RATHBONES

Investment Insights

Our monthly look at what's driving global markets

Alarms and (pleasant) surprises
Looking back and ahead in financial markets

In defence of growing returns
Increasing military spending in a more dangerous world

The battle for Fed independence
Keeping monetary policy free from harmful influence

Issue 50 | January 2026

Quicktake
In this month's issue

Alarms and (pleasant) surprises
Looking back and ahead in financial markets

Equity markets delivered stronger-than-average returns in 2025, with gains across regions and balanced portfolios holding up well despite bouts of volatility.

Market wobbles were largely driven by US trade policy threats and periodic doubts over the pace and profitability of generative artificial intelligence (genAI) investment.

Economic conditions remain supportive heading into 2026, with easing inflation, falling interest rates and a low risk of recession, even as fiscal pressures persist.

Government bonds remain vulnerable at longer maturities, while gold has reasserted its role as a more reliable diversifier in uncertain conditions.

Overall, the outlook remains positive but measured, with diversification and a willingness to look beyond the most crowded areas of the market seen as key to sustaining returns.

Read the full story on page 3.

In defence of growing returns
Increasing military spending in a more dangerous world

Global defence spending is rising sharply as geopolitical risks intensify, with military outlays reaching record levels in 2024 and setting the stage for a multi-year rearmament cycle.

Europe is undergoing a structural shift after decades of underinvestment, committing to much higher defence spending and reduced reliance on the US.

These trends have pushed defence-sector valuations higher, but long-term growth drivers remain intact, supported by replenishment needs and modernisation of military capabilities.

Investors may find more attractive opportunities among long-cycle defence contractors, where valuations reflect less of the anticipated uplift from higher spending.

Technological change, including AI, cyber warfare and autonomous systems, is reshaping the sector, offering long-term growth potential alongside ongoing ethical and governance challenges.

Read the full story on page 5.

The battle for Fed independence
Keeping monetary policy free from harmful influence

Central bank independence has played a crucial role in keeping inflation low and stable since the 1990s, after the damaging experience of politically driven monetary policy in earlier decades.

US President Donald Trump's attempts to influence the Federal Reserve mark a sharp break from long-standing convention and raise questions about the Fed's future autonomy.

While legal, institutional and political constraints make a wholesale takeover of the Fed unlikely, the risk of increased pressure cannot be dismissed.

Even the perception of political interference could unsettle markets, pushing up inflation expectations and long-term government bond yields.

Against this backdrop, a cautious approach to bonds and continued use of diversifying assets seems prudent, reflecting concern about a gradual erosion of central banks' ability to anchor inflation.

Read the full story on page 8.

Snapshot
The global economy and markets

Key facts and figures from around the world, including surging AI-driven investment by big tech, China's expanding trade surplus, sharp moves in coffee prices, and the latest snapshots of growth, deficits and performance across equities, bonds and currencies.

Find out more on page 10.

Alarms and (pleasant) surprises
Looking back and ahead in financial markets

John Wyn-Evans, Head of Market Analysis

The year's end provides, along with the Christmas pudding, Brussels sprouts and ephemeral resolutions, the usual seasonal opportunity. We can look back on the past 12 months, take stock of the current situation, and share some thoughts about what might happen in the new year and how we should position portfolios.

Most investors have been pleasantly surprised by higher returns than the long-term average in 2025. Yet some are disappointed not to have made even higher returns, given further exceptional outperformance from companies developing genAI. Others remain fearful that a market crisis is just around the corner.

One question we regularly asked ourselves during 2025 was "what could go right?" Looking back on the year, a more positive mindset paid off. A similar attitude could be required in 2026 as all sorts of uncertainties continue to cloud the outlook.

Better than average
Annual returns for equity markets were generally higher than average, with some doing exceptionally well. There was a long-overdue spurt of decent performance from the FTSE 100 (up 25.8 %) and a welcome bounceback for European (up 26.8%) and Emerging Market (up 25.1%) equities. They all outperformed the US (up 9.8% for sterling investors) despite it being the home of the big technology leaders.

