaging with management teams to assess how business models may evolve or be challenged in an AI-driven landscape. We continue to think about how AI-driven disruption will evolve beyond the Technology sector. The first-order effects have been concentrated, but the second-order impacts across industries and their implications for credit fundamentals are likely to broaden.

We continue to embed a little more US and Canadian interest rate exposure within several of our portfolios, with a preference for domestic duration. We believe the recent oil-driven inflationary impulse is likely to prove temporary, and that underlying North American economic fundamentals do not justify the current level of short-term yields.

Finally, within our alternative strategies, we are making greater use of tail-risk hedging tools. In an environment characterized by both structural and cyclical disruption, this allows us to better balance risk and return while maintaining the flexibility to capitalize on future dislocations.

Author Takeaways

- The "old world order" has given way to an unpredictable environment riddled with constant shocks, requiring deep fundamental analysis, robust stress testing, and risk management.
- The opportunity emerging is how AI disruption will evolve beyond the Technology and Software sectors and how credit implications will broaden the dispersion of outcomes across the credit market.
- Moving forward, we believe active credit management will be particularly important to balance return potential and risk management as these shocks become the new normal.

Important Information