Q3 2026 Market Update

The third quarter of 2026 tested investors' patience. Hopes that the US–Iran deal would bring a lasting normalisation of energy flows faded as the stand-off over the Strait of Hormuz dragged on, and the resulting rebound in oil prices – together with signs that the US economy is running hot – drove a sharp sell-off in government bonds across the developed world. Equity markets were resilient rather than exuberant in the face of higher yields: global indices edged up, but gains were modest and uneven, and leadership broadened, with some of the strongest moves coming from markets with little AI exposure, notably emerging EMEA and Latin America. The MSCI World index returned 1.79% over the quarter, with the S&P 500 the strongest major market at 2.1% and the Eurostoxx 50 the laggard at -1.4%.

Two themes stand out for portfolio construction. The first is that bonds and equities have again been driven by the same force – rising yields – which has left equities looking expensive relative to bonds, while ten-year gilt yields close to 5.4%, now offer genuine income. The second is the dollar: having softened in July and early August, it recouped its losses from mid-August as US interest rate expectations rose, so currency decisions continued to matter for sterling-based investors. Gold held up better than the rise in real yields would imply, supported by central-bank buying, while property shares lagged as higher yields made their bond-like income less attractive.

At home, the renewed energy shock is pushing inflation higher again, and political uncertainty and thin fiscal headroom remain a risk for sterling and gilts. Money markets now price a meaningful tightening cycle from the Bank of England, but we doubt the economy and labour market are strong enough to turn an energy-driven rise in inflation into a lasting one. The commentary that follows – prepared with our research partners at Capital Economics – reviews the quarter's returns in detail and sets out the economic and market outlook by region.

Asset Class Returns (GBP, Q3 2026)

EQUITIES	Performance
MSCI World	1.79%
FTSE 100	1.82%
S&P 500	2.13%
Eurostoxx 50	-1.42%
Nikkei 225	-1.04%
MSCI Emerging Markets	-0.46%

PROPERTY/ COMMODITIES	Performance
Global Property	-6.19%
Gold	3.63%
Oil (Brent)	41.81%

BONDS	Performance
UK Gilts	-2.53%
UK Index Linked Gilts	-1.24%
UK Corporate Bonds	-1.74%
Emerging Market Debt	-3.95%

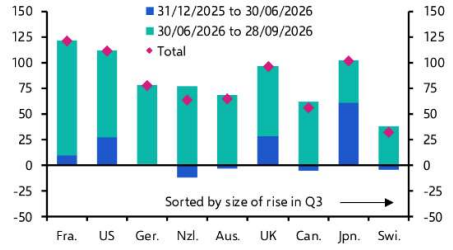
Looking ahead, the AI rally in stock markets appears to be in its final stages. Equities may make further gains over the rest of this year – possibly in a final 'blow-off' phase led by tech – but Capital Economics expects the bubble to burst during 2027, with all major stock indices projected to fall next year before recovering much of their losses in 2028. Government bonds look better placed: the third-quarter sell-off appears overdone, and yields should fall as energy prices ease and central banks raise rates by less than markets expect.

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Global equities rose modestly in Q3, with the MSCI World index returning 1.79%. US tech stocks generally fared well, although volatility in the sector rose to levels previously seen only in the dotcom bubble and the 2022 sell-off. Some of the largest gains came in markets with little exposure to AI, such as emerging EMEA and Latin America, helped by higher commodity prices, while developed Europe and emerging Asia lagged in sterling terms. The FTSE 100 returned 1.82% and the S&P 500 2.13%.

Safe assets had a difficult quarter. Government bond yields surged across developed markets, particularly in September, with higher oil prices the proximate cause. Ten-year gilt yields rose to around 5.4% and Treasury yields to above 5.2%, while French yields rose furthest on fiscal concerns. UK gilts returned -2.53% in Q3 and UK index-linked gilts -1.24%. Corporate bonds returned -1.74%, with credit spreads remaining exceptionally tight.

Chart 10: Change in 10Y Yields Since 30th Jun. 2026



Gold held up better than might have been expected given the rise in real Treasury yields, helped by an uptick in central-bank purchases and resilient risk appetite, and ended the quarter up 3.63% in sterling terms.

