RATHBONES

Monthly Digest

By John Wyn-Evans
Head of Market Analysis

Back to school, market lessons

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We look past the headlines as earnings resilience battles AI worries, bond market nerves, and geopolitical uncertainty.

Quick take:

- August was respectable for markets despite louder geopolitical and policy noise.
- AI concerns have not derailed earnings, but leverage remains a key risk.
- Bond markets are forcing governments to confront uncomfortable fiscal realities.

The cacophony seems louder than ever. Behaviour is getting unruly, and it's time for the headmaster to call the class to order: a brief look back at summer, then it's time to lay out the curriculum for the term ahead.

Despite scary headlines, August was very respectable for markets and balanced portfolios. Concerns persist - from geopolitics to interest rates. But companies continue to deliver strong earnings, leaving investors to balance resilient fundamentals against persistent risks.

In the last Monthly Digest, [Waiting for God(ot)], we covered four unresolved themes: the Iran War, AI, central bank policy, and the UK's public finances. If anything, the waters have become murkier. Even so, investors have taken solace from an encouraging second-quarter company results season and purchasing manager surveys suggesting the global economy is navigating these challenges.

(Lack of) Situational Awareness

At the beginning of August, markets were digesting the rapid loss of value of the hedge fund Situational Awareness. We read this as an isolated incident involving a relatively inexperienced fund manager with extreme views on AI who became overextended and was forced to liquidate his positions; so it proved. There was some contagion into the more speculative corners of Asian markets, but it was contained, helped by Citadel (a much bigger hedge fund), which mopped up the spillage. Citadel has already booked its multi-billion-dollar profits on the trade and moved on.

Such incidents are keeping investors on edge. Bank of England Governor Andrew Bailey recently warned that a sharp fall in the value of AI-related companies could trigger a market sell-off - an easy line for alarming headlines.

But context matters. Bailey chairs the Bank's Financial Stability Board, whose job is to flag market risks, not predict imminent crises. After missing many warning signs ahead of the global financial crisis in 2008, regulators are understandably determined not to be caught out again.

It is worth reiterating the warning by Charlie Munger, the late confederate of famed investor Warren Buffett, that (financial) leverage is one reason why "a smart person can go broke" (with the others being "liquor" and "ladies"). That's not to say that debt should be avoided at all costs. Indeed, the world would be a less developed place if savers were unwilling to lend to innovators and entrepreneurs who could then create new productive assets. Companies can optimise their balance sheets to blend more expensive equity capital with debt to maximise returns for shareholders. But when investing, we avoid highly leveraged instruments. The potential upside is outweighed by the risk that volatility forces untimely selling or, worse, a total loss of capital.

A welcome dip

This extraordinarily hot summer has made any dip in cool waters a welcome relief. The latest AI-related sell-off gave investors another chance to 'buy the dip', sending global equity indices to new all-time highs. We recognise that, at some point, there will be a dip not worth buying.

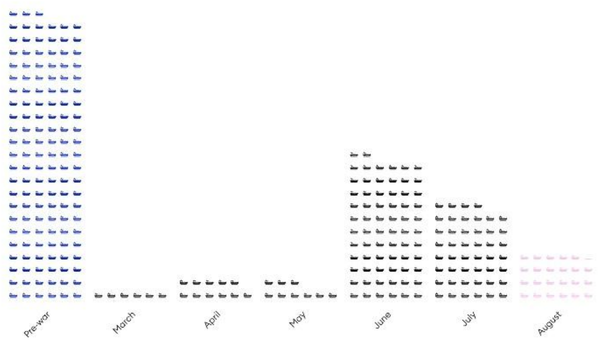
Even so, there's no imminent catalyst for a major setback in economic growth or profits.

If trouble arises, it will probably result from a geopolitical mistake or a bond-market riot. In geopolitics, the US, Iran and Russia make for difficult analysis, but game theory still suggests severe escalation is a lower-probability outcome, even if the impact could be high.