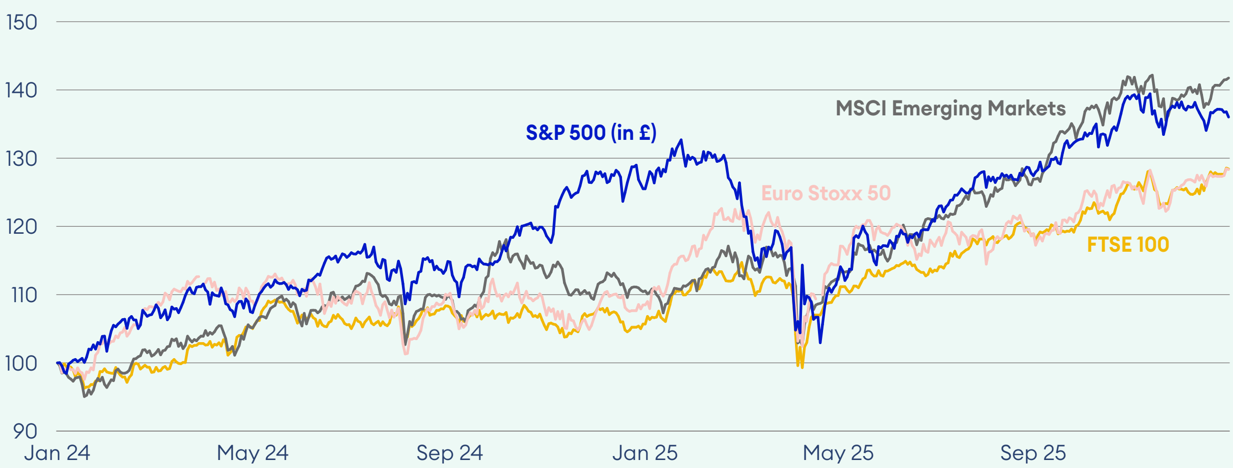
Notwithstanding wobbles over fiscal concerns, bond markets held relatively steady, with returns roughly in line with the yields offered at the beginning of the year. This left balanced portfolios in decent shape.

Even so, and as we anticipated a year ago, there were bouts of volatility. In the main, these were driven by Trump's policy salvos and the technology sector.

Trump's 'liberation day' tariffs announcement triggered a near-20% fall in US equities and accompanying weakness in bond markets and the dollar – a rare and destructive combination of market moves. But within days he'd put the tariffs on 'pause'. Markets rallied and have rarely looked back since.

However, there was another wobble in October, when Trump threatened punishing restrictions and tariffs on China again. That bomb was quickly defused when

Figure 1.1: Welcome bouncebacks
in 2025 UK, European and emerging stocks enjoyed long-overdue spurts



Source: LSEG, Rathbones

Chinese President Xi Jinping warned of retaliatory tightening in export controls on the rare earth minerals crucial to manufacturing supply chains.

Given President Trump's fondness for using trade threats as a policy weapon, we can only expect to see more of the same in 2026, perhaps triggering further market volatility.

Show me the money

The volatility around the technology sector, and around genAI specifically, came in three separate episodes.

1. In January, Chinese company DeepSeek released its large language model (LLM), which it claimed had been developed on a shoestring budget. That sent the share prices of the big US tech players into a tailspin. But the DeepSeek model proved less compelling than it first appeared, and confidence soon recovered.
2. The Massachusetts Institute of Technology released a study during the summer which claimed that 95% of corporations employing genAI solutions were seeing no benefit. Again, the resulting market wobble was short-lived. We are very early in the genAI adoption cycle, and remain confident that usage will evolve, boosting productivity.
3. The final few weeks of 2025 saw some profit-taking in genAI-related companies as investors grew anxious to see returns on these firms' massive investment in things like data centres, especially as this investment is increasingly financed by debt. Nevertheless, for now, this feels more like a healthy shake-out of excess, rather than the beginnings of something more sinister.

Forward momentum

Economic conditions globally are generally favourable. Consumer and corporate finances are in decent shape, unlike those of many governments, and purchasing manager surveys have picked up recently. Interest rates are falling in most countries against a background of lower inflation, while governments remain reluctant to consider cutting expenditure. One of the main threats to an equity bull market is a recession, but our analysis suggests this is currently a low-probability outcome.

Conversely, there's a risk that growth is too perky and inflation too sticky. Our central view is that inflation is likely to remain generally higher and more volatile than in the pre-Covid era given political preferences (more deficit spending and less globalisation) and issues such as climate change and demographics. That's a key reason why we continue to maintain a relatively short maturity profile in our government bond investments.

Government bonds proved a very poor diversifying asset in balanced portfolios in 2022. While the sizeable repricing that occurred then is highly unlikely to be repeated, longer-dated bonds remain vulnerable to concerns about persistently high levels of government debt.

Precious metals have proved much better safe havens recently. We're not expecting them to make further similar gains, but we believe they have a role to play in asset allocation, with gold still preferred.

