RATHBONES

Quarterly Investment Update

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Half-time report

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The closure of the Strait of Hormuz kept inflation high in the first half of this year, but corporate earnings growth flowed freely.

Football supporters can currently choose from an extended daily menu of knockout games as the World Cup moves into the business end of the tournament. The half-time break offers coaches an opportunity to assess what they've seen so far and adjust tactics and personnel accordingly. As the first half of the year ends, what's our assessment? And do investors need, like fretful football managers, to adjust their approach and asset allocation?

Let's imagine we could have laid out in January some of this year's events and then asked investors to forecast returns after six months. We can be reasonably confident that most investors wouldn't have been optimistic enough in their forecasts. Granted, the majority of investment strategists were looking for further gains in 2026. But those advances were largely predicated on a world in which inflation and interest rates were falling. Today, inflation is stubbornly elevated and futures markets are pricing in increases in interest rates.

Quick take:

- Massive capital spending related to AI sustained markets in the first half of 2026, during geopolitical turbulence and stubbornly high inflation.
- This boom has surpassed the US railroad and canal boom, the Roaring Twenties, and the dotcom mania, so investors should take care.
- But major market setbacks are rare when earnings are rising this strongly.

As 2026 began, an event such as the US-Israeli attack on Iran wasn't given a high probability. The ensuing closure of the critical Strait of Hormuz was equally unanticipated.

Investors were a bit more prepared for the political demise of British Prime Minister Keir Starmer, but his departure occurred with almost indecent haste.

And yet through all of this, equity markets have prospered and bond markets have been reasonably resilient. There's been one source of enduring strength. While

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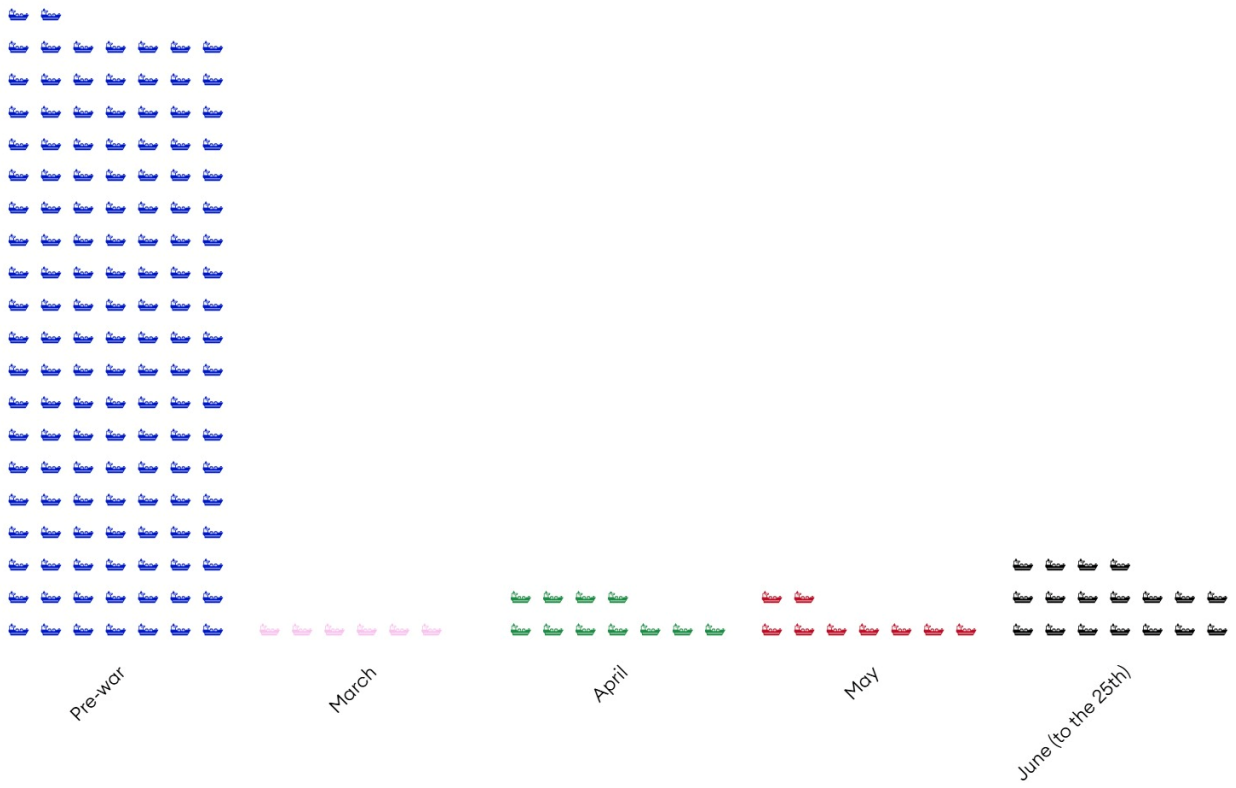
Wait and sea

The number of vessels passing on the average day through the Strait of Hormuz remains much lower than before the Iran War. This is a risk for markets.



