RATHBONES

Monthly Digest

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Still looking for what could 'go right'

6 January 2026

Equity gains were stronger than average in 2025, pleasantly surprising investors who are still climbing a wall of worry. The outlook remains positive as we look ahead to the new year, though similar uncertainties also look likely to persist.

This first monthly commentary of 2026 provides the usual opportunity to look back on the past year, take stock of the current situation, consider what might happen in the year ahead and set out how we should position portfolios.

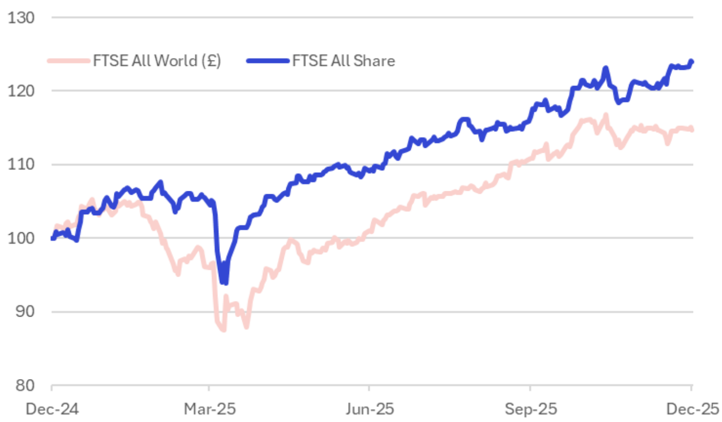
Most investors have been pleasantly surprised: returns were higher than the long-term average last year (figure 1). Yet the general mood does not reflect that. Some are disappointed not to have made more, given another exceptional period for companies involved in the development of generative artificial intelligence (genAI); others remain fearful that some sort of market crisis is just around the corner.

It paid off to regularly ask the question "what could go right," and more of that sort of attitude could be required in 2026 as all sorts of uncertainties continue to cloud the outlook.

Quick take:

- UK, European and emerging markets did exceptionally well in 2025
- Economic conditions remain supportive, with inflation easing and rates coming down
- Diversification could be key to sustaining returns in 2026

Figure 1: UK vs World equity returns (2025)



Source: LSEG, Rathbones; total returns, rebased to 100 from 31-Dec 2024

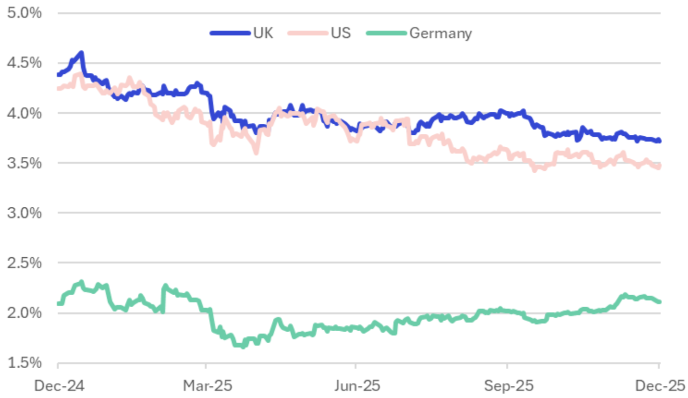
Better than average

Amid the generally higher-than-average returns for equities, some markets did exceptionally well. There was a long overdue spurt of decent performance for

The value of investments can go down as well as up and you could get back less than you invested. Past performance is not a reliable indicator of future performance. This information should not be taken as financial advice or a recommendation.

the FTSE 100 (+22%) and a welcome return to form for European (+23%) and Emerging Market (+22%) equities. All of them outperformed the US (+8%) despite it being the home of the big technology leaders (performance data in sterling). Bond markets were relatively steady, with the odd wobble on concerns about government indebtedness (figure 2). This left balanced portfolios in decent shape.

Figure 2: 2-year government bond yields



Source: LSEG (lower yields=higher prices)

Even so, and as we anticipated a year ago, there were bouts of volatility. The main contributors to those were US President Donald Trump and the technology sector. The reaction to 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. But within days Trump had declared a 'pause' in their application. Markets rallied and have barely looked back since, as this pattern repeated itself several times, with diminishing effects, throughout the year.

Show me the money

There were three bouts of volatility related to genAI. The first was the January release by China's DeepSeek of its large language model (LLM), reportedly developed on a shoestring budget. The reality was not quite as compelling, and confidence soon recovered. Still, if China does not possess the 'brains' of leading technologies, its access to plentiful cheap energy – a key input for datacentres – leaves it well placed to make progress through the employment of 'brawn'.

