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Monthly Digest

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Waiting for God(ot)

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We look past the noise as Iran, AI, and central banks leave investors waiting for resolution.

Quick take:

- Markets are waiting for a 'deus ex machina', but a crisis would be a high price for clarity.
- The Iran war looks contained for now, though dwindling oil buffers leave little room for complacency.
- AI demand keeps rising, but investors are questioning funding, returns, and who ultimately pays.

Ancient Greek playwrights, when in need of a conclusion, often used the 'deus ex machina': a god winched down to resolve the plot.

With broader indices struggling for direction, do we need a higher force? Usually, that force takes the form of government or a central bank. The problem is they usually intervene when a crisis is at hand, and it would be churlish to invoke a crisis to break the current logjam.

The same themes keep recurring: the Iran War; AI optimism and pessimism; central bank policy; market-crisis fears; and UK fiscal politics – and remain far from resolved.

The great gulf

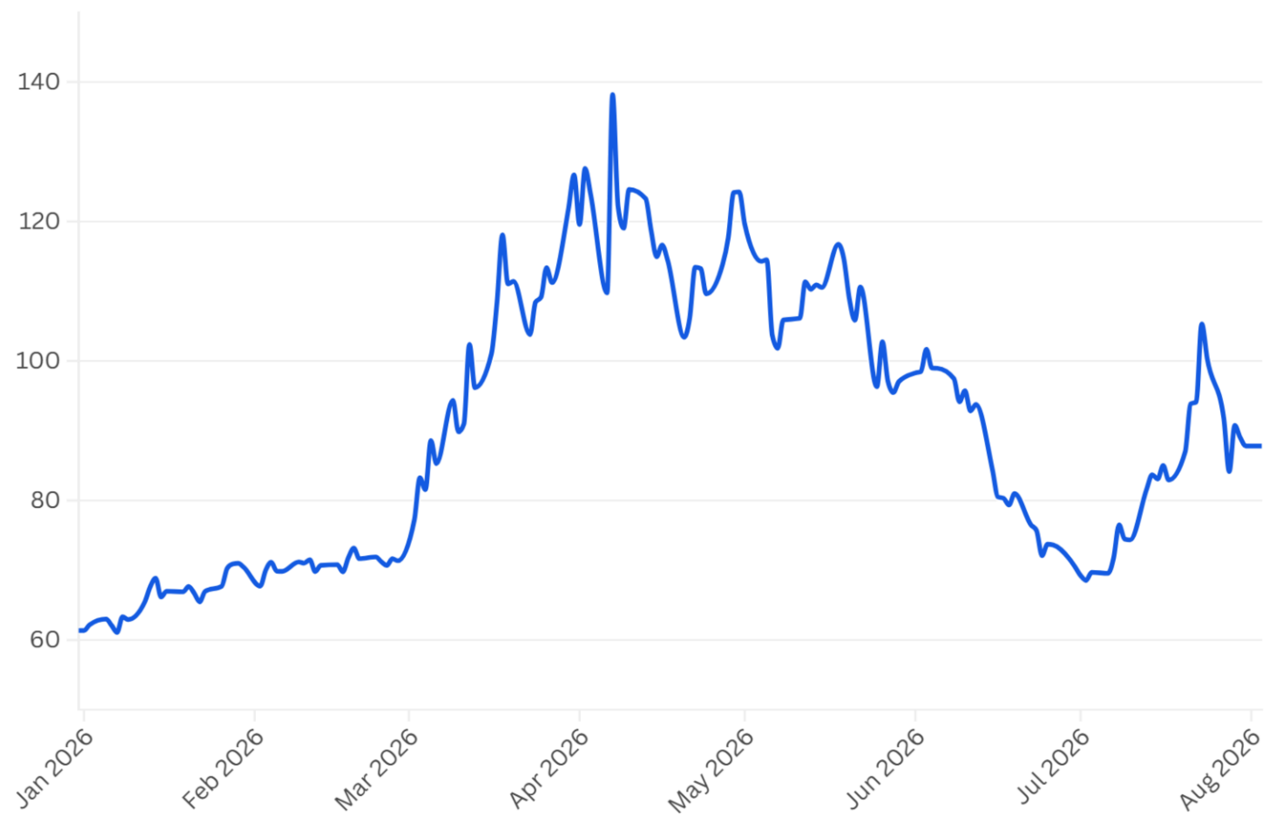
Ships and commodities remain trapped in the Persian Gulf amid the ongoing closure of the Strait of Hormuz.

