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Weekly Digest

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Looping back

21 September 2026

Markets remain resilient, but prolonged conflicts, higher inflation and strained government finances are increasing the case for broader diversification.

Quick take:

- Prolonged conflicts and energy shortages could keep inflation higher for longer.
- Higher debt and borrowing costs are putting increasing pressure on government finances.
- Broader diversification may help portfolios withstand inflation, recession, and market stress.

The last few weeks have brought choppy market action: short, sharp moves but limited progress. It's when we're in the void between company reporting seasons that we remember traders are like sharks, which need to keep moving unless they suffocate, and so every news headline and central bank statement is analysed to death to wring out even the smallest available signal. Thankfully, we're not in the short-term trading game, so we can afford to take a longer view, although we're constantly monitoring the scene for incoming predators.

The second round

Last week, I looked at the tug-of-war between rising interest rates and bond yields on the one hand, and powerful corporate earnings on the other. Rising rates are reducing valuations, while strong earnings provide support. The two are cancelling each other out, leaving equity markets range-bound but close to all-time highs.

I concluded that a positive resolution of the Iran War, bringing lower energy prices, could trigger an upside breakout for equities. But we also need to consider what might go wrong. The most immediate threat is higher inflation, and the most probable cause is even more severe shortages of energy and refined products. The outcome is highly dependent upon President Trump, Iran's religious and military leaders, and Russia's President Putin, making the risks extremely difficult to assess and price into equity valuations.

We're not talking about mainstream politicians here. It's about legacies, ideologies and an existential fight for survival.

Our outlook remains informed by past research on geopolitical risks. Investors have generally benefited from not reacting too defensively to initially shocking events. But we acknowledge that some events can have more severe consequences, especially if they turn into long, drawn-out affairs. Both the Ukraine and the Iran Wars are heading that way.

The world tends to be quite creative in adapting to supply shocks – sudden disruptions that reduce the availability of essential goods, such as energy or raw materials – which can be thought of as having 'first-round' effects (the immediate impact of a supply shock on prices and economic activity). Consumers can switch to alternative products or materials; shocks can accelerate the adoption of new technologies, and strategic reserves of commodities can be drawn on. Governments will sometimes smooth over temporary price increases with subsidies or price controls. This can allow central banks to 'look through' a short-term increase in consumer prices – to avoid raising interest rates, on the grounds that the inflation caused by the shock will be transient.

More pernicious are 'second-round' effects, when an initial rise in prices leads to further increases elsewhere in the economy. This is when, for example, employees begin to demand wage increases to offset the rising cost of living. If demands are met, they might be clawed back through even higher prices. This can set off a dreaded wage-price spiral, where rising wages push up business costs and prices, prompting workers to seek further pay increases.

The good news, for now, is that central banks are more focused on the first-round effects, which they believe to be temporary. That means the Bank of England has kept the base rate unchanged at recent meetings, while the US Federal Reserve only began its policy-tightening cycle last week. They have some justification for not being too aggressive. Wage growth remains contained as labour markets are subdued. Furthermore, market-derived inflation expectations – investors' forecasts inferred from bond prices – remain well-anchored. Even so, there's a bit of a 'chicken and egg' problem here. Could inflation expectations be contained because central banks are expected to act more aggressively if required? And what if they don't? The rising 'term premium' for bonds suggests more than a hint of uncertainty on that front.

