Investment review

After a volatile, yet ultimately rewarding, first half of the year, the third quarter has been somewhat lacklustre by comparison, but not without periods that have tested investor nerves again and thrown some doubt on the state of the world economy, the path of inflation and the appropriate response from central banks. Global stockmarkets have generally moved forward slightly during the quarter, whilst bond markets have encountered more challenged conditions, but for most investors the strong gains made in the earlier months of 2026 have been preserved.

Iran conflict still centre stage

Lying at the centre of the market mood has been the continuing conflict in the Middle East. Back in early summer there was hope that a brokered agreement and the prospect of reopening the Strait of Hormuz would return energy markets, inflation and interest-rate expectations to more comfortable territory. Like the summer itself, however, there has been rather more heat than expected for investors to contend with. Volatility has been prevalent within energy markets, with the price of Brent crude swinging between $75 and $100 a barrel and as high as $110 very recently before falling back a fraction as this update is written. Not helping the volatile scene has been the temporary closure, following infrastructure attacks, and then re-opening of Saudi Arabia's East-West pipeline, which allows oil to bypass the still closed Persian Gulf and reach the Red Sea. Meanwhile, the continuing vulnerability of shipping through both the Gulf and Red Sea has demonstrated how important these arteries remain to the world's energy supply and the flow of global trade more generally.

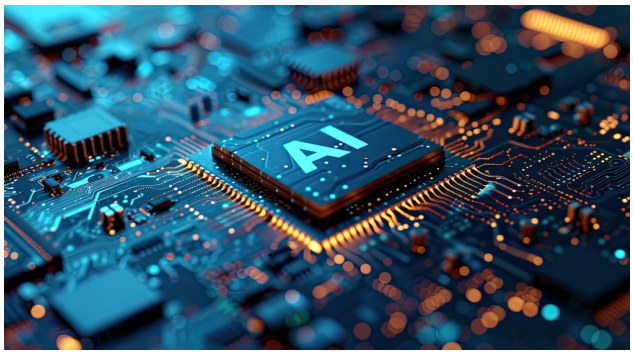
Perhaps more significant than the oil price itself has been the behaviour of downstream products such as diesel, jet fuel and other refined products, where prices have become unusually detached from their normal relationship with the price of crude oil. These products are an important transmission mechanism through which the Middle East conflict could feed into broader inflation.

Similarly, natural gas prices have also risen again and become somewhat decoupled from the oil price. The knock-on effect can already be seen in European gas storage levels, which are now well below normal heading into winter, increasing the region's vulnerability to a prolonged energy shock. The more persistent these pressures become, the greater the likelihood that they eventually find their way into the prices paid by businesses and consumers. That is important because the investment consequences of oil briefly trading above $100 a barrel are very different from those of energy prices remaining elevated for six or twelve months. The former is an uncomfortable but manageable shock; the latter potentially changes the outlook for inflation, interest rates, economic growth and ultimately corporate profits.



Global economy holding up well

There is, however, an important counterbalance to all this energy price uncertainty: the world economy has proved surprisingly resilient over the summer. Economic forecasts have generally been revised upwards rather than downwards, with the specific economic fallout from the Iran conflict being cushioned to some degree by meaningful oil and gas inventories, increased supply from outside the Gulf region and government support initiatives. Continued strength in AI-related investment has also helped sustain industrial production, trade and economic activity generally. Measures of global business activity have also improved and are consistent with global economic growth being maintained at around 3%, both this year and next.



The US has remained particularly resilient and many Asian economies have continued to benefit from exceptionally strong investment in technology, semiconductors and the infrastructure required to support AI. The world economy also seems to be adjusting quite well to a weighted average US tariff rate of around 10%, with tariff-related rhetoric also having dissipated considerably compared to earlier in the year and now seemingly less influential on business sentiment and investor confidence.

This resilience creates something of a dilemma. Earlier in the year we talked about the possibility of a 'Goldilocks' environment in which growth was neither too hot nor too cold, inflation continued to moderate and central banks were able gradually to reduce interest rates. The energy shock has clearly interrupted that journey. The debate today is therefore more about whether the world is moving towards an uncomfortable period in which inflation remains elevated while growth eventually slows – in other words, stagflation – or whether the present inflationary episode proves sufficiently temporary for the 'Goldilocks' scenario ultimately to reassert itself. For the moment, we are resisting becoming too wedded to either outcome.

