RATHBONES

Weekly Digest

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The market tug of war

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Strong earnings are winning the market tug-of-war for now, but rising bond yields are putting more pressure on valuations and future returns.

Quick take:

- Robust earnings growth is keeping equities ahead despite climbing bond yields.
- Government borrowing, inflation, and AI investment are increasing pressure on debt markets.
- Higher rates raise the bar for earnings and leave expensive valuations more exposed.

There's been a tug-of-war for a while between two of the main forces that drive equities: earnings and the cost of capital (what it costs a company to borrow money). We can also overlay influences such as sentiment, narrative, and flows, but, as the famed American investor Warren Buffett reminds us, "price is what you pay, and value is what you get".

Heavyweight earnings

To the surprise of many, given the headlines, equities have risen this year, even as bond yields have risen too. The 300-pound team member anchoring the rope for equities has been earnings momentum. For example, US earnings-per-share growth forecasts for 2026 have risen by 16% since the start of the Iran War, and I'm struggling to identify anyone who predicted that. The lion's share of it comes from AI-related capital expenditure. The net effect is that we're looking at some extraordinary growth estimates for 2026, including 33% for the MSCI All-Countries World Index, 31% for the US and 73% for emerging markets. These are numbers usually associated with the recovery from a recession, not mid-to-late cycle, which is another reason why they are so unexpected.

Unsurprisingly, earnings are not expected to continue growing at this pace next year. In any normal environment, respective growth forecasts for 2027 of 15%, 15% and 23% for the same group would be considered more than adequate. But if growth is going to re-accelerate further, it could well come from forces that are negative for bonds. These could be more inflation pressure (such as AI capex) or worries about government borrowing (namely, President Trump's promised $5,000 offer to voters if the Republicans win the midterm Congressional elections).

Higher cost of capital

Pulling in the other direction is the rising cost of debt. At the beginning of this year, interest rates were expected to be cut around the world, and bond yields had remained in a defined range during 2025. There was an apparent calm.

Markets now expect several interest-rate rises across the US, UK, Europe, and Japan. Bond yields are consistently reaching fresh highs, in some cases revisiting levels not seen since before the 2008 global financial crisis or even the 1990s. There are a few exceptions. China is one, thanks to its domestic demand problems. Switzerland is another, more for its safe haven status.

Everyone seems desperate to name the culprit behind rising bond yields. I see five potential candidates:

1) Fears about fiscal deficits. Governments have been spending way more than they receive in revenue for years, funding the shortfall through borrowing, without triggering the widely feared crisis. Deficits have been accelerated in recent years by the response to COVID, household subsidies to counter the cost-of-living inflation resulting from geopolitical developments, and 'populist' government policies. A burgeoning supply of government bonds is testing appetites, especially when central banks such as the US Federal Reserve and Bank of England are reducing their holdings. More recently, the doom loop of higher rates leading to higher (and potentially unsustainable) debt service costs has been the final straw.

2) Inflation. This is coming from multiple sources. Supply-side pressures are most evident in energy prices and, increasingly, in refined products such as diesel, as capacity is reduced involuntarily. This portion is highly dependent on the outcome of the Iran War. The AI capex boom is driving up prices of IT hardware, thanks to a shortage of memory chips. There doesn't seem to be any sign of an imminent let-up, given the long lead times for new capacity. A capex 'pause' might help – but that would be catastrophic for the equity earnings side of the equation. Note this week's market sell-off related to cautionary comments from the CEOs of frontier AI model companies. The current El Niño cycle could also play a role.

3) Crowding out. This usually occurs when heavy government borrowing pushes up bond yields, making it more expensive for companies to raise money. That's certainly on the cards today, but it's also working the other way as the hyperscalers, the world's largest cloud-computing companies, issue hundreds of billions of dollars worth of credit to fund their data centre buildout.