Political agendas

In the UK, betting markets don't reflect much optimism about the chances of Keir Starmer being in office a year hence (the same goes for Chancellor Rachel Reeves). A change of leadership is widely expected to take Labour's policies further to the left, something investors are unlikely to cheer. Political risk is often expressed through the level of the pound, which may prove a helpful barometer in 2026. For now, it remains in the middle of the trade-weighted range held since the Brexit referendum.

On the other side of the Atlantic, the relentless political cycle moves towards November's mid-term Congressional elections. Given his low favourability ratings, Trump will be keen to whip up support and avoid economic upsets.

Remaining constructive

We remain constructive about the outlook for balanced portfolios, while not getting carried away.

We too have been pleasantly surprised by the past year's returns, but, in retrospect, they are not unjustified given strong corporate profit growth. Equity market valuations have risen in anticipation of future growth, and it's hard to see that card being available to play to the same extent in 2026. But we continue to resist talk of a bubble in equity markets. Yes, the US market's price/earnings ratio of around 22x, based on forecast 2026 earnings, looks elevated. But with projected earnings growth of around 13% and a core of very profitable companies, a derating would need a specific catalyst, such as an unexpected economic deceleration or sharply higher interest rates and bond yields. We currently expect neither.

Other regional equity markets offer more attractive valuations, though admittedly they lack the same weight and calibre as world-leading index constituents.

We also anticipate some broadening of returns in 2026, as companies reap productivity gains from genAI implementation. A recent upturn in the fortunes of the healthcare sector, for example, provides clues as to where investors might look next. As ever, we see diversification as the key to sustainable returns.

In defence of growing returns
Increasing military spending in a more dangerous world

Claire Titmarsh, Equity Analyst

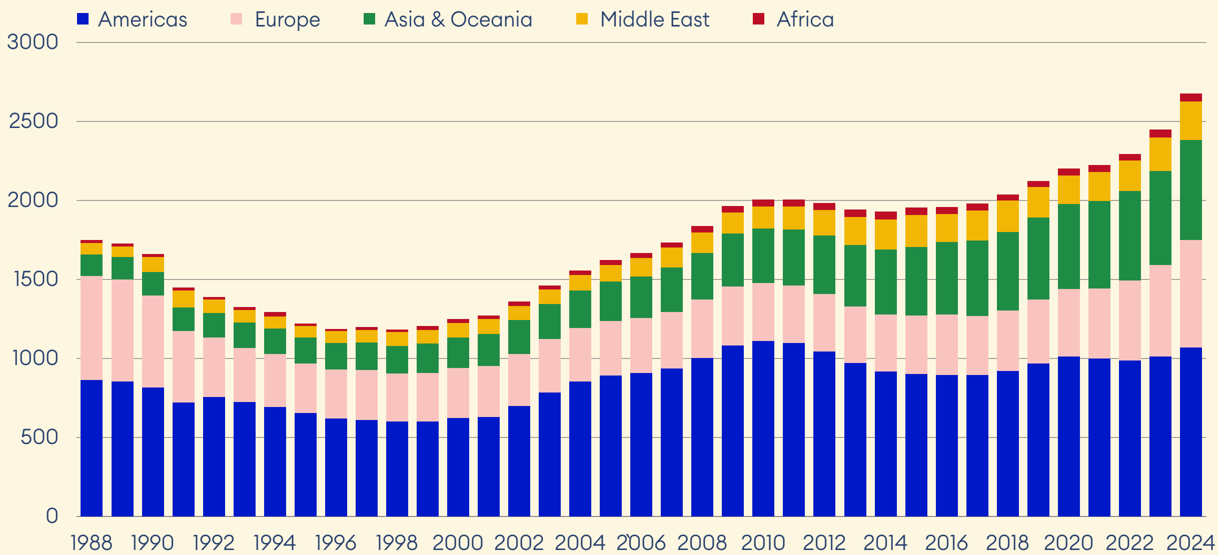
Governments around the globe have been increasing their defence spending amid mounting geopolitical risk. In 2024, world military expenditure rose 9% to $2.7tn, equivalent to 2.5% of global GDP – the steepest yearly increase in decades. While this has triggered strong demand for defence stocks, pushing up valuations, we still see good opportunities for long-term returns within the sector.

What are the biggest long-term trends in this sector?
The US remains the largest defence spender, accounting for nearly 40% of global outlays, prioritising strategic deterrence (preventing attack by convincing potential adversaries that the costs will outweigh the gains), next-generation air superiority, hypersonic weapons, and cyber capabilities.