Central banks move into action

What has changed more clearly during the past quarter has been the attitude of central banks. Having initially had the luxury of watching the effects of higher energy prices, policymakers are increasingly moving into action. The European Central Bank has felt it necessary to make two one-quarter point rises in interest rates over the summer and the US Federal Reserve ('Fed') has recently joined the party by making a similar 0.25% increase, taking its target range to 3.75-4.00%. Importantly, the decision by committee members was unanimous. The Fed continues to describe economic activity as expanding at a solid pace, but inflation remains too high for comfort and policymakers have therefore made it clear that price stability remains their priority.

Interestingly, financial markets initially took this move by the Fed reasonably well. That might appear counterintuitive – investors would normally prefer lower interest rates – but markets tend to dislike uncertainty even more than they dislike bad news. Clarity about what a central bank intends to do can therefore sometimes be more reassuring than prolonged uncertainty over whether it will act.

It is also worth remembering that central banks are being asked to solve a problem over which they have relatively little control. Higher interest rates cannot produce more oil, reopen a pipeline or allow tankers to sail safely through the Strait of Hormuz. What they can do is prevent an initial energy-price shock from becoming embedded in wages, wider prices and inflation expectations.

If geopolitical tensions ease and energy prices retreat relatively quickly, central banks may discover that relatively modest action is sufficient. If energy prices remain elevated into the winter and inflation broadens, rates may need to stay higher for longer and perhaps rise further. This helps explain why government bond markets have borne much of the strain during the quarter.

Bonds feel the pressure

Government bond yields have risen significantly as investors have adjusted to the prospect of more persistent inflation, higher interest rates and, importantly, increasingly uncomfortable levels of government borrowing. The 10-year US Treasury yield has moved towards 5%, while similar-maturity UK government debt has seen yields rise to 5.3%, even though the Bank of England has yet to make a move on raising interest rates, perhaps a reflection that it is already coming from a more restrictive level of 4%. The cost of even longer-dated UK government borrowing has touched levels not seen for almost 30 years, with low confidence in the state of the UK's finances compounding the pain. These may seem increasingly attractive headline yields for investors, but an attractive *nominal* yield is clearly not necessarily an attractive *real* return if inflation remains elevated.

We are therefore pleased that we reduced our commitment to fixed interest markets at the start of the Iran conflict and resisted the temptation to recommit materially at the end of the second quarter when the geopolitical mood seemed to be shifting more towards a resolution in the Middle East conflict.

There will come a point when government bonds become much more interesting. Indeed, if inflationary pressures disappear quickly or economic growth deteriorates sufficiently to force central banks eventually to cut rates aggressively, today's higher yields could provide the foundations for some very attractive future returns. But that scenario is not part of our current thinking or something we are yet ready to act upon.



Credit appeal

Instead, our preference is to hold most of our fixed interest commitments via shorter-duration and high-quality corporate debt (credit). Credit markets are certainly more richly valued than they were, with the additional yield available from corporate bonds over equivalent government bonds – the credit spread – unusually narrow. Normally that would make us somewhat more cautious. There is, however, an interesting feature of today's credit markets: narrow yield spreads do not solely reflect investors bidding corporate debt to expensive levels; they also reflect the considerable rise in government bond yields themselves.

Companies, meanwhile, have generally continued to demonstrate impressive financial resilience. Corporate profit margins remain healthy, interest payments remain manageable and default rates are low. In many cases, investors appear more comfortable lending to well-managed, cash-generative international businesses than they are long term to governments confronting high debt burdens and substantial future spending commitments. This may sound like an unusual state of affairs, but at present it is not an entirely irrational one and it is something we are comfortable supporting via our tactical positioning in fixed income markets.

Technology and AI-related profits do the heavy lifting

The resilience of companies has also been evident in equity markets, where earnings have once again been strong and technology and AI-related businesses in particular have continued to lead the way. This inevitably raises questions about whether markets have become too dependent upon a relatively small number of very large companies and whether enthusiasm for AI has gone too far.

