



The past month summed up

With businesses doing their best to avoid war-induced disruption, and signs of substance to the artificial intelligence (AI) boom, we're ok for now.

The rationale

Our central view remains that the AI-revolution is driving the US economy and adding impetus to an infrastructure investment cycle that has the capacity to invigorate the global economy. The recent relatively stable interest rate and inflation environment is however being threatened by disruption to oil supplies and prices due to the continuing blockade of the Strait of Hormuz. The risks are escalating the longer it continues.

For now, the outlook for the economy, at least in the eyes of stock markets, seems to be relatively positive even amid a raft of global geopolitical uncertainty (the S&P 500 index is about 8% higher this year). In effect, for the last couple of months we have had simultaneously one foot on the throttle of the global economy in the form of the generational unleashing of capital, spending and innovation that is the AI technology revolution, with the other foot tentatively on the brake in the form of conflict in the Middle East.

Impact delayed or avoided

Why only tentatively given oil still isn't passing through the Strait of Hormuz? There are several reasons. First, signs of economic damage tend to take time to emerge following an oil shock such as that caused by the war. This is due to the somewhat counterintuitive behaviour of businesses. So, while consumers may well rein in spending immediately as confidence drains in the face of a threat on the horizon, businesses tend to do the opposite seeking to stockpile inventory to ensure their operations can continue. After all consumers can substitute a meal at home for a meal out or turning on the TV rather than visit the cinema. Businesses still have to buy in the materials they need to produce goods and thus far it seems they've been dusting off the lessons of COVID to ensure they are best prepared for any squeeze on supplies. As a result, US factory production notched up its largest increase in 14 months in April.

A second relative boon has been that the chokehold on oil supply hasn't yet filtered down strongly into the economy. The US is relatively well protected given that it is self-sufficient in energy production, but even in the rest of the world a patchwork of different anticipatory and reactive measures are contributing to keeping things ticking over, at least for now. For example, China has benefited from having a strategic reserve of oil while Indians have been encouraged by Prime Minister Modi to work from home and to reduce their energy consumption in order to direct increasingly scarce oil supplies to where they are needed the most. But these measures are only temporary patches.

Thirdly, the amount of stimulus being pumped into the US economy via the tax cuts of President Trump's One Big Beautiful Bill Act is also helping to shore up any deceleration from the war and its associated economic consequences.

For consumers the pinch is becoming "real"

However, these shock absorbers won't work forever. Cutting off the supply of oil, the ingredient that's essential for so many elements of our energy and manufacturing needs, will eventually feed through to inflation and a damping of economic growth. That inflationary effect is already starting to emerge with US consumer prices jumping by 3.8% in April, the most since 2023, from just a 2.4% increase in February – the US government said half of April's increase was down to rising energy costs. Producer prices rose by an even higher 6%.

That inflation figure is now rising faster than the pace of increases in wages which will likely have an even more negative effect on consumers already weary from rising costs. According to the US government, real average hourly earnings taking into account inflation fell 0.3% in the year from April 2025 to April 2026. Consumer spending decelerated to a 0.5% growth level in April from 1.6% in March, while the University of Michigan's consumer sentiment index dropped to a record low in May.

The AI's have it

While businesses and consumers are pulling in different directions for the moment, the effect of the AI revolution is singularly one directional. It's fair to ask why the all-encompassing power of this trend? A useful exercise might be to measure just how different the world is today from when ChatGPT first came on the scene in 2022. Already what we call AI has revolutionised Internet searches and a range of tasks from writing articles to code for computers. The most skilled of white-collar workers the world over are fearful that their jobs will be replaced relatively quickly by machines, while defence departments are eagerly courting AI companies in the race for superiority on the battlefield.

Even if some of these might still be speculative rather than tangible, the scale and speed of spending is both being driven by and underwriting the earnings at the largest companies. Alphabet, the parent of Google, reported its net income rocketed 81% in the first quarter in part due to cloud computing revenue, Microsoft's cloud business posted a 40% increase in revenue and Amazon also reported better-than-expected results on the back of its cloud unit; all three reported record cloud computing backlogs with the demand driven by AI. And businesses are splurging more than ever – capital spending from Meta, Alphabet, Amazon and Microsoft will be \$725 billion this year, nearly double last – in the first quarter of this year more than half of US growth was driven by capital spending, principally investment in AI and data centres. At the same time, we are also seeing a surge in the share prices of companies building our energy infrastructure, particularly those who can maintain supplies to meet huge demand from data centres but also can diversify away from the dependency on Middle Eastern oil.

Is this exuberance getting out of hand, especially in the context of ongoing disruption in the Middle East? Probably not yet. The market for initial public offerings, a measure of risk appetite, has a very healthy pipeline at the moment with urban bike rental company Lime looking to raise \$2 billion, data centre operator DayOne looking to raise \$5 billion and at the summit (where else for Elon Musk?) SpaceX seeking \$75 billion, the biggest offering in history, that would value the cosmic exploration company at about \$1.75 trillion.

Some froth combined with robust returns from tech firms and no sign of a return to normality in the Middle East provides a delicate mix that promotes maintaining a sensible balance between risk and safety in portfolios.

Hedging it all

Gross imbalances across the market, global oil supply constraints, huge investments into technology? While conventional stock or bond investors might find the present situation unsettling, it is proving to be the sweet spot for those hedge funds who make trades on the ups and downs of markets and in particular are able to bet on falling prices as well as those that are rising. Reuters reported last month that stockpicking hedge funds were on track for their best monthly performance in more than a decade, citing data from Goldman Sachs.

Thus, hedge funds form a very important component in portfolios, providing a different way to manage risk and balance stocks as we enter even more uncertain times and as the dispersion of outcomes across the market intensifies. All the more so given the bond market is yet again under attack from inflation, political dysfunction and questionable discipline around deficits. Since COVID, bonds have failed to provide the same crisis protection as they did when inflation wasn't on the menu.

Conclusion

With markets still caught in an economic tug-of-war between the self-inflicted stagflationary wound in the Gulf and the wealth of capital spending on technology now is not the time to take on additional risks in portfolios but to continually reassess the appropriate balance within asset classes. There are industries that look more vulnerable to oil-induced harm and there are others which look set to benefit from spending whatever the economic weather. For now, the market is giving the benefit of the doubt to the latter, not an irrational verdict when S&P 500 earnings grew by 25% in the year to the end of March! Signs of tangible real returns from technology mean that there are clear opportunities in this area and we continue to lean equity portfolios towards businesses profiting from not only the investment boom underpinning artificial intelligence but also energy security and infrastructure resilience.

Holdings of bonds at the short end of the market continue to make sense given that the increased uncertainty in relation to inflation and interest rates makes the returns of longer dated bonds less appealing. Finally, we are seeking to build further resilience in portfolios through the alternative assets we hold, particularly in funds that find the present volatile conditions advantageous for their investment style.

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