The second moment of short-lived concern came with the summer release of an MIT study claiming that 95% of corporations employing some sort of genAI solution were seeing no benefit. We are very early in the adoption cycle and it seems that many of the users were trying to use generic LLMs where application-specific tools were needed. We remain confident that usage will evolve and deliver increases in productivity.

Still, with annual expenditure on data centres now running into the hundreds of billions of dollars, investors are keen to see a return on that investment, especially as more of it is being financed by debt.

We seem to have reached an inflection point where investors are demanding to see more revenue and profits before making further commitments. A big test could come this year if, as rumoured, both OpenAI and Anthropic (owner of the Claude LLM) attempt to list their shares on public markets.

Forward momentum

While trade and technology seem likely to continue dominating investment conversations, there ae plenty other things that merit our attention. Global economic conditions are generally favourable. Consumer and corporate finances are in decent shape, unlike those of many countries, and there has been a recent pick-up in surveys of business activity. With inflation lower, interest rates are falling in the majority of countries, and governments appear either unwilling or unable to cut their own spending. Even Germany has rediscovered the spending habit. A year of tariff-related uncertainty has left a potential backlog of (non-AI) capital investment that needs to be made. The probability of recession – one of the main threats to an equity bull market – is currently low.

Conversely, the risk might be that growth is too perky and inflation too sticky. That is certainly something we will continue to monitor, as will central banks. Core inflation in, for example, the US and UK, is proving slow to return to the 2% target. Our central view is that it is likely to remain generally higher and more volatile than in the pre-covid era, fuelled by political preferences (for more deficit spending and less ‘globalisation’) and issues such as climate change and demographics. It’s a key reason why we continue to prefer shorter-dated and less interest-rate-sensitive government bonds.

Although government bonds are unlikely to repeat the kind of losses they suffered as inflation spiked in 2022, longer dated bonds remain vulnerable to concerns about persistently high government debt. Precious metals have proved much better safe havens recently. We don’t expect last year’s strong gains to be repeated, but we continue to see a role for them in asset allocation, especially gold. We can also use actively managed funds, which are designed to provide steady but unspectacular nominal returns in different market environments. They will tend to lag strong bull markets but preserve capital when the going gets tough.

Political agendas

Politics will be on agendas again in 2026. Domestically, betting markets do not reflect much optimism about the Prime Minister or his Chancellor still being in office a year on from May’s local elections. A change of leadership could take Labour’s policies further to the left, a prospect that investors are unlikely to cheer. The pound is another barometer of political risk to keep an eye on. 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. But there may be some upside here - with his favourability ratings at a low point for this presidency, Donald Trump may well be keen to whip up support and not create economic upsets.

Sailing into the wind

As we have for the last couple of years, we see balanced portfolios continuing to make gains into these headwinds. We, too, were pleasantly surprised by 2025's returns, but in retrospect they were justified by strong corporate profit growth. Equity prices have risen further relative to earnings in anticipation of future growth, and it is harder to see valuations going up again this year. But we also continue to resist talk of a bubble in equity markets. Yes, the average price of shares in the US market looks elevated at around 22 times 2026 earnings forecasts.

But with projected earnings growth of around 13% and a core of very profitable companies, a specific catalyst such as an unexpected economic deceleration or sharply higher interest rates and bond yields (we're not expecting either) would be needed to push valuations lower.

We also expect some broadening of returns this year. Other regional markets continue to offer more attractive valuations, and it wouldn't take many things to 'go right' for them to attract further interest from investors. And a broader range of companies should experience productivity gains from the implementation of genAI in their processes. As ever, diversification is the key to sustainable returns.

Regional highlights

US. Owing to their weight in global equity market indices (accounting for almost two-thirds of the global market capitalisation), US equities were once again the key contributors to investors' wealth accumulation in 2025. Even so, the main indices underperformed their non-US peers, and even more so when currency movements are taken into account, given that the trade-weighted dollar index devalued by almost 10%.

Since the launch of ChatGPT three years ago, returns have been dominated by companies involved in the development of genAI. Although the concentration was less marked in 2025, the best performing sectors were still Communications Services (thanks to Alphabet's 65% gain) and Information Technology (home to the world's biggest company, Nvidia, which gained 39%). However, only these two of the so-called 'Magnificent 7' market-leading technology-related companies outperformed the broader S&P 500 index over the year as investors became more discerning in picking the winners. At the sector level, only Comms Services and IT managed to do better than the index.