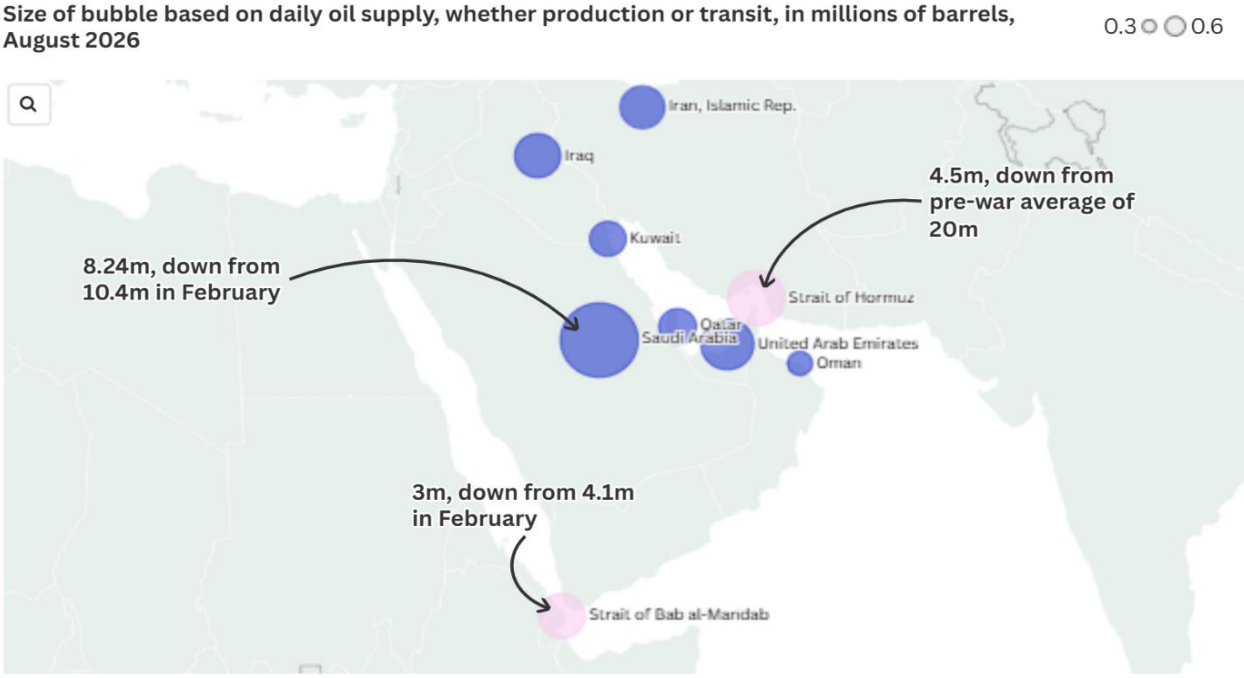
4) The neutral rate of interest. Defining the 'neutral rate' (the level at which short-term policy rates neither stimulate nor dampen economic activity, relative to its underlying trend) is like pinning jelly to a wall. Even so, economic theory suggests that it will rise during a period of accelerating productive growth; that might well be happening now.

5) Higher term premium. The 'term premium' is the extra yield that investors demand over and above the implied cash interest rate over a bond's life, to account for risks such as inflation and default. It's a moving target and somewhat prone to

Oil and troubled waters

Oil production in the Middle East - and supplies out of it - are considerably down on pre-war levels. This has pushed up inflation.

Size of bubble based on daily oil supply, whether production or transit, in millions of barrels, August 2026



Sources: International Energy Agency, International Maritime Organisation, Economist newspaper, Financial Times, Trading Economics, Y Charts, The Guardian, Mees, Rathbones. UAE number is for July.

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.

swings in sentiment. But all measures of it appear on a rising trend.

The endgame

So how does this tug of war conclude? The market can probably withstand higher rates if they remain a reflection of higher earnings potential, but it does put a heavy onus on those earnings. Given that corporate revenues are closely linked to inflation, equities should protect investors' real wealth over the cycle. Still, the short-term risk to valuations from the rising cost of capital can't be ignored.