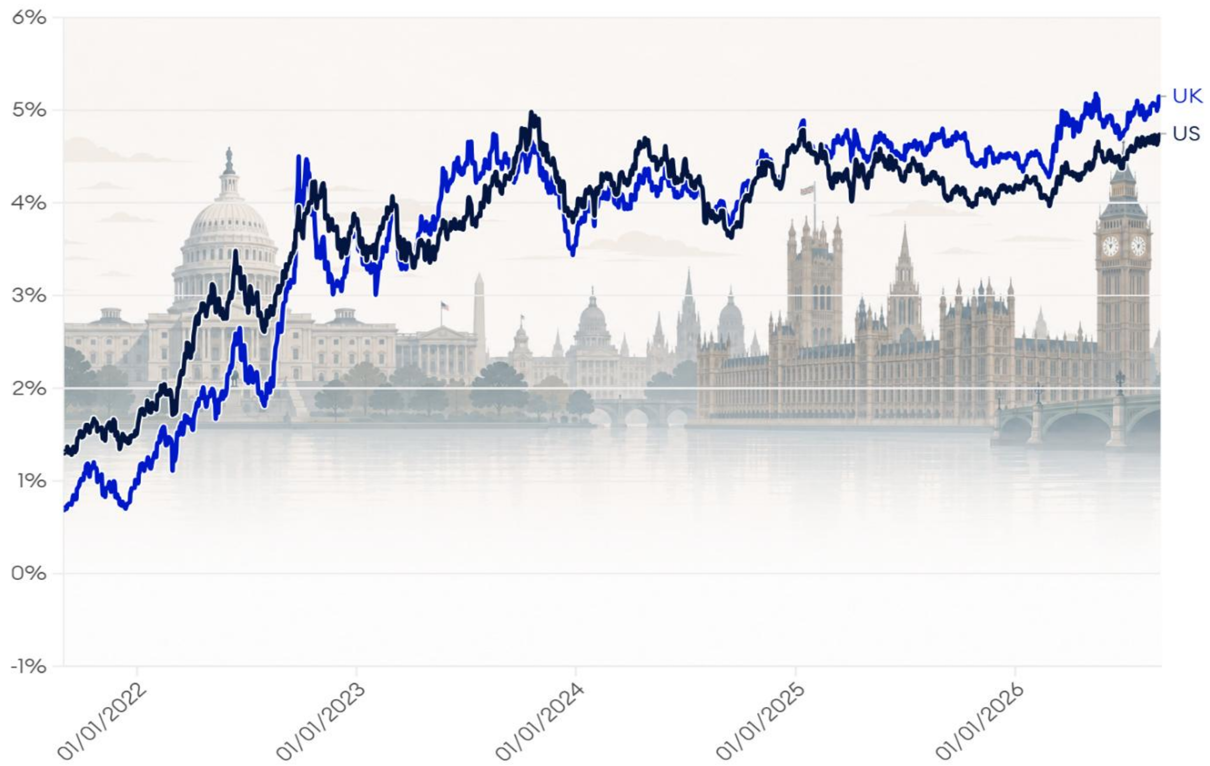
Let's say central banks do, in the end, have to hit the brakes harder. Then we are at risk of a more traditional recessionary cycle developing as demand is deliberately curtailed to bring it back in line with reduced supply. That would tend to dampen corporate earnings expectations, which, of course, have been a key driver of recent portfolio returns. It would be reasonable to expect an equity market reversal.

Fiscal sustainability – avoiding a sovereign doom loop

Another risk is that investors begin to question government finances. The UK faces high debt and a persistently high annual deficit, but it is not alone: the United States, France, Italy and Japan are in the same leaky boat.

Bond markets turn up the pressure

US and UK 10-year government bond yields have climbed as investors demand greater compensation for inflation and fiscal risk.



Source: FactSet, LSEG, 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.

Spending far exceeds income for several reasons, including the cost of supporting ageing populations and increasing defence budgets. Political pressures also make spending cuts difficult, especially when there's someone in opposition making (impossible to keep) promises to spend even more. Cyclical issues include potential cost-of-living subsidies, such as help with energy bills.

Worst-case, investors could fear that governments will struggle to repay their debts, at which point the concerns become almost self-fulfilling. Interest rates rise as investors demand higher bond yields (the return they receive for lending money to a government) to compensate for ownership risk. A bigger chunk of your taxes goes to paying interest rather than being invested in productive infrastructure or even basic services. This could be described as a sovereign doom loop.

