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Quarterly Investment Update

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Richer, not wiser

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Strong company profits offset the pressure of high inflation, helping balanced portfolios make small gains in an uncertain quarter.

The last quarter has left investors none the wiser about the future, but, in aggregate, slightly better off. The three big questions we asked three months ago remain unanswered. There has been no resolution of the Iran War. There remains a cloud of uncertainty hanging over the adoption of AI and the returns to be generated, and all the investment being made into developing it, not to mention the added question about the fate of humanity! With inflation pressures rising again, the peak of interest rates is not clearly in sight. Here in the UK, speculation about the impact of the forthcoming Budget is affecting long-term financial planning.

Bond markets have borne the brunt of investors' concerns, with yields rising sharply for several reasons. This has caused capital losses – falls in the value of their investments – for holders of bonds maturing in more than a couple of years. But equity markets, despite the odd wobble, remain close to all-time highs, driven by strong earnings growth. The second-quarter reporting season was exceptionally strong. The stronger US dollar has helped boost returns for sterling-based portfolios, as US companies make up a large share of global stock market indices.

Quick take:

- The Iran conflict lifted inflation and borrowing costs, but strong profits supported stock markets.
- AI shares stumbled, highlighting the risks, but their long-term potential remains.
- With bonds under pressure and markets near highs, diversification remains essential.

Iran – the wait continues

Starting in the Middle East, the long-hoped-for ceasefire has not materialised. The sticking points are the continued US blockade and sanctions, Iran's stance on its nuclear capabilities, and its desire to maintain some sort of control over the shipping through the Strait of Hormuz. Our game-theory approach to the situation has always led to the conclusion that,

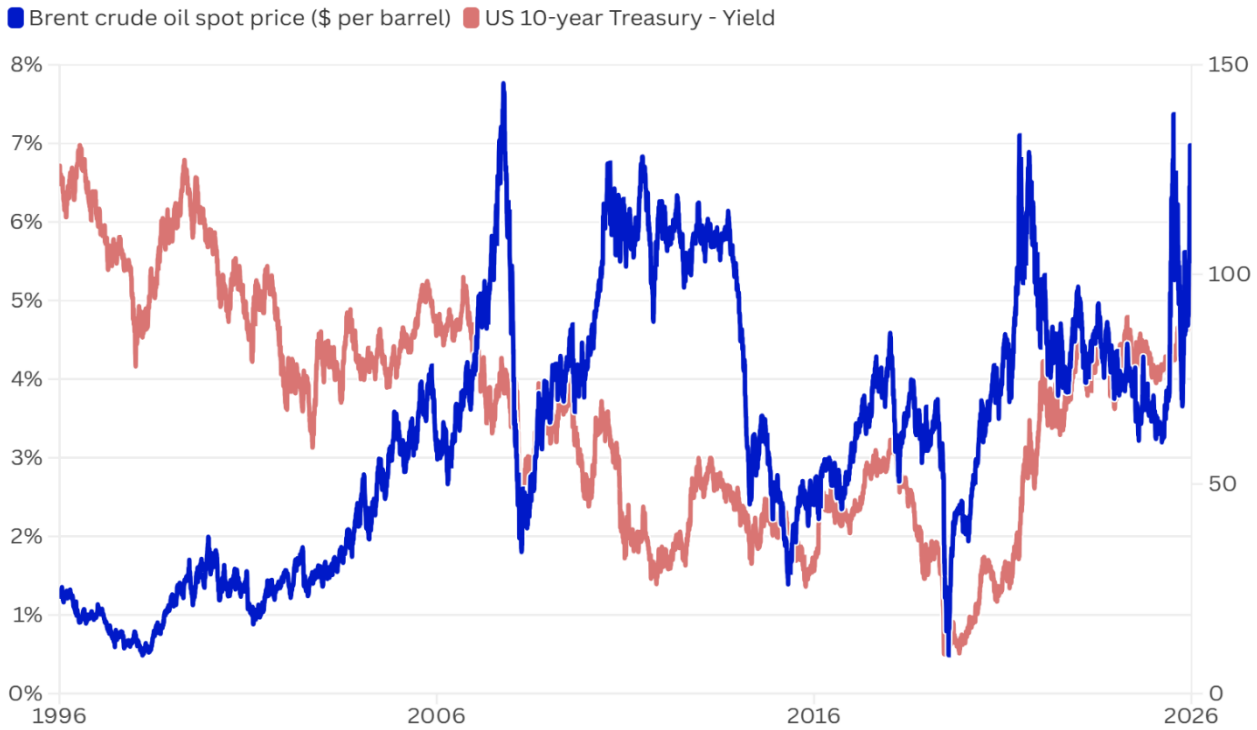
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ultimately, there would be a mutually discovered pain threshold for both sides that would encourage an agreement, with the deadline being the mid-term US Congressional elections. With just over a month to go, this is going to the wire, but our view is unchanged.