Any commentary comes with the caveat that events may have moved on by the time of reading. Still, the sticking points are clear: the US, Gulf states, and most of the world want free passage through the Strait of Hormuz, while Iran sees the threat of closure as both a means of leverage in negotiations and a possible source of future income. The US is determined to neutralise Iran's nuclear threat; Iran is loath to comply.

The global economy has cruised relatively unscathed since the war began in February, risking complacency. Oil consumers drew on strategic reserves, but these have dwindled. Energy source pivots and a modicum of privation are the easy

The crude collar

Brent crude oil price, $/bbl, 31 Dec 2025–3 Aug 2026



Source: FactSet, Rathbones

wins that one might describe as trimming fat, but we're getting closer to the muscle now.

So why do markets remain relatively calm? The consensus is that neither side has the appetite for prolonged hostilities as the financial and political costs rise, and the US is rumoured to be running low on key ordnance.

BCA Research's credible "oil price collar" theory sees Brent crude trapped between $70 and $100 a barrel. At the lower end, tensions tend to rise as the political and economic costs fall; as prices approach the upper end, escalation gives way to de-escalation as the costs rise again. That concept, albeit a fragile one, seems to be holding.

Mismatched expect-AI-tions

Amara's Law says we tend to overestimate a new technology's short-term effect and underestimate its long-term impact. Generative artificial intelligence (AI) is showing this today, with extreme consequences for certain share prices.

The AI push is largely driven by frontier large language model (LLM) developers (think ChatGPT, Claude, or Google Gemini) and the 'hyperscalers' building the data centres needed to train and run them. LLM funding has come largely from private equity backers.

Hyperscaler spending has so far been funded largely by operating cash flow, which is massive for companies such as Alphabet, Microsoft, Meta, and Amazon (with Oracle, of the Big 5, being the notable debt-funded exception). The numbers are mind-boggling: annual capex is forecast to rise from $224bn in 2024 to around $700bn this year and $900bn in 2027.

Problem number one: this level of capex is now outrunning cash flow generation. This leads to massive equity issuance ($85bn for Alphabet, for example). It also prompts huge debt issuance (more than $200bn so far in 2026 in public markets and potentially the same again in private markets and through the backing of special-purpose off-balance sheet vehicles).

Problem number two: will all this spending generate a return? It must beat the cost of capital and, ideally, match the returns from existing operations. That is a high bar for hyperscalers, whose exceptional performance has been built on scalable, 'capital light' business models where the majority of every dollar of extra revenue turns into profit.

Problem number three: who's paying for the service? Engagement with LLMs has risen exponentially, but most users are not paying for them. Revenue is mainly coming from 'enterprise' customers, or companies. Anthropic's record revenue growth has yet to translate into a sustainable profit.

Billing has shifted from an 'all you can eat' basis to a 'per token' or 'per task' model earlier this year. As invoices rose, usage was curtailed or switched to cheaper models for less onerous tasks, many of which are based in China, which is another concern.

This all makes for a very difficult market to negotiate on a short-term basis. Especially as ownership of the shares involved is meaningfully funded by borrowed money and by leveraged exchange-traded funds and options, all of which exacerbate short-term volatility. The forced liquidation of positions by a hedge fund, ironically called Situational Awareness, at the end of

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July now seems to have been a key contributor to recent gyrations.

Our central view today is that both the frontier model builders and the hyperscalers are committed to their growth paths, and the demand for computing power will continue to rise as companies and individuals learn to integrate AI-based solutions productively into their operations and lives, especially if it becomes cheaper (as in Jevons' Paradox). But it will not happen linearly.

