RATHBONES

Weekly Digest

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Shots on target: the portfolio case for measured attack

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Markets are no longer relying on the usual AI goal scorers, with investors rotating across the pitch rather than heading for the exits.

Quick take:

- Investors need shots on target, but portfolios can suffer from both 'parking the bus' and leaving the back line wide open.
- AI's early goal scorers have lost momentum, but markets are rotating across the pitch rather than heading straight for the exit.
- A broader rally is welcome, but inflation, oil prices and the Middle East remain the threats that could trip markets up.

Whatever happened with England's tactics in last week's World Cup semi-final match against Argentina, the team switched into defensive mode far too early (in the opinion of almost every armchair expert, including this one!). At least they waited until they had scored a goal, which is more than can be said for Argentina in the final. Its team failed to register a single shot on target in the 120-minute game.

It's hard to score without hitting the target. And you have to take a bit of risk, in terms of de-emphasising your defence, to get yourself into a scoring position. Investors face the same decision when building portfolios. A 100% allocation to cash is the equivalent of 'parking the bus'. It feels safe, but won't produce a win and might be broken down by relentless attacks. In investing, the biggest risk to a cash-based investment strategy is inflation, which erodes the real value of savings over time.

At the other end of the spectrum, an all-out attack is much more entertaining but can lead to extreme volatility. An exponent of this approach in his managerial career was Newcastle United's Kevin Keegan, who passed away on Monday. His thinking: score more than you concede, whatever the risk. This left Newcastle with a seemingly insurmountable 12-point lead in the Premiership title race in February 1996, but Manchester United ultimately overhauled them.

The most recent market parallel to the all-out approach is the South Korean private investors' approach to memory chipmakers. They enthusiastically bought into the rising trend using borrowed money and leveraged exchange-traded funds, which use borrowing or derivatives to magnify gains and losses.

There were sound reasons at first, owing to the strong demand for memory chips to fill rapidly expanding data centre capacity. But it was taken to extremes. At its peak, just a month ago, South Korea's Kospi index had risen by 116% this year and by 300% since the 'liberation day' lows of last year. It has since given back 28.5%.

This has been played out elsewhere across the AI-related spectrum. The Philadelphia Semiconductor index was up 106% year-to-date four weeks ago, but has since fallen by 20%. More broadly, the tech-heavy Nasdaq index, which had risen 21% to its early-June all-time high, has given up 7%. But the S&P 500 index remains within 2% of its peak, with the equal-weighted version less than 1% below its all-time high, made as recently as 16 July.

A game of two halves

These contrasting fortunes reflect a sharp divergence between individual stocks and broader markets. The implied volatility of the S&P 500 index remains below its long-term average, but volatility among its average index constituents is at a record high relative to the index.

Put another way, the correlation between individual stocks is at an all-time low. In theory, this is fertile ground for active fund managers – if they pick the right stocks. If you were a hero a few weeks ago, you've probably lost a lot of your gains since. Few are likely to have perfectly timed the switch from AI winners into other areas of the market.

The peak of AI mania was reached on 22 June. Since then, the MSCI global technology index has fallen 8.2%. Other sectors linked to AI capital spending (capex) are also in the red: Materials (-5.5%) and Industrials (-3.4%). The beneficiaries of rotation have been Healthcare (+6.25%) and Energy (+5.5%), with the latter boosted by the re-escalation of hostilities in the Middle East. Consumer Staples (+3.4%) has also found its feet again.

A strong start to the season

The next-best-performing sector is Financials (+3.3%). That's encouraging: if investors feared an imminent economic or market collapse, Financials would probably be on the back foot. Some strong Q2 results from the major US banks have supported them. Indeed, the reporting season, which I previewed last week, has got off to a good start.

Although it's early days, with only 10% of S&P 500 company reports in, so far 89.8% of the 49 companies have beaten expectations, and 4.1% have missed them. In a typical quarter since 1994, 67% beat estimates and 20% missed estimates. Over the past four quarters, 80% of companies have beaten the estimates, and 16% missed them. In aggregate,

earnings are 12.3% above estimates, compared to a long-term (since 1994) average positive surprise factor of 4.4% and the average positive surprise factor over the prior four quarters of 7.5%. Financials are leading the way with 19 reports so far and a 94.7% beat rate.