Source: International Maritime Organization, Lloyds List Intelligence, Rathbones. Oil Tanker by Yosua Bungaran from Noun Project.

analysts were correct to forecast continued growth in capital expenditure on AI data centres, the amount of growth has far surpassed expectations. That has made the second-quarter corporate earnings season one of the strongest in living memory.

Four market factors to watch

When markets have their intermittent wobbles, it's always important to re-

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examine the fundamentals and judge whether anything has materially changed. We see four key factors to watch.

First factor: the Strait test

Although recent days have seen strikes by both sides of the Iran War, renewed escalation of hostilities isn't priced into financial markets. The oil price is still the best gauge. At just over $70 per barrel, Brent crude is pretty much where it was before the first missile was launched. Yes, that's about $10 higher than at the beginning of the year, but one should expect some premium to account for the commercial and strategic reserves that need replacing.

We're far from complacent about the situation but have judged throughout the war that it suited neither side to extend it. So we've maintained a full exposure to risk assets for its duration, often in the face of worrying headlines.

Second watchpoint: AI's spending surge

The AI-related capital expenditure boom is one of the most powerful in history. If spending is measured as a multiple of the previous cycle's trough, the Bank for International Settlements, known as the 'central bankers' central bank', thinks this boom has surpassed the buildout of US railroads and canals, the Roaring Twenties before the Wall Street Crash, and even the dotcom boom.

So far, the bulk of spending has been financed by the operating cash flow of the 'hyperscalers'. These are the technology behemoths building the data centres that provide the computing power for the frontier large language models – the AI systems that understand and generate human language. Demand for computing power has risen exponentially as users begin to deploy AI agents, tools that can run themselves and undertake complex tasks.

This means the hyperscalers increasingly need to issue bonds and equity to fund their spending, heightening the risks for investors. Past booms have tended to falter when the returns are insufficient to cover the interest payments on debt. We're nowhere near that stage, but some sort of Rubicon has been crossed, with this new issuance.

It's still too early to declare with any certainty whether the returns will be sufficient. Much will depend on the productivity gains captured by companies using AI models. We think we're still in the infancy of this technological advance, when companies are grappling with how best to engage with it.

The latest bout of uncertainty is around what users are willing to pay for access to frontier models. There are reports of companies burning through their annual AI token budget in the first few months of

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the year as model providers shifted from the 'all you can eat' pricing model to one based on token consumption. Revenue growth may slow as users reassess their budgets or shift to free open-source models, created by communities and companies to execute certain tasks. But for now, at least, there's absolutely no sign of a reduction in capital spending plans by the hyperscalers and the underlying demand growth trend is strong.

Reflecting this risk, a UBS basket of hyperscalers has produced no return in more than a year. The returns have flowed instead to the recipients of the capex: the 'picks and shovels' providers. The Philadelphia Semiconductor Index, home to makers of memory chips, has gained 140% over the same period. We've focused on capturing the benefits of investing in the recipients of the capex.

The third test: interest rates

Traders are pricing in at least a quarter-point increase from the US, UK, and eurozone central banks. This is largely in response to the lingering higher costs for energy, and its derivatives, such as fertiliser, resulting from the Strait's closure. The AI spending boom is also contributing – note Apple's big price increases for computers, for example.

Further hawkishness emanated from the newly appointed chair of the US Federal Reserve, Kevin Warsh. In our opinion, he said what he felt he had to say to calm the market's nerves about his particular version of the Fed being too fast and loose with inflation. This was a concern born of the fact that he was appointed by US President Donald Trump, who only ever thinks interest rates should be lower. Even so, we don't think rates need to rise as long as the oil price remains lower and the effect of tariff increases stays out of the annual inflation data. Tariffs boosted inflation for a while, particularly after last year's 'liberation day', but the effect will fade again as the year progresses

We also feel much tighter UK monetary policy is unwarranted, given weak economic performance. For example, employment growth is negligible.

The fourth support: earnings growth

Year-on-year growth in earnings per share for the US S&P 500 was 17% in Q1, excluding some one-time benefits. This exceeded analyst estimates by 5 percentage points. The consensus forecast for Q2 is 22%. In Europe, earnings are expected to grow 18% in Calendar Year 2026.

It's rare to experience a major market setback when earnings are rising this strongly. The usual catalyst for an earnings reversal is a recession. More often than not, this comes from monetary policy tightening, which, as explained, we see no current need for.

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Burnham: building prosperity?

Finally, UK politics. Prospective Prime Minister Andy Burnham has used a speech to set out an agenda that includes "sound public finances" and commitment to the current fiscal rules. This was welcomed by government bond investors, worried that he'd loosen fiscal policy too aggressively and without reference to productive growth.

Ultimately, raising the UK's economic growth rate is the best way to improve the UK's fiscal position. As we mentioned in our *Building Prosperity* report last year, devolving some decision-making to cities and regions could be one step in the right direction. But we think a Burnham government would need to go much further to encourage private investment, thereby improving the UK's growth prospects. That includes reforming parts of the tax system.

I've written more here about what a Burnham victory might mean for investors. We've also written about what it might mean for your wealth and financial planning.

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