Europe, after decades of underinvestment in defence, is undergoing a paradigm shift. Collective European defence spending increased 17% in 2024 amid the ongoing Russia–Ukraine war and the threat of America pulling back on military support for Europe under President Trump's new administration. A structural shift within NATO, with less reliance on America, also underpins the long-term growth outlook for the defence sector in Europe: allies have committed to spending 5% of GDP on defence by 2035 – with 3.5% for core defence and 1.5% for broader security (cybersecurity, resilience and critical infrastructure). This implies a multi-year rearmament cycle, with annual growth in European defence budgets projected to be in the high single to low double-digits.

How are these trends affecting valuations?
The substantial increases in defence budgets, to meet the need for EU member states to act independently in the areas of security and defence, has triggered strong demand for shares in Europe's defence sector. This has pushed valuations (such as prices relative to expected earnings and cash flows) higher. In the near term, the shares remain sensitive to headlines around peace negotiations in the Russia–Ukraine war, but the structural drivers of higher defence spending remain

Figure 2.1: Preparing for a more uncertain world
Military spending has risen as geopolitical tensions intensify (1988–2024, $bn).



Source: SIPRI (Stockholm International Peace Research Institute), Rathbones intact. In addition to this need for strategic autonomy, money will also need to be spent on rebuilding from low levels of military equipment and investing in the new weapons of modern warfare.

What's the best way to invest in the sector?
We believe the valuations of companies that tend to have longer-term contracts (such as for complex, capital intensive projects such as fighter jets, aircraft carriers or missile systems) are relatively attractive. In particular, these 'long-cycle' contractors' shares seem to be discounting less upside from increased European defence spending than their short-cycle peers, which are focused on smaller projects such as weapons and ammunition.

We also think it makes sense to focus on how well companies execute their plans, on the resilience of their supply chains and on the rates of return they get from incremental investment. These factors will be critical in converting government commitments for orders into profitable growth.

Are any long-term trends emerging that could be even more important?
Advances in computing are feeding into the trend toward cyber warfare, and AI-enabled intelligence, surveillance, reconnaissance and targeting, as well as unmanned and autonomous systems (including drones). Other technological advances include hypersonic weapons and new weapon systems, known as directed-energy solutions, that use concentrated electromagnetic energy (such as lasers) rather than projectiles (such as missiles) to disable or destroy targets.

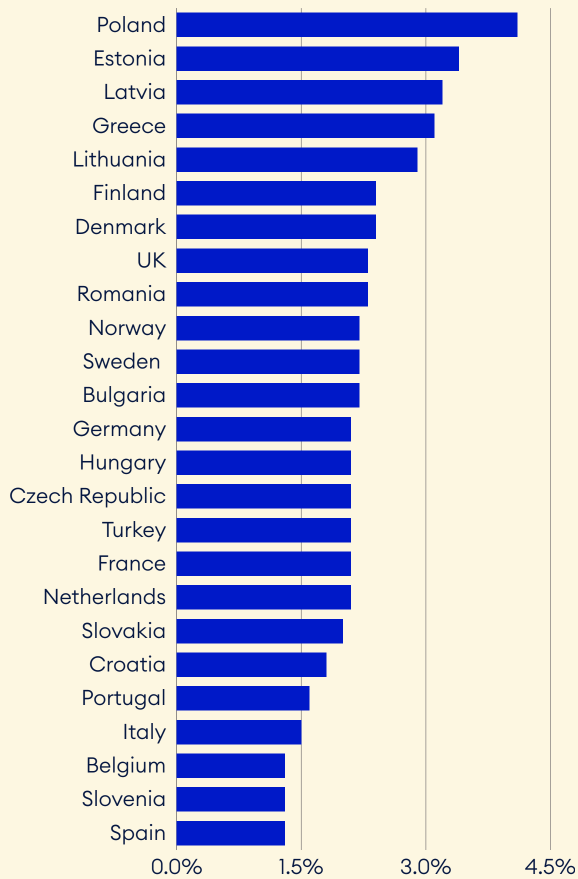
These shifts have opened the door for new, agile defence-technology companies developing disruptive solutions at speed. Established contractors also have the opportunity to embrace innovation, including through strategic partnerships, joint ventures and corporate ventures. The opportunity to compete – and increasingly collaborate – in shaping Europe's future defence ecosystem is significant, for both startups and established players with broad capabilities.

Elsewhere, US Secretary of War Pete Hegseth recently outlined a major overhaul of the Pentagon's procurement approach, with a focus on speed and cost-effectiveness. Major US defence contractors, which previously operated in a highly consolidated market, have now been warned they must adapt or will fade away.