Those are legitimate concerns, but there is an important distinction between a share-price bubble and an earnings bubble. The technology boom of the late 1990s was populated by companies whose valuations frequently bore little relationship to their profits – and in some cases there were no revenues at all, let alone profits. Today's largest technology businesses are very different. They are among the most profitable and cash-generative companies in the world.

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This does not make them immune from disappointment. Quite the opposite: when expectations are extremely high, even a perfectly respectable set of results can cause a share price to fall if investors had expected something better. We have already seen several examples of this during the year and will no doubt see more in the coming months. Active managers are in a strong position, however, to anticipate or react to such events and take action as necessary.

Cheaper valuations

The more interesting development, however, is that earnings have risen sufficiently quickly that many technology and AI-related shares are actually less expensive compared to their profits than they were at the beginning of the year, despite stockmarket indices having risen. Conversely, some of the areas that look more stretched today are sectors such as consumer discretionary and industrials, where share prices have participated in the broader market advance without the same acceleration in profits. This illustrates why news headlines we sometimes see stating that "the US market is expensive" or "technology is in a bubble" need treating with some care. Beneath the headline market indices there is considerable dispersion.

The same is true geographically. Strong earnings growth means US valuations have not expanded as much as market levels might suggest, while parts of Asia remain attractively valued despite very strong performance. In continental Europe, by contrast, share prices have risen more quickly than profits, making valuations somewhat less obviously cheap than they were.

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The sustainability of earnings is consequently one of the more important questions for markets as we move closer towards 2027. For now, the evidence remains encouraging. Forecasts have been tempered somewhat, but analysts continue to expect healthy profit growth next year across developed and emerging markets, in most cases still in double-digits. As long as companies continue delivering, there is a fundamental underpinning beneath equity markets that should not be ignored.

The US and Asia continue to lead

There is also an unusually wide divergence between the world's major economic regions. It is clear that the US remains the principal growth engine of the developed world. Domestic spending has been resilient, capital investment is strong and the extraordinary sums being invested in AI, data centres and associated infrastructure continue to support economic activity well beyond the technology sector itself.

Asia is also benefiting from many of the same trends. Semiconductor manufacturing, electronics and the broader AI supply chain have provided powerful support to several Asian economies. Longer term, parts of the region also enjoy demographic advantages over ageing Western economies.

That does not mean that we are blind to the risks. The mainstream US equity market index has become exceptionally concentrated, while some Asian markets and investment strategies are increasingly dependent upon the same handful of semiconductor and technology businesses. We continue to monitor that concentration carefully. But concentration alone is not a reason to sell successful companies. What matters is whether the earnings that justify their valuations begin to falter.

For the time being, we therefore continue to favour the US and Asia as the principal growth engines within global equity portfolios, while remaining conscious that the best-performing investments of the recent past will not necessarily be the best performers indefinitely.

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A more difficult European backdrop

Europe presents a rather different picture. Economic growth remains subdued and Europe's greater dependence on imported energy leaves it more exposed to events in the Middle East. Germany in particular continues to face a difficult combination of relatively weak industrial activity and high energy costs.

The UK has its own challenges. It now represents only 2% or so of the global economy in purchasing power parity terms and its domestic economic outlook remains difficult. As noted, government borrowing costs have risen and business confidence remains fragile. Meanwhile, the fiscal arithmetic confronting the government ahead of the autumn Budget leaves relatively little room for manoeuvre.



Few positives for the pound

These issues also leave us cautious on sterling, particularly relative to the US dollar. Higher US interest rates provide support for the dollar at the same time that concerns about the UK's fiscal and economic outlook weigh upon the pound. For UK-based investors, overseas investments therefore continue to provide not only geographic diversification but potentially useful currency diversification as well.

It would, however, be wrong to conclude that UK and continental European market exposures have no place in a global portfolio. The UK may represent only a small share of global economic output, but its stockmarket, even at less than 4% of the global stockmarket pie, still houses important international companies in banking, insurance, healthcare, energy and consumer industries. Continental Europe provides many similar opportunities.

Neither region currently offers the same technological dynamism as the US or parts of Asia, but that is partly the point. These markets provide diversification, filling some important gaps in the global asset-allocation matrix, introducing different sources of earnings, strong cash flow and, in some areas, valuation protection should investors' appetite for higher-growth companies and market momentum begin to wane.

