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Third Quarter 2026

The third quarter of 2026 was characterised by an increasingly complex backdrop for investors as strong corporate fundamentals and continued enthusiasm surrounding artificial intelligence (AI) competed with rising inflation concerns, higher bond yields and renewed geopolitical tension in the Middle East. While global equity markets ultimately delivered marginally positive returns over the quarter, performance became increasingly uneven and volatility rose as investors reassessed both valuations and the likely path of monetary policy.

July proved challenging for risk assets following the strong recovery witnessed during the second quarter. Equity markets, particularly those most closely linked to AI infrastructure and semiconductor production, experienced a period of consolidation as investors questioned whether the pace of recent gains had become detached from underlying fundamentals. At the same time, renewed disruption to energy supplies in the Middle East contributed to a rise in oil prices and reignited concerns that inflationary pressures could prove more persistent than expected.

These themes remained firmly in focus during August. Bond markets took centre stage as sovereign yields moved higher across most major developed economies, reflecting a combination of factors rather than any single catalyst. Investors continued to grapple with elevated government debt levels and expansive fiscal policies across many developed economies, while sustained economic resilience raised doubts over how quickly central banks would be able to ease monetary policy. At the same time, substantial debt issuance by major technology companies, many seeking to finance continued investment in AI data centre capacity, added to the overall supply of fixed income securities and contributed to upward pressure on yields.

In the US, attention centred on the Federal Reserve. Earlier in the year, markets had become increasingly concerned that political pressure from the Trump administration might encourage a more accommodative policy stance from the central bank; however, Chairman Warsh adopted a relatively hawkish tone in August, reinforcing confidence in the independence of monetary policy while simultaneously reducing expectations for near-term interest rate cuts. This was followed by an interest rate hike in September, with a further one likely before the end of the year.

The final few weeks provided a balanced conclusion to the quarter. Equity markets broadly regained momentum as investors focused on generally healthy corporate earnings and evidence that economic activity remained resilient despite tighter financial conditions. AI continued to dominate market leadership, with semiconductor manufacturers, software providers and data centre-related businesses remaining among the strongest-performing areas of global markets. However, market participation remained relatively narrow, with a small number of large-cap technology companies continuing to account for a disproportionately large share of overall index returns.

Geopolitical developments influenced investor sentiment throughout the quarter. Tensions involving Iran remained unresolved; while fears of a severe and prolonged disruption to global energy supplies eased, oil prices remained sensitive to developments in the region. Higher energy prices have had a negative impact on stock and bond markets as well as complicating the task facing central banks which often 'look through'

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commodity price moves but must be mindful of the impact on food, fuel and other goods that can strongly influence consumer behaviour.

Fixed income markets experienced a difficult quarter overall. Government bond yields moved higher as investors reduced expectations for imminent monetary easing and became increasingly focused on structural fiscal challenges in several developed economies. However, fiscal concerns alone do not fully explain the move. Strong economic data, elevated levels of government and corporate bond issuance, and continuing investment in AI-related infrastructure all contributed to a significant increase in the supply of debt securities reaching the market during the quarter. The move higher in yields was evident across most major developed bond markets. The gilt market remained particularly sensitive to these concerns, even though the UK government has in recent years been forced into a more responsible stance than other countries including the US.

Outlook

Looking ahead, the balance between growth and inflation remains the dominant consideration for financial markets. While economic activity has remained broadly resilient throughout 2026, inflation has proven more persistent than many investors and policymakers anticipated at the start of the year. Energy markets remain a source of uncertainty, and the combination of elevated fiscal spending, tight labour markets and periodic supply-side disruptions suggests that inflationary pressures may take longer to subside than current market expectations imply.

Equity markets continue to benefit from genuine technological innovation, particularly within AI and related industries. However, leadership has become increasingly concentrated within a small number of companies, sectors and investment themes. Although many of these businesses continue to deliver impressive earnings growth, current valuations assume a continuation of exceptionally favourable outcomes. Furthermore, as AI systems become increasingly powerful and autonomous, questions surrounding regulation, governance and societal acceptance are likely to become more prominent. While appropriate oversight may ultimately support wider adoption, there is a risk that future regulation could slow deployment, increase costs or reduce the profitability of some parts of the sector. History demonstrates that periods characterised by strong momentum and crowded positioning can persist for extended periods but can also reverse rapidly when expectations become too optimistic.

We therefore continue to believe that diversification remains particularly important. Attractive opportunities remain available across a broad range of asset classes and regions, including areas that have not participated as fully in the recent technology-led rally. Bond yields also remain significantly higher than has been typical for much of the last decade and may provide increasingly attractive opportunities should economic growth moderate or inflation begin to ease more convincingly.

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