The stand-off has disrupted supplies of oil, gas, and related commodities. This has been seen most visibly, recently, in the retail price of diesel, which is now even higher than it was during the worst of the spike in energy prices in 2022, after Russia's full-scale invasion of Ukraine. The price move is exacerbated by a shortage of refining capacity, some of which is the result of Ukraine targeting Russian assets – a reminder that the effects of that war cannot be ignored. Other key commodities also remain in short supply. The fact that the global economy has powered on despite the disruption is a testament to its resilience, but we continue to monitor supply chains for signs that the

Crude awakening

Rising oil prices have helped push US Treasury yields higher as investors brace for stickier inflation.



Source: FactSet, Rathbones

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impact is delayed rather than non-existent.

Inflation and interest rates rebound

All of this is feeding through into inflation, interest rate expectations, and bond yields. Headline consumer price inflation – broad measures of inflation that include volatile items such as food and energy – is rising again. In the UK, for example, October's expected increase in the household energy price cap could push inflation above 4%. While that's a far cry from the 11.1% reached in 2022, it's an unwelcome reversal of the falling trend we were seeing before the US and Iran locked horns.

Higher inflation squeezes households' disposable income and puts government finances under pressure. Bond investors demand higher yields to compensate for inflation eroding the value of their returns, increasing governments' borrowing costs – although inflation can help reduce the value of their debt, in real terms. The effect is particularly pronounced in the UK because it has issued large amounts of index-linked gilts, where the payout rises in line with inflation. It's hardly a consolation that governments across much of the developed world face similar pressures because of the global rise in energy prices.

As for interest rates, this year has seen a sharp reversal of expectations. In January, investors expected several quarter-point cuts from the Bank of England (BoE) and US Federal Reserve (Fed). Now they expect a similar number of increases, or more. Both the Fed and the European Central Bank have embarked on a policy-tightening cycle – a series of measures, typically including interest rate rises, designed to curb inflation. It seems inevitable that the BoE will follow suit.

The optimistic take is that this will inflict short-term pain, through higher mortgage rates, for example, but deliver the long-term gain of keeping expectations for future inflation under control. We also believe that higher bond yields, at least to some degree, restore a bond's ability to provide stability for portfolios during a recession (although they may offer less protection during a government debt crisis).

Another silver lining is that annuities are returning to the conversation about retirement income. Now that bond yields have risen, annuities can once again form part of a broader retirement plan, depending on personal circumstances.

The AI rollercoaster

AI continues to dominate equity-focused discussions, and the technology sector rode a rollercoaster in the third quarter. Earlier in the summer, there were signs that speculation was becoming excessive as investors chased the strongest-performing companies, particularly those producing

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memory chips. Much of this activity centred on South Korea, where soaring share prices for chipmakers Samsung and SK Hynix – alongside gains for Taiwan's TSMC – helped emerging market indices outperform. Korean retail investors used leveraged exchange-traded funds (ETFs) – funds that can amplify both gains and losses – to benefit from the boom.

However, they flew a little too close to the sun, and the smallest hints of doubt set off a cascade of selling. Among those caught up in it was a 24-year-old US hedge fund manager, Leopold Aschenbrenner. His fund, Situational Awareness – ironically named after his influential 2024 paper on AI's vast potential – had used borrowed money to build multibillion-dollar positions in leading AI-related shares. When selling began, he was forced to liquidate his entire publicly traded share portfolio, triggering further falls. The meltdown halted when another hedge fund, Citadel, stepped in to buy what remained.

Still, Aschenbrenner, unlike Icarus, lives to fight another day and is already betting on the next leg of growth, but with greater circumspection. And we think he is on the right track. AI promises to be a transformational technology, and we remain in the foothills of adoption. No doubt there will be setbacks. We are seeing some in the form of the revolt against data centre construction and potential regulatory intervention in the face of large language models evolving into computer hackers. Not much more than a century ago, a man with a red flag had to walk in front of cars to warn pedestrians of the risks. Now the cars don't even have drivers!

Strange times indeed

In providing these reviews, we often try to temper expectations when things look a bit too exuberant. Perhaps more importantly, we also endeavour to keep a sense of perspective when the emphasis is on gloom and doom, as investors are most at risk of jettisoning sound long-term investments in the face of short-term volatility.

Today, we're in the odd position where the doom-mongers are out in force calling a bond market crisis, while, from the perspective of a sterling-based investor, global equity markets overall are at all-time highs. As ever (and channelling Odysseus in this summer's blockbuster film), we aspire not to be seduced by siren voices. Portfolio diversification remains a key discipline in these uncertain times, allowing us to exploit attractive investment opportunities while limiting both volatility and downside risk.

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