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So where next for markets?

There are reasons for both optimism and caution as we enter the final quarter. The optimistic case is relatively straightforward. It sees corporate earnings continuing to grow, the global economy remaining resilient and central banks applying only a modest tap on the brakes to prevent the energy shock becoming embedded in wider inflation. Against that backdrop, there is every possibility that equity markets can continue to grind higher.

A meaningful de-escalation of the Middle East conflict would improve that outlook substantially. There is still some hope following the recent United Nations summit that renewed diplomatic engagement between the US and Iran can find a way forward. In the meantime, energy markets are currently hanging quite nervously on a combination of facts and hearsay, but there is little doubt that the investment mood would lift quite quickly if a resolution was found and energy and trade supply routes normalised. Falling oil and refined-product prices would remove an important source of inflationary pressure just as Northern Hemisphere energy demand enters the autumn and winter period. That, in turn, could bring central banks' current tightening bias to an earlier conclusion.

Under such circumstances, today's stagflation concerns could begin to give way once again to a more benign combination of reasonable growth and moderating inflation – the 'Goldilocks' scenario we have referred to. Equities and bonds might then become comfortable bedfellows again.



The flipside

The less favourable scenario is that the conflict persists, energy prices remain elevated and central banks are forced to tighten even further. Growth would eventually feel the effects, leaving markets to contend with higher inflation and weaker activity simultaneously.

Government bond markets would remain vulnerable and, eventually, corporate earnings would become harder to sustain.

It is precisely because both outcomes remain plausible that we do not believe this is the moment for large, pre-emptive portfolio changes.

Follow the money

Instead, our approach continues to follow the growth and earnings momentum evident in global equity markets, without overpaying for it. Against this backdrop, we remain comfortable holding equity exposure towards the upper end of our strategic ranges, reflecting the continued resilience of corporate earnings and our preference for the US and Asia as the principal engines of global growth.



Outside of stockmarkets, we continue to favour good-quality corporate debt over longer-dated government bonds and no changes are currently planned to the mix of our fixed interest investments. We are, however, making a small adjustment within our suite of alternative investments to ensure that the funds we utilise continue to provide the appropriate degree of risk diversification across clients' portfolios, particularly at a time when correlations between more traditional asset classes can change quickly.

While this adjustment is being made, clients may see us temporarily holding a little more cash than usual. Cash is currently offering a reasonable 'risk-free' return and is still a useful tool to dampen short-term portfolio volatility, but we expect cash levels to move back towards their more normal strategic positions once the adjustment within the alternatives segment has been completed.

Balanced positioning

Overall, therefore, our positioning remains deliberately balanced: towards the upper end of our strategic equity ranges to participate in continued earnings and market growth, selective within fixed interest, and increasingly focused on ensuring that our alternatives allocation provides genuine diversification should conditions become more challenging.

Fundamentally, we continue to distinguish between the continued likelihood of near-term volatility and a genuine change in the investment case. There will inevitably be periods when geopolitical headlines, inflation data or even an individual company's results cause markets to wobble or correct. But we do not believe that every correction requires action.

As we have seen on a number of occasions in recent years, attempting to do so can easily result in selling good long-term investments during temporary weakness and then missing out on the subsequent recovery, thereby negating the efficacy of the exercise. What would concern us more going forward would be clear evidence that today's strong corporate earnings are beginning to deteriorate materially, particularly within the US and Asian technology companies that have provided so much of the market's momentum in recent times. We do not see sufficient evidence of that today.

> *"...we continue to distinguish between the continued likelihood of near-term volatility and a genuine change in the investment case."*

In summary

For now, therefore, the investment landscape remains less comfortable but far from uniformly negative. Global growth has been more resilient than might reasonably have been expected, companies continue to produce strong profits and equity valuations are in many cases more reasonable than they were at the start of the year or than headline market levels suggest.

The Middle East and its consequences for energy and inflation remain the largest clouds on the horizon. But clouds do eventually clear. Until there is greater clarity over when that might happen, patience, diversification and a willingness to distinguish short-term noise from genuine changes in fundamentals remain, in our view, the most appropriate way to navigate the months ahead.

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