If that sounds worrying, it is. However, as long as a government can tax its citizens and issue debt in its own currency, it can save the situation. The central bank might need to help by buying government bonds, making it easier for the government to finance its debt. But as we have observed from Japan doing this for a couple of decades, the currency tends to devalue against those that are not forced down the same route.

How to mitigate portfolio risks?

If it were just about the risk of a typical recession developing, the answer might be to buy more government bonds. They typically rise in value when investors seek a safe haven. But if the recession undermines government finances too severely (and remember we haven't before entered a recession with such high levels of existing debt), then it's possible that government bonds themselves become a risky asset.

That's one very good reason why we continue to recommend diversification across different industries and countries. Increasingly, we're exploring diversifying assets that haven't historically been adopted by mainstream investors. These include tail-risk hedging vehicles, which aim to protect portfolios and deliver positive returns during rare but severe market falls. Macro funds seek opportunities across a wide range of investments, while trend-following funds can benefit from sustained market downturns. Long-short equity funds may also reduce losses by backing stronger companies and profiting from falls in weaker ones. In the event that governments run persistently high deficits and finance them in ways that fuel inflation and weaken their currencies, real assets – such as real estate, infrastructure and commodities – have a role to play. So do precious metals, especially if ‘currency debasement’ – a sustained loss of a currency’s purchasing power – becomes more widespread.

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Regional highlights

UK. The Bank of England left interest rates unchanged at last week's meeting, as expected. But there were concerns expressed about persistently high energy costs owing to the Iran War, and markets are pricing in a quarter-point increase to 4% by year-end. In fact, they're indicating that the base rate will rise by 1 percentage point from current levels by next summer. That seems improbable to us given the low levels of economic growth, but much will depend on geopolitical issues. Meanwhile, the government's finances continue to cause concern ahead of next month's Budget. The latest borrowing figures showed a monthly deficit of £18.3bn for August, some £3bn higher than projected. Higher spending is the culprit, with much of the overshoot blamed on higher index-linked bond payments (which rise with inflation). It's inevitable that the Chancellor, John Healey, will raise taxes in the Budget and less likely that he will cut spending, although certain new projects might be shelved.

US. The Federal Reserve did raise the Fed Funds rate by a quarter-point at last week's meeting. This move was largely expected, given the new Chair Kevin Warsh's previous hawkish commentary. The increase came as something of a relief to bond investors who had feared that he might succumb to pressure from the President to leave rates unchanged or even cut them. It's important that investors retain their faith in central banks to keep inflation (and inflation expectations) well-anchored. The Fed has the luxury (compared to the UK and Europe) of presiding over a strong economy. The Atlanta Fed's GDPNow projection for annualised third-quarter GDP growth stands at a remarkable 5.1%! That's probably overstating the case, but there's certainly no sign of slowdown at the moment.

Europe. There was a limited amount of important data released last week, and the European Central Bank had already raised rates the previous week. Investors' attention was more focused on politics and bond markets. France remains in a mess, with little chance of the minority government getting its latest Budget proposals through Parliament. Even if it did, the annual deficit would remain over 5%. With the Presidential election looming next April, 'impasse' is the status quo. Investors have voted with their feet, selling French OAT bonds. The yield premium over German 10-year equivalent Bunds is now over 1%, an indication of mistrust and the highest since the eurozone crisis in 2012. And Germany has its own problems, with two more losses for the ruling CDU in state elections. The political risk premium in Europe is rising again.

Japan. The Bank of Japan was the other major central bank to raise interest rates last week, from a lowly 1% to 1.25%. Japan continues to leave behind its decades of deflation and now has to set monetary policy to more suitable levels... Yet without shocking an economy where rates have been around zero (or even below) since the 1990s. With wages growing by 5% and inflation around 2%, the Bank is at risk of falling behind the curve and needs to press on. This will also provide support for the yen, which has rallied following recent intervention.

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