What are we watching in the short-term?
Budget intentions take time to convert into orders and deliveries. At the same time, European governments face fiscal trade-offs, given other priorities and overall spending constraints. Still, recent policy initiatives – such as EU Readiness 2030 – are designed to ease constraints and accelerate joint procurement and growth in industrial capacity. We think this means

"Advances in computing are feeding into the trend toward cyber warfare, and AI-enabled intelligence, surveillance, reconnaissance and targeting, as well as unmanned and autonomous systems (including drones)."

Figure 2.2: Europe still below NATO targets
Most European countries remain well short of NATO's new goal to spend 5.0% of GDP on security and defence, including 3.5% on core defence.



Source: NATO, Rathbones; 2024 estimates

spending on defence will stay resilient, despite budgetary pressures. We are monitoring companies' order books, their additions to capacity and potential supply-chain bottlenecks to determine how quickly the headlines on increases in defence spending translate into sales and profits.

How have geopolitical events reshaped investor attitudes towards defence?

The Russia–Ukraine war marked a turning point, when some investors who had historically excluded defence companies on ethical grounds came to view them as essential to safeguarding democracy and stability. This shift has broadened institutional and retail investment in the sector. Beyond Europe, renewed tension in the Indo–Pacific and Middle East has reinforced the importance of defence. These investors can benefit from the sector's dependable multi-year projections for growth in sales and profits, resilient cash flows, and expertise in critical technologies that could produce strong future returns.

What are the ethical and reputational risks still associated with defence investing?

While some ethical concerns have abated, environmental, social, and governance risks remain significant. These include environmental impacts, the lethal nature of the products, human-rights concerns, bribery and corruption, and opaque supply chains. Disclosures can be limited by customer sensitivity, necessitating close due diligence and rigorous engagement with companies on governance issues. Most investors, including Rathbones, still maintain exclusions on controversial weapons – such as anti-personnel landmines and cluster munitions – even when allowing conventional defence exposure. This underscores the ongoing reputational sensitivity of investing in defence.

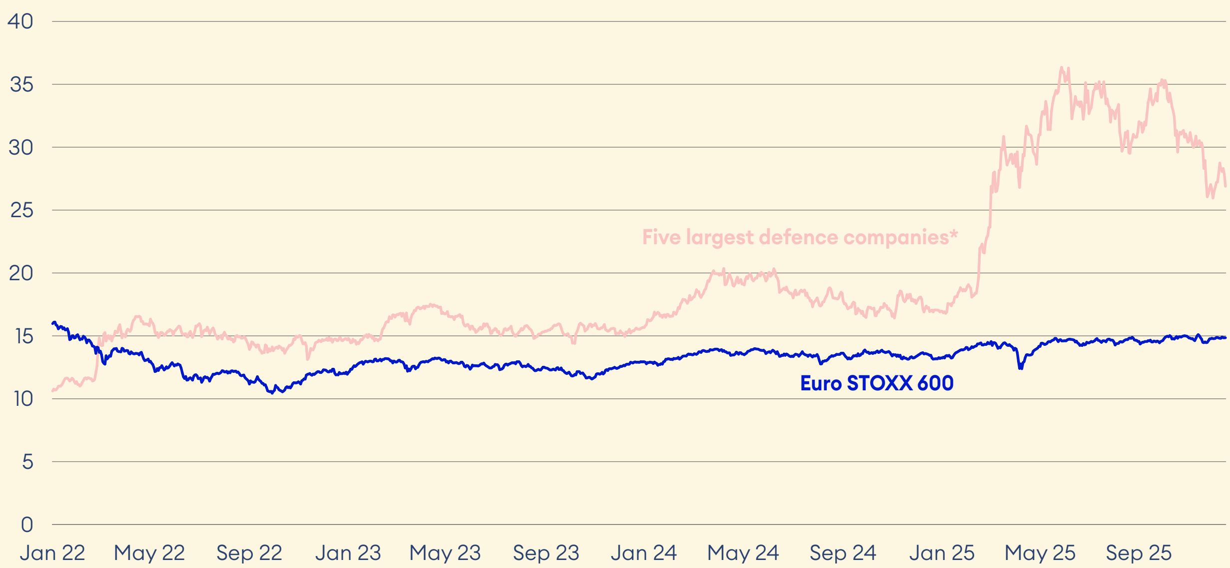
"Most investors, including Rathbones, still maintain exclusions on controversial weapons – such as anti-personnel landmines and cluster munitions – even when allowing conventional defence exposure."