For longer-term investors, swings from overoptimism to unmerited pessimism create opportunities for active managers.

Central bankers sit on their hands

The latest central bank meetings produced no changes to monetary policy. The new US Federal Reserve chair, Kevin Warsh, has made his committee's intentions less clear and allowed markets to set rates. Markets have duly obliged, leading to a sell-off in long-dated Treasuries, pushing yields back to levels last seen in 2007.

In the UK, despite a 6-3 vote to leave the base rate at 3.75%, one more voter joined the 'hawks' in July. Yet the tone of accompanying statements was interpreted as relatively dovish. The European Central Bank's message fell somewhere in between.

With underlying economies weak in both the UK and Europe, and President Trump marking Warsh's homework, policymakers remain reluctant to increase interest rates. With inflation steadfastly refusing to return to the 2% target, futures markets are pricing in increases later this year. Policymakers are largely 'looking through' the war-related inflationary pressures given that: 1) they are the result of a supply shock that is not readily countered by monetary policy; and 2) there are limited 'second round' effects, such as higher wage demands.

Conclusion: Diversification pays off

Current sentiment swings, amplified by leveraged trading vehicles and strategies, make it easy to look like a hero one day and a failure the next. A diversified portfolio provides a more stable ride and keeps us focused on longer-term investment and planning goals. We still take bigger directional bets where conviction is high, and continue to filter markets for opportunities. AI-related winners are likely to proliferate, including in areas not yet apparent, as adoption of this technology remains in its infancy. Many media stories about extraordinary gains (or losses) probably reflect leverage and/or poor risk management. We don't borrow money to juice returns, and we remain attentive to portfolio volatility relative to agreed benchmarks as stewards of clients' hard-earned wealth.

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Regional highlights

US. The relatively calm exterior of the S&P 500 index continues to mask a riotous party behind closed doors, one that has resulted in several hangovers. As previous winners have encountered profit-taking, laggards have prospered. The most representative trade of 2026 has been 'long/short momentum'. This is a strategy whereby (mainly) hedge funds buy the shares that are going up the most and sell the ones that are going down the fastest. In late June, a Morgan Stanley index based on this strategy was showing year-to-date gains of 50%. By the end of July, all of those gains had been wiped out. If we look at this period on a sector basis, it's clear who the winners and losers were. The worst performers were all tied to AI-related growth: IT (-3.5%), Industrials -3.1%), and Utilities (-2.3%). The leader was Energy (+12.5%), mainly thanks to the curtailment of the US/Iran ceasefire, but Healthcare (+2.2%) also put in a creditable performance. Financials (+6%) were supported by a strong earnings season. Consumer Staples (+2%) are seen as a traditional safe haven and have been roundly ignored in the more optimistic environment.

Even that fails to tell the whole story. Shares of Micron, the largest US manufacturer of memory chips, had risen more than fourfold by late June this year and tenfold over the last year. By late July, they had fallen 40% before staging a recovery.

The S&P 500 index fell 0.13% in July, but there are welcome signs of a broadening of participation. The equal-weighted version was +1%. And an index that removes exposure to the AI trade was +3.4%. The year-to-date gaps are even bigger, with the S&P 500 +9.4% and the equal-weighted index +12.1%. This has been achieved with no assistance from the Magnificent 7 group of mega-cap technology leaders (+0.3%), another positive signal.

UK. The early days of the Burnham government have revealed little in the way of policy initiatives. The biggest surprise was the appointment of John Healey as Chancellor of the Exchequer, and investors took that relatively well. Even so, his previous role as Minister of Defence, from which he resigned after failing to secure funds from the Treasury, suggests he'll seek increased spending in that area. The government inherits a fiscal straitjacket which has been made even more restrictive following the re-escalation of hostilities in the

Middle East and the rise in interest-rate expectations and bond yields.