Persistently high oil prices from Middle East supply disruption are not fully baked into expectations. Bank of America's August Fund Manager Survey found only 1% of respondents expect the price of a barrel of oil to be over $100 by the end of the year (versus $95 for the Brent crude international benchmark at the time of writing). The consensus is that US President Donald Trump wants to declare some sort of victory before the 3 November mid-term Congressional elections, using escalation to pressure Iran to agree to acceptable terms. But Iran knows this and will also seek to extract the best possible terms for itself.

Weapon of mass disruption

The number of vessels passing on the average day through Strait of Hormuz remains much lower than before the Iran War, as Iran uses its power to create shipping chaos as leverage.



Source: International Maritime Organization, Lloyds List Intelligence, Rathbones. Oil Tanker by Yosua Bungaran from Noun Project.

The Streisand Effect

In 2003, the singer and actor Barbara Streisand tried to remove an aerial image of her Malibu home from the internet. Captured for a documentary about Californian coastal erosion, it had been seen by only a handful of people interested in the subject. Her high-profile lawsuit counterintuitively drew attention to it, and viewership rocketed.

The US Treasury Secretary, Scott Bessent, seems to have made a similar blunder, albeit in the rather more important US bond market. Yields had been rising, but panic only began when the US joined Japan to support the yen. In theory, there was nothing untoward in that; in practice, there was. US yen purchases were funded from euro reserves, while Japan was offered dollar liquidity through the US's central bank, the Federal Reserve. This allowed Japan's Ministry of Finance to access dollars (to buy yen) without having to sell any of its US Treasuries.

Bessent then went further, announcing buybacks of longer-dated bonds funded by issuing short-term government debt. The purpose was to stop the rot in Treasuries, but the effect was to highlight the precarious state of US public finances. Interest payments and entitlements already absorb all US government revenue, leaving discretionary spending to be funded through deficits running at around 6% of GDP.

The icing on the cake was a suggestion that the Treasury General Account (TGA) - effectively the government's current account at the Fed – could be used to buy back bonds. It's meant for day-to-day spending and liquidity shocks, not as a slush fund to suppress yields.

Restless traders, with most of the results season behind them and no new AI themes to chase, alighted on bonds, and a fresh round of selling began. The US was not alone. Four other targets with fiscal problems are in investors' sights: the US, Japan, the UK and France.

We've avoided longer-dated government bonds for precisely these reasons, but we may finally be approaching the point where investors force politicians to address structural fiscal deficits. And while bonds offered no shelter from weaker equities in 2022, it's worth remembering that the UK 10-year gilt bottomed at just 0.07%, compared with 5.2% today.

Conclusion: More heat than light

The current market environment remains challenging. The old mantra of 'time in the market' is better than 'timing the market' has again proved helpful. So too has diversification, which has mitigated some of this year's volatility. We hope the 'time in the market' mantra has encouraged investors to stay the course.

As ever, energy is devoted to every passing piece of news, fed by a bottomless repository for information and commentary demanding daily replenishment. That, alongside current market structures, exaggerates short-term price swings. Like Odysseus in this summer's blockbuster hit movie, we sometimes must tie ourselves to the mast and resist the siren calls. At the same time, we remain vigilant for the rocks and whirlpools lurking close to our path.

Regional highlights

UK. The FTSE 100 failed to make any progress in August, but the mid and small-cap indices performed better. This could be attributed to continuing takeover activity and, to some degree, perhaps, to the 'Burnham Bounce', a feeling that the new Prime Minister will have more success in growing the economy.

But we're taking nothing for granted, especially before the latest Chancellor, John Healey, reveals his Budget on 28 October. The rise in interest rates and bond yields looks set to force his hand. Not only do Burnham's policy promises need to be funded, but 'fiscal headroom' needs rebuilding. This is the margin of safety required to allow some flexibility if revenue undershoots expectations. At the time of the Spring Statement, it was estimated at £23.6bn, but it's probably around £10bn less today. Many would like the narrowing in this gap to be addressed by reducing spending, but past experience suggests that this will be a struggle to get past Labour's own MPs. We're going to have to brace ourselves for higher taxes again.