Personal reflection

I was struck by the pace of innovation within the defence sector that was on display at last year's Defence Security Equipment International trade show in London, a flagship event for the UK defence sector. Out on the exhibition floor, I saw both established contractors and emerging tech firms showcasing next-generation capabilities – from AI-enabled uncrewed vehicles, planes and submarines to robotic systems for replacing human intervention in dangerous situations. The breadth of technologies on display also underscored how rapidly the sector is evolving and highlighted the growing role of automation, autonomy, and advanced AI in shaping future defence strategies.

Figure 2.3: Defence stocks' valuations stand apart

Defence companies trade on higher prices relative to annual earnings forecasts than European equities in general.



Source: FactSet, Rathbones; *weighted average prices relative to annual earnings for five largest defence firms

The battle for Fed independence
Keeping monetary policy free from harmful influence

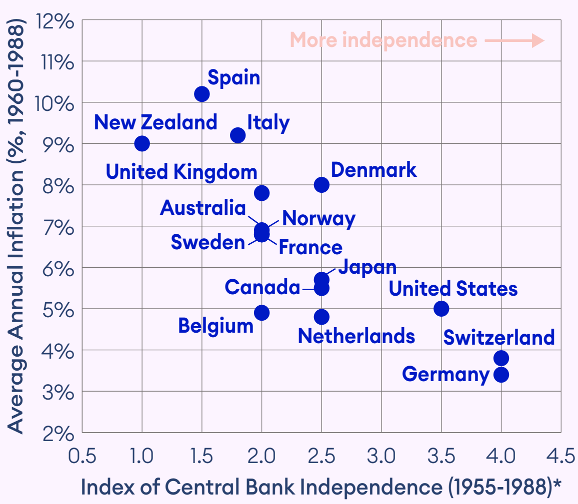
Adam Hoyes, Senior Asset Allocation Analyst

Federal Reserve Chair Jerome Powell's term expires in May. Meanwhile, President Trump is running roughshod over decades of convention with his attempts to influence monetary policy and his verbal abuse of the Fed chair. With the central bank facing a battle for its independence in the months ahead, we set out why independence is important in the first place, how big a threat Trump's actions are, and how we are responding.

We can trace the origins of many of today's independent central banks to the high inflation of the 1970s. Academics at the time showed how governments tended to over-inflate their economies, especially around elections, unless they made a credible commitment not to.

For monetary policy (controlling the amount of money and the cost of borrowing) one proposed solution was to delegate decisions to an independent central bank. The theory was that this would insulate policymakers from the political process and short-term incentives, allowing them to make initially unpopular decisions that benefited the economy in the long run. Like the gold standard of the late 1800s and early 1900s, it created a commitment to price stability, but without the unsustainable rigidity of that system.

Figure 3.1: Independence pays off
Countries with more independent central banks had lower and more stable inflation in the 1960s to 1980s, pushing other countries to follow suit.



Source: Summers & Alesina (1993), LSEG, Rathbones; * Summers & Alesina's index of independence (1993)

The theoretical work was followed by empirical evidence: countries with more independent central banks, such as Germany and Switzerland, generally had lower and less volatile inflation in the 1960s, 1970s and 1980s than those with less independent central banks, such as Spain, Italy, and the UK (figure 3.1).

The emerging academic consensus pushed many countries to increase central bank independence, often complemented by formal inflation targets. New Zealand, where central bank independence had been low and inflation high, is often credited as being the first to take such steps. In 1989 its government granted the Reserve Bank much more autonomy and the single objective of price stability – defined as 0-2% inflation in 1990 – which it met in 1991. Many others followed suit throughout the 1990s (including the UK in 1997). These changes were followed by a period of low and stable inflation in the 2000s and 2010s.

The path to independence

The Fed's path to independence has been more convoluted but still offers lessons about the benefits. During World War II it essentially followed orders from the Treasury Department, holding down interest rates to support the war effort. Unsurprisingly, the Truman administration was reluctant to give up control after the war, and low interest rates ultimately contributed to the high and volatile inflation of the late 1940s (figure 3.2). But the Fed eventually won out, reaching an agreement in 1951 that gave it much more freedom, which in turn supported the relative stability over rest of the 1950s and much of the 1960s.

Fed independence came under renewed pressure in the late 1960s when President Lyndon B. Johnson tried to persuade Fed Chair William McChesney Martin to be more accommodative of increased government borrowing. Johnson was unsuccessful but his successor Richard Nixon appointed Arthur Burns as chair. Burns proved more willing to assuage the White House's desire for lower rates, helping to set the stage for the high inflation of the 1970s (figure 3.2). It took President Jimmy

Carter appointing the famously hawkish Paul Volcker as chair in 1979 to finally tame it. As a clear global consensus for independent central banks emerged in the decades that followed, Fed independence enjoyed the support of successive presidents, who generally steered clear of commentating on monetary policy matters.