But heaven forbid that a company disappoints. This was the fate of past technology leader IBM. The US company's shares fell 25% in one day, reportedly its worst-ever one-day performance, as it warned that its customers were prioritising spending on AI-related products and services rather than in IBM's traditional core markets. I cautioned last week that we should not be surprised to see some big moves in response to results. I doubt this will be the last example.

Timely substitutions

When concerns rose last year about capital spending by hyperscalers (the big cloud-computing companies building AI infrastructure), many feared equities could not keep rising without the Magnificent 7 (Alphabet, Amazon, Apple, Meta,

Microsoft, Nvidia and Tesla). Yet the Mag 7 are up just 2.1% so far this year, versus total returns of 9.6% for the S&P 500 index and 10.4% for the MSCI All-Countries index. That was initially driven by the strong performance of the companies that were the recipients of the hyperscalers' capex dollars.

But as the Mag 7's fortunes have declined in relative terms, there has been broader market participation in share price rises. Investors don't seem to be heading for the exit but changing seats. This is healthy for broader markets.

Of course, there's no cause for complacency. Equities remain vulnerable to anything that undermines earnings. The main threat is a tighter central bank policy in response to higher inflation, possibly driven by constraints on energy supply, pushing up oil prices.

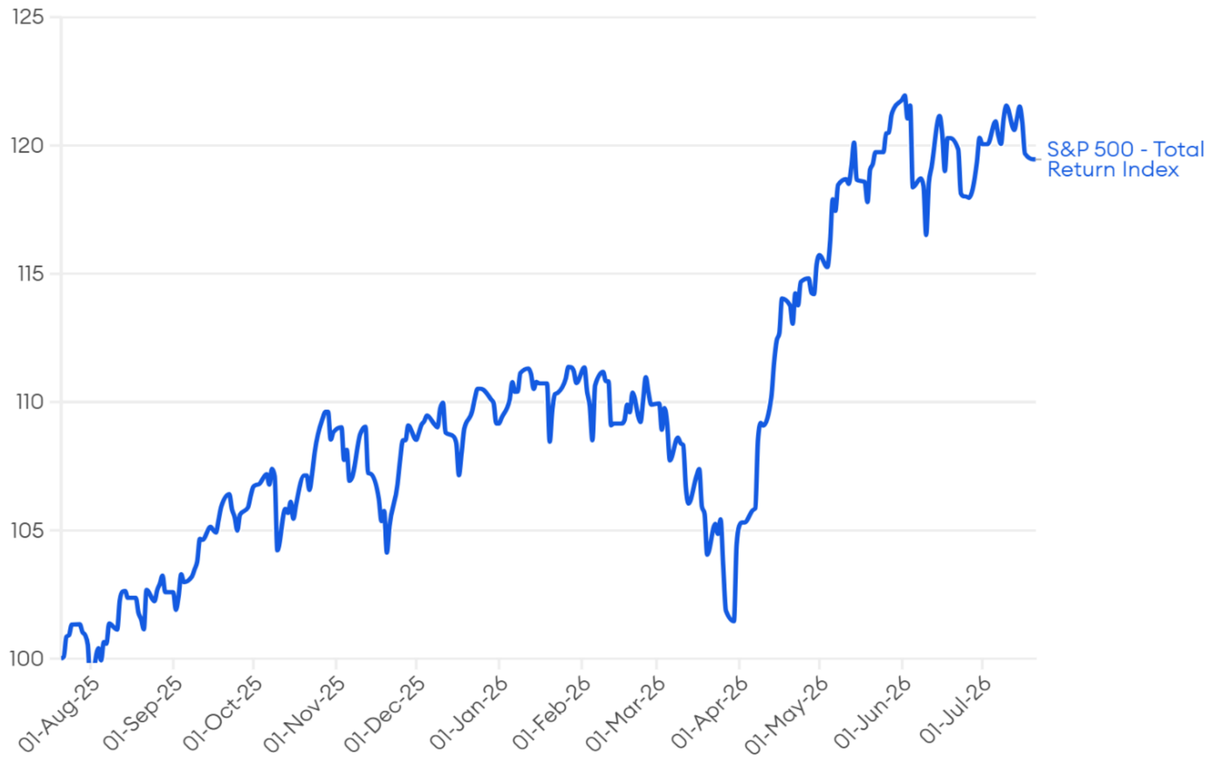
We remain keenly focused on events in the Middle East. For now, markets assume neither side can sustain the economic and political costs of escalation for long. We concur. Still, it might take more disruption and a higher oil price to bring negotiators back to the table, so we're prepared for short-term volatility. In portfolios, we aspire to be neither Argentina nor

