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Snapshot

Strong US growth and healthy company profits are supporting global stock markets, although higher bond yields underline the importance of a balanced and diversified portfolio.

Writing these market commentaries is a constant balancing act. On one side is the need to keep long-term objectives in focus; on the other is the demand for explanations of today's market movements. I could say, "clowns to the left of me; jokers to the right", but the truth is that both approaches are key to successful investing. We especially need to know which of today's 'big news' needs to be taken seriously and which we can set aside.

Think of the toolkit of a good photographer. They might use a telephoto lens to see something a long way off, then a macro lens to get up close to the details. And a wide-angle lens is useful too. Investors can be easily distracted by negative domestic headlines when the bigger picture reveals something more attractive. That seems to be the case today, more than ever.

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Quick take:

- Rising bond yields partly reflect a stronger US economy, but inflation and government debt remain concerns.
- Global stock markets have reached record highs, supported by healthy company profits and continued investment in AI.
- With the outlook still uncertain, portfolio diversification can help manage risk.

Zooming in

The hottest topic for investors today is bond yields, which have been rising relentlessly. I have covered this subject in recent Weekly Digests, but make no apologies for returning to it. We have identified several reasons why yields have risen, including:

- 1) Concerns about government borrowing and debt
- 2) Rising inflation

Weekly Digest

3) Governments competing with companies for investors' money, particularly as large technology companies issue debt to fund AI investment

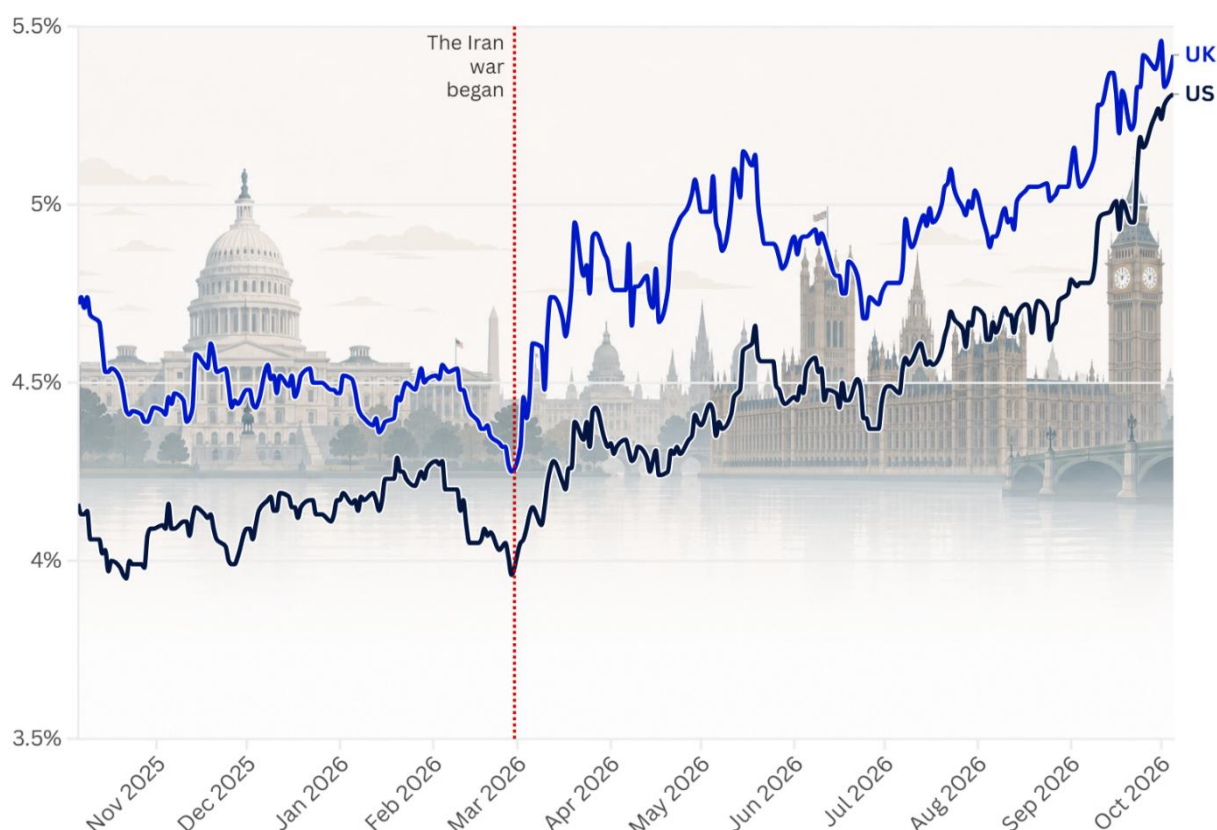
4) Expectations that interest rates may settle at a higher level over the long term, partly because of stronger economic growth

