

Fault Lines

11 November 2025

Equity markets retreated from their highs last week, but it was more a case of some AI-related speculative froth being blown off than a sign of a bigger correction to come.

A Californian who lives anywhere near the San Andreas Fault also lives in fear. Even a relatively small tremor elicits the question, “Is this the Big One?” The huge earthquake that everyone knows is coming one day but the timing of which is impossible to predict?

Sometimes it feels the same in financial markets. Every minor reversal in equity markets is greeted with people predicting a crash and every move up in bond yields is a prelude to the collapse of government finances. This is especially the case today with equity markets still close to all-time highs and government debt at the sort of levels (relative to GDP) normally seen in the aftermath of major conflicts. Even so, animal spirits are elevated and history also tells us that they can stay that way for a lot longer. If financial conditions remain benign, leaving the party early can be a source of regret – as in life, so in finance.

Blowing off the froth

The MSCI All-Countries World Index retreated a bit last week (see figure 1), falling 1.5% in what was largely characterised as the froth being blown off the top. A wobble in sentiment related to AI was the underlying reason, and this was reflected in regional, sector and fund performance. It mostly affected the smaller companies which currently make little in the way of profits (or none at all) and

Quick take

- Global equities fell last week amid a wobble in AI-related sentiment.
- Still, warning signs of a bigger correction are yet to appear on the horizon.
- We remain vigilant, with safety measures at the ready if needed.

those that have been driven by speculative trading. This was one of those weeks when more questions were asked than answers provided.

Figure 1: Global equities come off their highs



Source: Factset, MSCI AC World Price Index

I have commented regularly this year that the technology leaders are treading a tight line between spending enough to maintain their

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position (or even cement an unassailable one) and spending so much that they end up squeezing profit margins and competing away returns.

We are heading into a period when lots of debt is maturing and refinancing risk is rising with interest rates substantially higher than they were four years ago. One counterbalance to these higher refinancing rates is the current trend toward lower interest rates. Here in the UK, the Bank of England failed to cut the base rate last week as the Governor, Andrew Bailey, cast the deciding 5-4 vote, siding with the 'hawks' in their concerns about inflation.

Of greater import in a global context is the path of US interest rates. Following the Federal Reserve's (Fed's) quarter-point cut two weeks ago, its pointed reluctance to signal a follow-up cut in December has caused some investor concern. But when push comes to shove, we still believe that the Fed will err on the side of supporting employment and being a bit more lenient on inflation.

Warning signs to watch for

We have a couple of ways of assessing the risk of a major setback in equity markets: to look at valuations (what investors are willing to pay for a given dollar of earnings) and a mixture of investor positioning and sentiment. Most valuation measures are flashing warning signs in the US, but they are a dreadful market timing tool.

On the sentiment front, short-term indicators, such as those based on activity in the options market, suggest over-exuberance. But most active managers (those who don't simply track an index) are lagging benchmark returns this year because they have not had enough exposure to high-flying equities. While merger and acquisition activity and new company listings on stock markets are both on the up, they are nowhere near past peaks that signalled potential exuberance. Indeed, they seem more to signal a growing level of confidence.

In the UK, there is certainly no sign of the glut of speculative listings that characterised the technology boom at the turn of the century. Indeed, one of the highest profile debuts this year has been from a company that sells tinned tuna! How old economy can you get? The top 10 points contributors to the FTSE 100's 20% year-to-date return (accounting for 80% of the gains) trade at an average 16 times their 2025 earnings forecasts,

which is hardly a stretch (as you can see from the chart below on historical valuations).

Figure 2: FTSE 100 valuations not stretched



Source: Factset, prices relative to annual profits

Finally, if we look at last week's sector moves in the US, of the eleven primary sectors, four were down and seven were up. The losers were all AI-related. That looks more like a relatively healthy rotation than a wholesale flight from risky assets. There was no strong bid for traditional 'safe havens' such as government bonds or gold.

Safety measures

The good news is that today it is possible to construct buildings and infrastructure that are resistant (to some degree) to earthquakes. We can do the same for investment portfolios, not only in how we allocate to different asset classes but also how we allocate within them. There are lots of levers to pull. We can extend or shorten the interest rate sensitivity of our bond positions; move up and down the scale of credit quality in our corporate bond holdings; and weight our equities more towards cyclical or defensive companies depending upon the broader economic outlook and the valuations.

Our portfolio construction process is built upon aiming for the optimal return for clients with reference to how much risk (ranging from volatility to maximum drawdown) they are willing to tolerate, ranging from the volatility of returns to maximum tolerance for peak-to-trough declines. That doesn't mean you will have always had the highest absolute returns in the room, but you should not have the biggest losses either.

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Economic highlights

UK. The Bank of England held its base rate at 4% as widely expected (there was a 25% market-derived probability of a 0.25% cut ahead of the meeting). However, unlike the US Fed's recent 'hawkish cut', the decision could be described as a 'dovish hold'. The vote split was 5-4 in favour of no change vs the 6-3 consensus view of economists polled by Bloomberg. There was also a subtle change in the policy wording, with the path of future rate cuts being described as "gradual" rather than "careful". Inflation risks are seen as more balanced than previously, helped by recent more favourable data. But Governor Andrew Bailey (who cast the deciding vote to hold) highlighted the need to see more data. The committee does not see inflation returning sustainably to its 2% target until the second quarter of 2027. Even so, more rate cuts are on the way, barring a shock. Futures prices imply a further pause in December (63% probability of a cut), with the next reduction coming in February and as many as three in the whole of 2026 (to 3.25%). Capital Economics, which sees more weakness in the jobs market weighing on growth and inflation, has a forecast of 3% for end 2026.

This event was always going to play second fiddle to the 26 November Budget. The outcome of that and its impact on the growth and inflation outlook will play a large part in the next rate decision at the central bank's 18 December meeting.

US. The October national employment report from ADP, a payroll management firm, beat estimates, but remains consistent with a stalled labour market and slowing job creation. The report showed 42,000 new private-sector jobs, while September's figure was revised to a loss of 29,000. Only half of industries surveyed reported job growth over the past three months, down from 80% in July. We don't usually report monthly changes in ADP data, but the US government shutdown makes it a useful supplement in gauging labour market momentum. Another non-governmental release came from the Challenger, Gray & Christmas employment report showing October job cuts were up 175% year-on-year, totalling 153,074 – the highest October figure since 2003. Given the effects of the government shutdown, we should probably wait and see how this develops once the shutdown ends. But with more companies citing AI as a reason to cut jobs

(or at least not to hire), we need to watch this closely – and so does the Fed.

Europe. Citigroup's Economic Surprise Indicator, a measure of actual data vs economists' expectations, sits at +35, close to its highest level since early 2023. That stands at odds with the gloomy tone from many European commentators. But, as we have noted previously, this is a supertanker that will take time to turn and the primary driver, Germany's fiscal stimulus, is only now being unleashed. Europe is caught between the US and China in the global trade wars, which only emphasises the need for European leaders (both national and in Brussels) to loosen regulations and create a more innovation and investment friendly environment.

China. Both exports (-1.1% year-on-year) and imports (+1.0%) came in below expectations in October. China has been buffeted by US tariffs and other restrictions and so the figures are more volatile than usual. Inventory management on the part of its customers will also be playing a big role in short-term demand fluctuations. It is already clear that China is moving its trade focus away from the bigger developed economies and towards other emerging economies. This is a trend that is likely to persist in the current geopolitical environment.

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