Part of this is down to the fact that future earnings and cash flow are discounted back to net present value (NPV) – what those future earnings are worth today. Their contribution to NPV is high by historical standards, notably in the US, but not, as it happens, in the UK. We are paying up for future earnings that might not materialise.

The best-case scenario is one in which the Iran and Ukraine Wars are resolved, allowing an unimpeded flow of raw materials from the affected regions. Game theory continues to suggest this is the most probable outcome, but getting to the right square on the board is not easy, and there will be snakes and ladders en route. The icing on the cake would be strong, productive growth driven by widespread adoption of AI.

That's the positive take. A more negative outcome will have to be left for examination in next week's Digest. At the same time, I will discuss the implications for portfolio construction.

Weekly Digest

Regional highlights

UK. The run of positive surprises for UK economic data continued with July's monthly GDP. This saw month-on-month growth of 0.4% against an expected flat performance. Some of it was weather and World Cup-related, but a decent chunk was attributable to benefits accruing from the use of AI. On a year-on-year basis, information and communication services output rose 8.1%, while professional, scientific and technical activities expanded by 3.5%. Construction (-2.5%) remains the weakest area as higher interest and mortgage rates bite. Another area we are not seeing positive surprises in is the labour market. Pay growth held steady in the three months to July, with private sector regular earnings growth of 2.9%. This is slightly below the level the Monetary Policy Committee would normally consider consistent with meeting the 2% inflation target and is relatively low by recent historical standards. The number of payrolled employees fell by 26,000 in August. Along with a further drop in vacancies, this is an indication of the softness of current labour market conditions. The saving grace is that this will probably stay the Bank of England's hand at this week's policy meeting, with the base rate remaining at 3.75%. But markets are pricing in a quarter-point increase in November and as many as four in total by summer 2027.

US. Market participants viewed the latest inflation data as being critical to the Federal Reserve's next policy decision to be made on Wednesday 16 September. In the event, the Consumer Price Index for August was slightly above consensus expectations, raising the probability of a quarter-point rate rise to 93%. The core CPI rose by 0.3% month-on-month vs 0.2% expected, leaving the annual rate at 2.4%. Headline CPI, which includes energy, came in at a more elevated 3.4%. One driver is the cost of diesel, currently at an all-time high of $6.23 per gallon. A year ago, it was $3.70, so an increase of almost 70%. This week's Fed meeting will be an interesting test for the new Chair, Kevin Warsh. He needs to bolster his inflation-fighting credentials with actions as well as words to halt the inexorable rise in bond yields. But somehow, he has to frame his actions in a way that will not irk the man who appointed him, President Trump. We wish him luck!

Europe. The European Central Bank is already in policy-tightening mode and delivered its second quarter-point increase in the deposit rate (now 2.5%) last week. ECB President Christine Lagarde described the decision as a “no-brainer”. This is no-nonsense talk. New ECB staff projections maintain that inflation is set to remain ‘well above target for an extended period', and these were made before the latest jump in oil prices. Everything points to further rate increases if the environment remains the same. In aggregate, the eurozone economy has proved much more resilient than expected following the start of the Iran War, but it's becoming harder to see how it can continue to deliver positive surprises. Much will depend on whether the situation in the Middle East can be quickly resolved.

China. Monthly data continues to paint the same picture of China's economy: a decent industrial sector, largely driven by strong exports, and a weak domestic situation. Industrial production rose by 5.2% year-on-year in August vs 4.5% in July and 4.8% expected. Retail sales rose by a paltry 0.4% (vs +0.8% forecast), and new and used home prices fell by 0.17% and 0.31%, respectively, over the month. Fixed Asset investment is down 7.2% vs a year ago, property investment is down 19.9%, and residential property sales are down 13.1%. Unemployment ticked up from 5.2% to 5.3%. There seems to be no self-starting solution to China's domestic malaise, and the government remains reluctant to use aggressive stimulus owing to past boom-and-bust cycles.

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