5) Investors demanding a higher return to compensate for uncertainty

But we also need to look more closely, as the reasons yields are rising can differ considerably from one country to another. If asked why bond yields are rising, most people would probably say "inflation" as their first answer. But that's not necessarily the case everywhere.

US and UK bond yields rise in tandem

10-year government bond yields, year to date, %



Source: FactSet, LSEG, Rathbones

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Look at the US, for example. Long-term inflation expectations have barely budged since the latest inflation scare took hold when the Iran War began in February. One useful measure is the average rate of inflation that financial markets expect over the next 10 years, known as the inflation 'breakeven' rate. It was 2.25% when the conflict began, and it's 2.36% today. To some degree, that's because investors have faith in the Federal Reserve to keep inflation under control, but it's also because the US's domestic energy supplies make it less vulnerable (but not immune) to external disruption. Even so, the yield on 10-year Treasury bonds has risen from 3.93% to 5.31% over the period.

Let's compare that to the UK. Here, 10-year breakevens have risen from 3.08% to 3.42%, effectively pricing in an extra 0.35% of inflation every year over the next decade. That adds up. The 10-year gilt yield has risen from 4.23% to 5.42%. That's less of a jump than for Treasuries (1.19% vs 1.38%), even though inflation expectations are worse. Why should that be?

There are two possible explanations.

Let's start with the more concerning explanation. It could be fears about the sustainability of the US government's debts. Total government debt recently topped \$40trn. That's higher than the country's GDP, usually seen as a bad thing, although plenty of other countries

have survived, if not necessarily thrived, under the same burden.

More positively, it could be because the US economy is growing strongly. The Atlanta Federal Reserve's GDPNow model suggests an annualised pace of 3.7% in the quarter just ended. Goldman Sachs says 3.3%. A lot of that is the result of heavy capital expenditure on AI. If we add inflation to the real GDP growth figure, we get nominal growth (or what's counted in actual dollars spent) close to 7%.

There is a strong correlation between nominal GDP growth and the 10-year yield. That's partly because investors demand higher yields when growth is driven more by inflation. It's also partly because governments have to compete with equity returns when overall company profits are growing fast, as they are today. And so current yields are not as outlandish as they might seem, although one has to have been around a bit to have experienced them before.

Yields were substantially lower after the Global Financial Crisis, largely because central banks intervened to keep them down. That was the aberration. Maybe they'll return there. If so, I suspect it won't be for a good reason. But we'll cross that bridge when we encounter it.

Panning out

It might come as a surprise to many that, in sterling terms, at least, global equities

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are currently at an all-time high. And that's just capital return, not counting dividends. Sometimes equity markets reach highs on a wave of euphoria and speculation, but it really does not feel that way. We look at valuations, positioning indicators, and sentiment surveys, all of which suggest a degree of circumspection or even scepticism among global investors. Sentiment surveys show how investors feel, collectively, about equities. Positioning indicators show how they've acted this out: what's their actual financial exposure to stocks?

Another key point is that equity markets have 'derated' this year, meaning that the profits attributable to them, now and in the future, have risen faster than the indices themselves. We continue to observe that the conditions are very different to those that prevailed when the dotcom boom turned to bust in 2000. There are some echoes and similarities, but not to the same extent.

