RATHBONES

Quarterly Investment Update

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Alarms and (pleasant) surprises

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We review the financial markets over the past year – including bouts of volatility right up till the final few weeks.

The final quarterly review of 2025 provides the usual seasonal opportunity to 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 this year.

Yet some are disappointed not to have made even higher returns, given further exceptional outperformance from companies developing generative artificial intelligence (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.

Quick take:

- 2025 returns for equity markets were higher than average, with some markets doing exceptionally well.
- The tech sector suffered three bouts of volatility, including profit-taking at the year's end.
- As 2026 begins, economic conditions are generally favourable.

Better than average

Annual returns for equity markets generally were 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 President Donald 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 Chinese President Xi Jinping warned of retaliatory tightening in export controls on the rare earth minerals crucial to manufacturing supply chains and to the industrial magnets in everything from fighter jets to your smart watch. China controls around 90% of global refining capacity, giving it a very strong hand in this high-stakes game of trade poker.

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. Then again, he seems unlikely to tolerate much collateral damage to wealth and consumer confidence.

Show me the money

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

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. Even so, a warning shot has been fired, and investors will continue to monitor China's AI/LLM progress. It may lack leading technologies, but its access to plentiful cheap energy – a key input for AI data centres – leaves it well-placed to make progress through the employment of 'brawn' rather than 'brain'.

Next, the US' 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 many users seem to have been shoehorning generic LLMs into their day-to-day operations rather than using application-specific tools. We remain confident that usage will evolve, boosting productivity.

And then, 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. Grand announcements of higher capital expenditure are not eliciting the enthusiasm that prevailed even just a couple of months ago. US software company Oracle provides a salutary example. Its shares rose 35% in one day in September as it announced a deal to build data centre capacity for OpenAI (the creator of ChatGPT). But it has since given up all that gain and more as concerns grow over the level of borrowing required and whether OpenAI itself has the wherewithal to honour its spending commitments. Nevertheless, for now, this feels more like a healthy shake-out of excess, rather than the beginnings of something more sinister.

We retain our long-term belief that genAI will deliver positive outcomes for both companies and consumers (although its broad effects on society could prove more damaging). However, we seem to have reached an inflection point where investors are demanding higher revenues and profits before further rewarding companies with higher share prices.

We'll be watching to see how this plays out if, as rumoured, both OpenAI and Anthropic (owner of the Claude LLMs) attempt to list their shares on public markets in 2026 (potentially alongside Elon Musk's SpaceX). The incentives for investment banks to keep the plates spinning to generate a fee bonanza seem irresistible.

Forward momentum

While trade and technology seem likely to continue to dominate investment conversations in the year ahead, plenty of other things merit our attention.

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. Even Germany has rediscovered the spending habit. A year of tariff-related uncertainty has left a potential backlog of capital investment. One of the main threats to an equity bull market is a recession, but this is currently a low-probability outcome.

Conversely, there's a risk that growth is too perky and inflation too sticky. Core inflation in, for example, the US and UK, is proving slow to return to 2% targets. Our central view is that it's 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.

We can also use actively managed funds designed to provide steady 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, the May local elections promise to be another testing period for Prime Minister Keir Starmer. Betting markets don't reflect much optimism about his chances of still 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 it's 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

As has been the case for the last couple of years, we remain constructive about the outlook for balanced portfolios, while not getting carried away.

We too have been pleasantly surprised by this 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. But it would not take many things to go right for them to attract more investor interest.

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.

Additional information

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