Keegan's Newcastle United. Yes, we want enough shots on goal to perform well, but without leaving gaps that make us too vulnerable. We always counsel diversification. We also advise that clients take a level of risk appropriate with their own circumstances. Then we might have the chance to be "over the moon (Brian)" – as football players continually told football pundit Brian Moore in the Keegan era – but hopefully not "sick as a parrot".

And that's it for football metaphors for a while!

Still standing: S&P 500 since the peak

One year of total returns (rebased to 100): July 2025 – July 2026



Source: FactSet, Rathbones

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.

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Regional highlights

UK. The new Chancellor was greeted with a relatively benign first set of data. UK employment did not deteriorate in May or June, but a further drop in private sector pay growth means that there is less need for the Bank of England to raise interest rates. The redundancy rate eased back to its lowest level for ten months. Overall, the labour market looks stable but weak. Government borrowing for June came in lower than expected, at £16.0bn against a consensus forecast of £17.8bn. More encouragement came from revisions to prior borrowing figures, with the deficit for April and May combined revised down by £4.8bn. This leaves the public sector's current budget deficit in the fiscal year so far only £1.3bn above what the Office for Budget Responsibility had anticipated, a much less worrying picture than appeared to be the case last month.

US. US consumer price and producer price inflation slowed more than expected in June, running at 3.5% and 5.5%, respectively. That was interpreted as giving the Federal Reserve more reason to leave interest rates unchanged. However, the main reason for the weaker numbers was the decline in energy prices triggered by the Memorandum of Understanding between the US and Iran, which is currently being violated by both sides. The national daily average price of a litre of gasoline in the US got as low as $3.79 earlier this month but is now back over $4. This will be playing on the mind of the President as he contemplates strategy heading into the mid-term elections in November.

Europe. The final reading of core inflation in the eurozone was confirmed at 2.4%, also benefiting from lower energy prices. Looking further ahead, wholesale natural gas prices rose 16% last week and are back close to the highs of March. The recent escalation in the Gulf has raised fears over the lack of supply of natural gas in Europe next winter, as inventories are very much at the low end of the range for this time of year. This has been exacerbated by demand for electricity for air conditioning during the heatwave. While the price is still only a fifth of the peak reached at the time of Russia's invasion of Ukraine, a possible gas shortage will be a concern for policymakers.

China. China's Q2 GDP grew 4.3% year-on-year, slightly below expectations of 4.5% and the government's 4.5%–5.0% growth target range. While June industrial production surprised to the upside (+5.3% year-on-year versus 4.6% expected) and retail sales returned to positive territory (+1.0% year-on-year versus -0.1% expected), fixed asset investment remained weak (-5.7% year-on-year in the year to date versus -5.0% expected), highlighting the continued drag from sluggish domestic demand and investment activity. Stronger-than-expected trade data showed that exports remain supported by the AI and semiconductor cycle, but policymakers are likely to remain focused on the weakness in the domestic economy. Attention now turns to the end-of-July Politburo meeting for potential signals of additional policy support. Hopes for major stimulus have not been met so far in this cycle, and so expectations are low.

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