Of course, much depends on continued growth in AI investment, on that spending delivering strong returns, and on businesses successfully using AI to boost productivity. For now, everything is moving in the right direction, although it's also fair to say that the rotation between leaders and laggards is head-spinning as new models and tool releases leapfrog ahead of each other.

We'll get the next snapshot of development with the third quarter reporting season, and I'll be back with a preview of that next week.

The long view

Fitting the 1000mm zoom lens, the one that needs to be put on a stand, transports us to an objective a long way from our present location. To reach it, we might encounter a deep, rock-strewn valley or pleasant pastures offering an easier route. We cannot know for certain; that is both the beauty and beastliness of investing. The destination may be visible, but the path towards it is rarely direct. And the weather can change quickly. That is why a good guide, emergency provisions, and the right safety equipment are essential.

Which brings us back to balanced portfolio construction and diversification. I don't dispute that an all-in approach to risk-taking can sometimes be successful and highly rewarding. People do bonkers things like running marathons across deserts and jumping off mountains with a few square feet of fabric to use as 'wings'. But the results can be disproportionately catastrophic. Which is why keeping portfolios diversified helps our clients invest well. So they can live well.

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Regional highlights

UK. Q2 GDP growth was revised up from 0.4% quarter-on-quarter to 0.5%, suggesting that the economy was more resilient to higher energy prices in the first half of the year than previously thought. That followed an unrevised +0.6% in Q1 and 1.2% in 2025 as a whole. It's encouraging that this growth was not a function of government spending, which contracted by 0.5% q/q. Growth was driven by consumption (+0.3%), business investment (+1.8% q/q) and net trade (exports minus imports). The savings rate ticked up from 8.6% in Q1 to 8.8%. That suggests that consumers are not overspending, which reduces the risk of a sharper slowdown in future. But these figures don't capture the latest leg of inflation and rate increases. That was reflected in mortgage approvals of 54.9k in August, the weakest number since December 2023. Traders still expect the Bank of England to increase the base rate from 3.75% to 4%, either in November or December, to counter inflation pressures.

US. Headline payroll growth in September was weaker than forecast at 29k. August's strong print was revised lower from 162k to 133k. But the 3-month average is a steady 51k, at the upper end of the current estimated 'breakeven' rate in a world of lower US immigration/ labour force growth, at which the unemployment rate remains steady. Average hourly earnings

growth of 3% was also below expectations. There are no signs of second-round wage effects, which is good from the inflation perspective. The unemployment rate rose from 4.1% to 4.2% as more people re-entered the labour market. Conclusion: the 'no hire, no fire' labour market persists. That's fine for now, as loss of employment is the biggest reason to reduce consumption. This release, alongside dovish comments from two FOMC voting members, sharply reduced the probability of the Fed funds rate being raised at October's meeting. But an increase is still expected at the following meeting in December.

Europe. The trend of decent economic data in the eurozone persists, although it remains to be seen for how long, especially with bond yields rising sharply (with the exception of Germany, which has reaffirmed its 'safe haven' status in the region, at least from a fiscal sustainability perspective). That increase in yields was given more fuel by a hot inflation reading for August, when average eurozone headline inflation jumped from 3.2% to 3.8% (vs a forecast of 3.7%). Core inflation also rose from 2.4% to 2.5%. This increased the probability that the European Central Bank would raise its deposit rate for the third time this year, from 2.5% to 2.75%.

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China. Purchasing Managers' Survey data show limited signs of the economy gaining traction. The official Composite PMI stands at 50.7, barely above the growth/recession demarcation line at 50. The private sector RatingDog readings rose from 51.5 to 52.1 for Manufacturing and from 51.4 to 51.6 for Services. That left the Composite measure at 52.4 (up from 52.2), which is a bit more encouraging. There are still limited signs of government support, although some small incentives were announced for new mortgages. But China's housing market is going to be like a supertanker to turn.

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