The past month summed up

A global sell-off in government bonds and an existential challenge to artificial intelligence euphoria pose a challenge to the growth cycle that has so far weathered the geopolitical storm.

The rationale

Our core view remains that the economic growth cycle remains on track, powered by an artificial intelligence (AI) revolution that has the potential to drive wealth creation today, through massive capital investment, and in the future through productivity advances. On the downside though, some of those at the very top of the AI adventure are now openly expressing fears about the risks in such a major technological transformation, while there's significant trouble brewing in bond markets.

With a finely balanced inflationary situation alongside geopolitical uncertainty and bulging government deficits, it's no surprise investors have been demanding greater compensation for holding government debt. In fact, in recent weeks, we have had one of the most significant shifts in sentiment towards government bonds since the global financial crisis. US Treasury yields reached their highest level in almost 20 years as investors demanded greater returns in the face of ballooning uncertainty. The sell-off wasn't just limited to US debt, with yields on UK 10-year gilts now sitting well above levels seen in the middle of the Truss/Kwarteng budget debacle. German 10-year yields climbed to their highest in 15 years, and the Japanese 10-year yield neared its highest in three decades.

The catalyst seems to have been an escalation in hostilities between the US and Iran, with news that Iran-proxy Houthi rebels had attacked Saudi infrastructure and were dangerously close to controlling access to the Bab al-Mandeb Strait, another important choke point in the global supply of oil on top of the already imperilled Strait of Hormuz.

It is not just the supply of black gold that is constrained – brent crude rose above $100 a barrel for the first time since May – but with refining capacity in the Gulf and Russia damaged, second order impacts on the cost of petrol, diesel and jet fuel are building fast. President Donald Trump didn't help the situation when he stated that it was likely the conflict would continue until after US November midterm elections, indicating he isn't concerned in the near future to seek an accommodation with the Iranians that would allow oil to flow more freely.

The impact of attacks is now coming home to roost

Advancing energy prices threaten inflation and squeeze companies and consumers as they filter down into what they are paying for a host of other goods. Significantly, the price of diesel in the US is at a record level of more than $6 a gallon, up from about $3.50 at the start of the year. As we have pointed out before, the price of fertiliser, which contributes to the prices we all pay for food, is rising. Meanwhile the upswing in attacks between Ukraine and Russia on each other's shipping networks is also hampering the export of grain from one of the world's most important producing regions. And this is before we absorb the potential impact of a "super el Nino" climate surge. It could be a sign of these disturbed times that President Trump's reignited trade war with Canada, where he has imposed a series of tariffs on goods from whiskey to clothes to hockey stocks, is barely getting a mention.

All of this is keeping inflation risks at a higher level than policymakers would like, forcing central banks into a tightening cycle. The Federal Reserve followed the ECB and increased interest rates this week citing inflation fears and a desire to cool a turbocharged economy, a decision that drew the ire of President Trump coming in the run-up to the knife-edge November congressional elections.

The numbers keep getting bigger

Why has the bond market taken such a turn? Inflation sends bond yields higher (and prices down), because it reduces the real value of their fixed payments meaning investors want more return to compensate for that risk. But that's only half the story. Investors are already strained in their appetite for US debt with the government owing a gargantuan $40 trillion. More borrowing means more supply of debt and lenders want a higher interest rate when the amount borrowed is excessive and budget discipline is fading. The Federal government's annual budget deficit has already reached $2 trillion after the first 11 months of the fiscal 2026 year. In a further sign of the current administrations carefree approach to balancing the books, President Trump announced that he's planning to give a cheque for $5,000 to every adult citizen if the Republicans win the mid-terms. The move would add another $1.2 trillion to an already looming debt mountain – equivalent to 4% of annual GDP.

Rising yields increase the cost of borrowing not just for the government but set also set the benchmark for everyone else and so matter for the wider economy. Mortgage rates in the US are near 7%, heaping further pressure on a moribund property market and squeezing lower income earners. Small businesses in particular rely on borrowing and bank loans, and so rising yields have a direct impact on business strength in the heartland of the US.

So, the question must then be as to why much of the market thinks things are fine, and the reason remains AI, and specifically spending on the infrastructure build out. Here, there's no shortage of statistics reminding us of just how massive this phenomenon is turning out to be, with tech titan Oracle recording a 121% jump in revenue from its cloud infrastructure business to $7.4 billion in its fiscal first-quarter. According to JP Morgan, cumulative spending on AI will reach $5 trillion by 2030 (more than the entire UK economy produces in a year and 4x Trump's promised giveaway!). Everywhere companies' earnings seem to be benefitting, with Bank of America's global earnings revision ratio climbing from 0.99 to 1.35 in the month. Global stocks themselves advanced 2.6% over August and fund managers remain incredibly bullish with cash levels at an ultralow 3.5%, and investments in global equities at their highest level since November 2021.

Still, could the quest for AI dominance send us over the edge? There is no doubt that the amount of money being invested by technology companies is itself having an impact on inflation – witness how Apple recently hiked the prices of its phones by about $100 across-the-board because of the higher costs for chips and other hardware. Perhaps the bigger worry is the recent commentary around the threat posed by AI and the need to slow progress while guardrails are put in place – much of it coming from AI executives. With AI the driving force of the economy and markets, any slowdown would be negative for numbers and sentiment (perhaps a price worth paying if it saves us from extinction!)

Two speed economy?

And it's not as if the fruits of the AI boom are being spread equally. Poorer elements of the US society are getting left behind. The FT recently reported that while US corporate profits now represent their highest share of national income since just after World War II, the proportion employees receive has fallen to its lowest level since the 1950s. This is having an effect at both sector and corporate levels. Walmart's second quarter earnings showed the weakest same-store sales growth in many years while sales of previously occupied US homes slowed to the slowest pace in more than a year in August, showing potential owners may just not have the money to afford a new home, a fact also evident in statements from leading builders.

The good news for now is that the wall of investment going into AI is still spearheading growth way beyond the confines of US technology – the global earnings revision ratio now shows earnings upgrades are outpacing downgrades in every region around the world. But with the geopolitical and inflationary headwinds, the dominance of the AI-led boom in our economic story leaves markets increasingly vulnerable to any disappointment from this fast-moving technology.

Conclusion

We continue to balance our portfolio between the prospects of an equity market benefitting from AI-focussed capital expenditure and the risks that are becoming increasingly evident in inflation and in geopolitics. Our equity strategy remains centred on diversification. Identifying not only those companies who may prove real beneficiaries of the AI revolution – experience from other technological revolutions shows that those at the forefront today may not prove long-term winners – but also companies and sectors that can prosper independent of this technology super-cycle.

Significantly within our defensive bond allocation we are adding to our inflation protection given the rising price risks. We are doing this without raising our overall bond position and we are staying at the shorter end of bond duration, which is less vulnerable to fiscal deficit concerns. Lastly, we continue to find other opportunities for diversification in a range of hedge funds which thrive on uncertainty, volatility and dispersion between assets, regions and currencies.