Before taking office, Mr Burnham suggested he might unfreeze tax allowances and thresholds, but the cost of doing so meant he quickly backed down in favour of much cheaper, yet crowd-pleasing, options. Removing VAT from electricity bills for six months, capping bus fares at £2, and cutting business rates for pubs, clubs, and live music venues will cost around £1.4bn in total, balanced by promises to cut spending elsewhere, such as the scrapping of digital ID plans (which were never actually given a line item in the budget). Ominously, backbenchers have already warned Burnham that they would resist cuts to the welfare budget.

The 30-year Gilt yield continues to hover around the cycle highs at 5.04% as investors demand a premium return to account for the fiscal and inflationary risks, but at least it hasn't broken out to new highs. The pound remains close to the top of its post-Brexit trade-weighted range. Investors are giving the new regime the benefit of the doubt for now, but Mr Healey's first Budget in the autumn will be a crucial focal point, especially as some sort of wealth taxes appear to be on the agenda.

Although its constituents are less affected by domestic politics, we should note that the FTSE 100 index ended July at an all-time high.

Europe. Reports of the death of the eurozone economy were greatly exaggerated. Citigroup's Economic Surprise index for the region rose from -82 in May to a recent high of +63 by the end of July. Given that this is a mean-reverting index, this could be about as good as it gets, though, at least in terms of data relative to economists' expectations (which always catch up with reality eventually). The problem is that almost all of the information predates the latest increase in the oil price, and Europe remains a net energy importer. Looking ahead to next winter (however unseasonal that might feel given current conditions and when, for example, Germany is enjoying record production from its solar installations), one concern is that natural gas storage is at historically low levels for this time of year.

With liquefied natural gas supplies from the Middle East still curtailed, Russian resources under pressure and US export facilities running at full capacity, Europe's businesses and households might once again find themselves restricted. It's not a major concern for now, but it's symptomatic of the sort of supply chain shocks that bedevil the global economy.

On a more positive note, we expect more investment to continue to focus on supply chain resilience and sovereignty, and this will be a key growth factor for years to come. Germany is the standard-bearer in Europe thanks to its aggressive and uncharacteristic (by recent standards) fiscal stimulus packages. At the market level, we would note the very strong performance of the European banks sector, which has risen by 17.8% year-to-date vs the +9.2% for the broader MSCI Europe (ex-UK) index. That's a sign of confidence in the financial system.

Emerging Markets. The AI-related stock market volatility has been playing out in magnified form in Emerging Markets. We have frequently highlighted the increasing correlation between the performance of Emerging Market indices and the tech-heavy NASDAQ index as they became dominated by companies such as TSMC, Samsung, and SK Hynix, all key links in the global semiconductor chip supply chain. As such, Emerging Markets as a whole will not, in its current guise, provide the diversification potential that it has in the past.

The volatility of memory chipmakers Samsung and SK Hynix, which, between them, account for around half of the capitalisation of South Korea's KOSPI Index, has meant that trading has had to be halted with the index hitting a 10% daily limit down on several occasions. But on the last day of July, it rallied a scarcely believable 18%.

Fixed Income. The Bloomberg Global Aggregate Bond Dollar Index fell 1.5% in July. The sterling-hedged version returned -0.5%. This is slightly discouraging, following the stabilisation we saw in June. The main reason was increased inflation concerns as the oil price rallied again in the face of renewed hostilities in the Middle East, and concerns resurfaced about shortages of critical oil and gas derivative commodities.

The higher yields resulting from lower prices do, at least, provide a bit more of a floor to performance, and the yield on a 10-year Gilt would have to rise from the current 5% to around 6.8% to expose an investor to a negative nominal total return on a three-year view, although, of course, this wouldn't take inflation into account. With this in mind, we still find short-dated index-linked Gilts a better vehicle for pure wealth preservation at the current time.

The All UK Conventional Gilts index delivered a total return of 0.2% over the last three months and 1.3% over the past year. Index-linked gilts returned -1.8% and -0.2% over the same respective periods.

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Emerging market bonds produced a total return of 2.7% in sterling over the three months to end July (16.4% over 12m). Global high yield bonds delivered 0.3% (4.7% over 12m) in sterling terms.

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