President Trump has now made a clean break with this convention. He has made his desire for lower interest rates clear, attempted to remove Lisa Cook from the Federal Reserve Board of Governors by firing her, appointed Stephen Miran (one of his advisors) to fill a temporary vacancy on the Board, and even reportedly explored firing Jerome Powell.

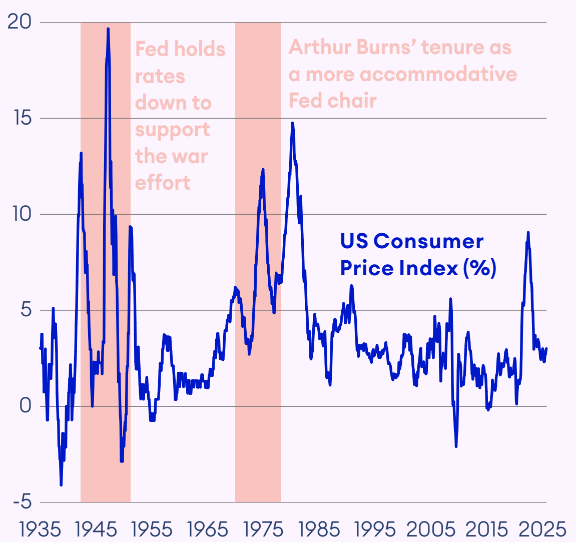
A limited impact

So far, these efforts to influence the Fed have had little impact. Trump didn't try to fire Powell in the end. Miran is only one of seven Governors and twelve voting members of the FOMC, the Fed's monetary policy-setting committee. And while he has attempted to remove Cook, the President's ability to do so has been challenged in the courts, leaving her in post for now.

But the Fed may come under more political pressure. The Supreme Court will hear oral arguments on January 21 on whether the President has the authority to fire Cook, and it isn't a foregone conclusion that the court will rule against him. If Cook is fired, that will open another spot on the Board to appoint someone potentially more sympathetic to Trump's views. He will also be able to pick a new chair from the Board members when Powell's term as chair ends in May.

Figure 3.2: When politics met policy

Political pressure on the Fed helped fuel inflation before independence was restored.



Source: LSEG, Rathbones, as of 12 December 2025

> We think it's most likely that the Fed will resist these efforts to undermine its independence.

Media reports suggest a leading candidate is Kevin Hassett, who is regarded as something of a Trump loyalist and could be appointed to the Board either in place of Miran (whose term ends in January), Cook (if fired), or Powell (who isn't obliged to resign from the Board when his term as chair ends, but that has been common historically).

As things stand, we think it's most likely that the Fed will resist these efforts to undermine its independence. To install a sympathetic majority on the Board the President would need to replace (by firing or via voluntary resignations) Cook, Powell, and one more governor. And to get a majority on the FOMC, he would either need to replace at least two more governors on top of that or persuade the Board to fire regional heads that make up the other five FOMC voting members. Trump's hesitancy to fire Powell and a Supreme Court judgement last year (hinting that it may only support the firings of governors "for cause") both suggest such aggressive action is unlikely.

The impact of influence

That said, the President is nothing if not unpredictable, so there is still a small risk that Trump might manage to reshape the FOMC with a majority of supporters. Even a signal that Trump is making a more concerted effort to influence the Fed could fuel investors' fears of political influence, potentially leading to higher US inflation and higher interest rates down the line to counter it. A perceived increase in this risk could prompt a sell-off in longer-term government bonds. After all, we've already had one demonstration of this in July amid reports that Trump had drafted a dismissal letter to Powell.

This risk is just one reason why we're taking a cautious approach to the bonds we choose to include in portfolios – generally preferring those that mature sooner. Indeed, we think this is just another symptom of a broader erosion of central banks' power to keep inflation low and stable. Not least given growing demands on them to prevent crises erupting in bond markets in the face of continued large-scale borrowing by governments.

This is also why, in many portfolios, we continue to include diversifying assets, such as gold and actively managed strategies – which could perform relatively well when inflation is running high or markets are generally volatile.

Snapshot
The global economy and markets

Figure of the month

$514bn

Expected 2026 capital spending of five big tech firms – Alphabet, Amazon, Meta, Microsoft and Oracle – roughly equal to the size of Norway's economy. Much of this investment is driven by AI. Optimists see AI unlocking faster economic growth. Sceptics argue the benefits may take years to materialise and accrue more to customers than to shareholders.