Even so, there were tentative signs of a broadening out of returns as the year progressed, with Healthcare notably making up a lot of lost ground once some of the uncertainty over drug pricing had been lifted thanks to new agreements with the Trump administration. For 2026, the average strategist forecast is for US equities to return around 10%. Despite elevated valuations, this is not unreasonable if the economy continues to grow and companies can achieve low double-digit earnings growth as currently forecast. Risks to this rosy scenario include a recession or an overheating economy that would force the US Federal Reserve to tighten monetary policy.

UK. Although the UK economy had grown by a meagre 1.1% over the twelve months to the end of October, the FTSE 100 returned 26% in 2025, including dividends. In terms of points contribution, the leading lights were HSBC, AstraZeneca and Rolls Royce, representing very different industries. Indeed, with BAT, Shell, Rio Tinto and Prudential all in the top 15 contributors, the UK offers a level of diversification often lacking in other markets.

From a sector perspective, the best performance came from Financials (+41%) as banks continued their rehabilitation. Current interest rates allow them to earn decent margins on lending and, despite the weak economy, credit conditions remain benign. Even now, though, they have not completely shaken off the stigma from 2008's financial crisis: they trade at lower valuations than peers in other regions.

The FTSE 250 (+13%) and Small Cap (+11%) indices lagged, owing to their greater exposure to the domestic economy. Furthermore, UK institutional investors continue to increase their exposure to non-UK stocks at the expense of their domestic holdings. This continues to weigh on performance. Many of the biggest gains in these smaller companies came by way of takeovers, and the UK still appears to be a fertile hunting ground for both industry and private equity-backed acquirers.

Europe. European equities had an exceptional year in 2025, and one that looks even better when the euro's strength is taken into account. The MSCI Europe ex-UK Index gained 21% in euros, but 27%

in sterling terms and a remarkable 37% when measured in dollars. Financials (+42%) was the leading sector here, too, with banks' shares enjoying a similar rerating to those in the UK.

The new German government's approval of more than €1 trillion of fiscal stimulus marked a major shift in its policy, while expectations for defence spending more broadly were boosted by President Trump's desire to see the US' allies take on more of the burden of providing their own security.

Europe is by no means free of troubles, with the frequent collapse of French governments a reminder of its wider fiscal and political headwinds. Even so, we remain confident that Europe has the opportunity to capitalise on increased confidence.

Emerging Markets. We often observe that the Emerging Markets label is misleading because the components have different drivers. 2025 was a case in point. China (+32%) was no longer 'uninvestible' as investors latched onto the promise of its cheaply valued technology stocks. India (+12%) paid the price (in relative terms) for previous outperformance owing to its status as a 'safe haven' from concerns about China.

Of the larger markets, the best performer was South Korea's Kospi index (+79%), thanks to demand for companies such as Samsung (+126%) and SK Hynix (+275%) which benefitted from genAI-related investment.

More traditional industries, including defence and shipbuilding, were also beneficiaries of global trends. Whereas in the past EM investing tended to be about following the booms and busts of China's economy, performance today is more correlated with the tech-heavy Nasdaq Index, although comparable exposure can often be found at much lower valuations. Even after last year's surge, the Kospi Index trades at 10.3 times earnings forecasts for the next 12 months.

Fixed Income. The Bloomberg Global Aggregate Bond Index gained 8.2% in 2025, although much of that was down to the weak dollar. The sterling-hedged version returned 5%. Effectively, bond investors clipped the coupons and there was minimal capital return.

There are two main features to observe. One is that yield curves 'steepened' as longer-dated bond yields failed to fall in line with short-term interest rates. This increased 'term premium' appears to reflect nagging concerns about persistently high fiscal deficits, as well the potential for inflation to remain above central bank targets. The other is that, despite the underlying concerns, bond volatility (as measured in the US by the ICE MOVE Index) fell sharply, indeed by the most since 2009, which was the year following the financial crisis.

Our preference remains to keep bonds on a short leash, with minimal exposure to duration (a measure of interest-rate sensitivity). This means that we can benefit from yields that are still attractive, with some potential tailwinds from further reductions in central bank interest rates. They also come with less exposure to the risks associated with deficits and inflation.

The All UK Conventional Gilts index delivered a total return of +3.1% over the last three months and +5% over the past year. Inflation-linked gilts returned +3.1% and +0.6% over the same respective periods. Emerging Market bonds produced a total return of +4.8% in sterling over the three months to end December (+13.2% over 12m). Global high-yield bonds (riskier debt with credit ratings below 'investment grade') delivered +1.3% (+7.5% over 12m) in sterling terms.

Additional information

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