But with manifesto promises leaving income tax, employee national insurance contributions and corporation tax off limits, there's only so much juice to squeeze. One suggested initiative is a 'defence levy' to fund increased defence spending, although if applied to income, it would be no more than a badly disguised income tax increase. Wealth remains the easy target and gels with Labour's soul. Aligning the Capital Gains Tax rate (now 24%) with Income Tax could scoop an extra £7.5bn, according to Capital Economics. There will also be the usual speculation about changes to pension rules, such as those covering the tax-free lump sum allowance. Worst fears have not been met in the past, but we cannot rule anything out. We continue to advise clients to seek financial advice before taking any possible evasive action.

US. S&P 500 consensus EPS growth for 2026 has increased by 16% since the US launched its first attacks on Iran and by 17% this year. Nobody was expecting that. Indeed, the worry at the time was by how much earnings estimates might fall. It's fair to say some of that is coming from higher energy sector profitability (3.1%), which is really just a wealth transfer rather than the result of productive investment and growth. Around half is from AI-related investment as hyperscaler capex continues to expand. From 2027, it's expected to be more than a trillion dollars annually. There are still huge questions around the eventual returns on all of this capex, how it's being funded, and how productivity growth is going to be distributed through the economy. These questions will remain key talking points.

The S&P 500 rose 2.7% in August, with leadership once again coming from high-profile technology shares, notably Nvidia, Microsoft and Tesla. But a custom index that removes the contribution from 'AI enablers' also gained 2.1%, suggesting healthy, broader participation.

Europe. Citigroup's Economic Surprise Index (a single number that tracks whether economic reports are beating or missing the consensus forecasts of financial analysts) for the region rose from -82 in May to another new high of 91 in August, although it has since slipped back to 73. This unexpected resilience of the eurozone economy has contributed to strong performance, especially from its banking sector. We've seen a steady rise in demand for loans and a willingness to meet that demand.
And yet there is a nagging suspicion that the region remains vulnerable. The political cycle is entering a tricky time

again, with a recent sell-off in the French bond market betraying nerves ahead of April's Presidential election. According to the latest opinion polls, the populist National Rally contender, Marine Le Pen, would beat the leaders of any other party should she succeed in getting through to the second Sunday run-off. This is contested between the two most popular candidates if no one secures a majority in the first round. Nobody has achieved that since the current system was introduced in 1965. Indeed, the last President to be elected with a majority first time round was Louis-Napoleon Bonaparte in 1848! We're also keeping an eye on reserves of natural gas. These are currently at the lowest levels recorded for this time of year as buyers have held off, awaiting resolution in the Middle East and lower prices. Something is going to have to change, or else the Continent faces energy shortages this winter.

Fixed Income. The Bloomberg Global Aggregate Bond Dollar Index rose 0.45% in August. The sterling-hedged version returned +0.11%. That might come as some surprise given the bad press given to the bond market. But it illustrates that it's worth stepping back from the noise and looking at the numbers. It also reminds us that the 'carry' on bonds is not insubstantial. With the UK 10-year yield at 5.2%, an investor's starting point is to clip a coupon equivalent of 0.43% every month. As we pointed out last month, the yield on a 10-year Gilt would have to rise from the current level to around 6.9% to expose an investor to a negative nominal total return on a three-year view, with the caveat that this would not take inflation into account. With this in mind, we still find short-dated index-linked Gilts a suitable vehicle for pure wealth preservation at the current time. They offer a real yield (i.e. over and above inflation) of close to 2%.

The All UK Conventional Gilts index delivered a total return of -1.4% over the last three months and 1.8% over the past year. Index-linked gilts returned -2.4% and 2.7% over the same respective periods. Emerging market bonds produced a total return of 3.5% in sterling over the three months to the end of August (17% over 12m). Global high-yield bonds delivered 0.9% (4.2% over 12m) in sterling terms.

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greenbankinvestments.com

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