At a glance

$1.076tn
China's trade surplus (first 11 months of 2025)

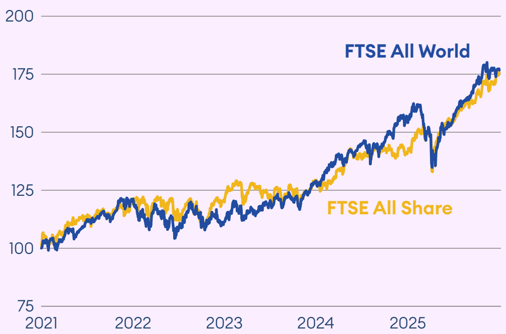
7.4%
US fiscal deficit for 2025 (forecast)

20%
Annual rise in Arabica coffee prices

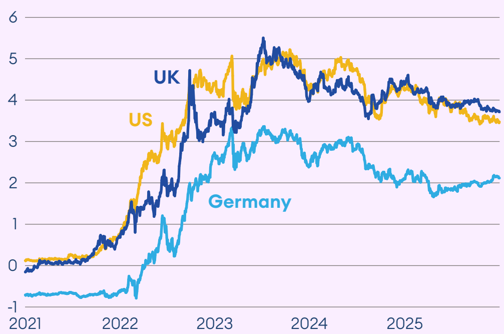
0.2%
Germany's GDP growth in 2025 (forecast)

Key market indicators

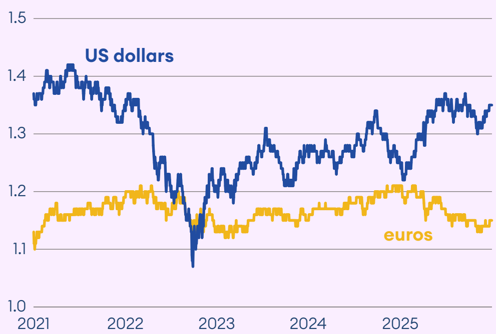
Equities
Total return in sterling (1 Jan 2021 = 100)



Government bonds
2-year yields (%)



Sterling
Value of £1 in US dollars and euros



Corporate bonds
Option-adjusted spread over government bonds (bp)

Sources: FactSet, LSEG, Rathbones

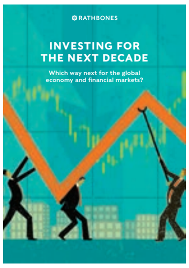
Find out more
Knowledge and insight

Alongside this monthly *Investment Insights* publication, we share a wide range of updates and analysis, from regular strategy commentary and video briefings to in-depth reports, all designed to help you understand what's driving the global economy, financial markets and the outlook for investment returns. To explore more, visit www.rathbones.com/en-gb/wealth-management/knowledge-and-insight

Video updates
Stay informed with regular update videos from Ed Smith, our Co-Chief Investment Officer, that explain how geopolitical tensions, market movements and global economic trends could affect your portfolio.

Weekly and monthly digest
Keep up to date with regular insights from John Wyn-Evans, our Head of Market Analysis, as he explores the key themes shaping the global economy and investment environment.

Research reports
In line with our focus on long-term investing, we produce in-depth reports. These publications reflect the thinking behind our portfolio decisions and explore how structural trends, risks and opportunities could affect investors over the long term.



The next decade for the global economy is likely to look very different to the 2010s. *Investing for the next decade* explores how the opportunities in fixed income have changed, the possible outlook for equities and why we believe the extraordinary outperformance of the US could end.

Geopolitical risks have risen in recent years, from conflict in the Middle East to tensions in the Taiwan Strait. *Peace of mind in a dangerous world* outlines the four risks we monitor most closely, the warning signs we look for, and how we prepare portfolios to help protect your investments.

Experience and expertise
Rathbones has a large and experienced in-house research team, covering global equities, fixed income, multi-asset strategies and responsible investing. With specialists dedicated to analysing market trends, sectors and individual securities, our team brings deep insight and rigorous discipline to every portfolio. This depth of knowledge allows us to uncover opportunities, manage risk effectively and respond quickly to changing conditions, helping you to invest with greater confidence.

You can access this expertise in a range of ways, from fully bespoke discretionary portfolios to ready-made multi-asset funds, tax-efficient investment strategies and specialist services for complex needs. To find out more and for details of your local office, visit www.rathbones.com/en-gb/wealth-management/contact-us