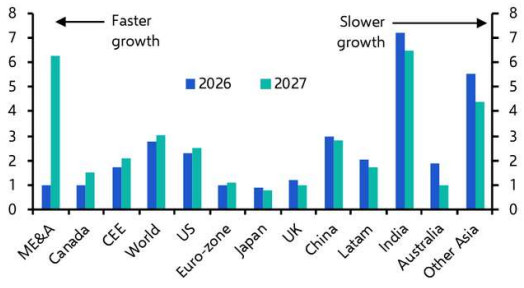
Global property returned -6.19% in the third quarter. REITs ceded ground to ordinary equities from late July in the US, developed Europe and developed Asia, as higher government bond yields made their bond-like income streams less appealing.

Brent crude oil prices rebounded in Q3, rising by 41.81% in sterling terms, as hopes of a swift normalisation in Gulf energy flows faded. Crude exports remain below normal levels and global inventories are still being drawn down, while refined product markets have come under particular strain. Capital Economics expects supply disruption to keep the oil market tight over the coming months and forecasts Brent at $100pb by the end of this year.

Economic Outlook – Weathering the energy shock

Global – The prolonged US–Iran stand-off has extended the energy shock, but the global economy is proving resilient: in Q3 world trade continued to boom, consumption held up and business surveys improved. Energy markets remain tight, and the damage to Qatar's LNG facilities means gas supply will be slower to recover than oil. Capital Economics assumes Brent stays around $100pb until year-end, then falls to $70pb by end-2027 and $60pb by end-2028 as Middle East exports recover. Global GDP growth is forecast at 2.8% in 2026, 3.1% in 2027 and 2.8% in 2028. Inflation should rise a little further before falling back during 2027, and with the risk of second-round effects low, the major developed-market central banks should tighten by less than investors expect. Beyond energy, the key risk is the sustainability of the AI boom.

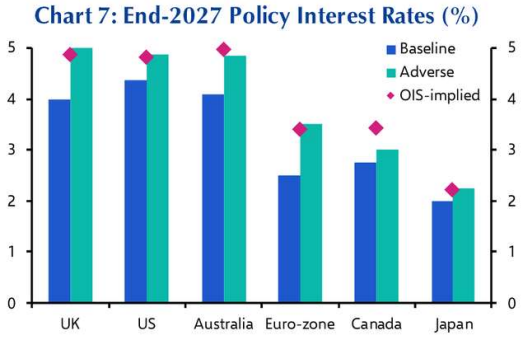
Chart 4: CE Forecasts of Annual GDP Growth (%)



US – Strong AI investment should deliver above-consensus growth of 2.3% this year and 2.5% in 2027, with unemployment falling to 3.8%. Headline inflation is set to rise towards 4% this year before falling below 2% by end-2027. The Fed, under new Chair Warsh, is expected to raise rates twice more – in December and the first quarter – fewer than markets price, then reverse those hikes in 2028 as the expected equity correction slows growth to 2.0%. The 10-year Treasury yield is

forecast to fall from around 5.25% to 4.75% by end-2026 and 4.25% by end-2027.

Euro-zone – The euro-zone has absorbed a significant energy shock. Headline inflation should peak at around 4% in December, but with the labour market not particularly tight, second-round effects should be negligible. GDP is forecast to grow at around its trend rate – 1.0% in 2026 and 1.1% in 2027. The ECB is expected to raise rates once more in December before cutting the deposit rate back to a neutral 2%, well below market pricing, while French bonds remain vulnerable to fiscal and political concerns.



UK – Higher energy prices mean CPI inflation is expected to rise from 3.1% in August to 4.3% early next year, and 10-year gilt yields have risen to around 5.4%. But growth is set to slow to 1.3% this year and 1.0% in 2027, and with the labour market loose – unemployment may rise from 4.9% in the three months to July to 5.3% – employees have little scope to push for faster pay, so inflation could fall to 2.0% by end-2027. Capital Economics predict that the Bank of England will probably raise Bank Rate from 3.75% to 4.25% as insurance, well below the 4.75%–5.00% investors expect, and the 10-year gilt yield is forecast to fall to 5.00% by end-2026 and 4.50% by end-2027. The Budget on 28 October did little to change this picture: headroom against the main fiscal rule is now only about £15bn, down from £24bn in March, so fiscal and political uncertainty remains a key risk for sterling and gilts.

Japan – Japan's economy has coped with the energy shock well, with real GDP up 0.4% q/q in Q2. Inflation is close to the Bank of Japan's 2% target and should accelerate into the first half of next year. The BoJ is expected to lift its policy rate to 2% as soon as mid-2027 and then stop, short of what markets price, leaving the 10-year JGB yield around its current level above 3%. Concerns over expansionary fiscal policy remain.

China – Capital Economics' China Activity Proxy suggests growth slowed to just 1.2% y/y in August; on this measure GDP is forecast to grow 3.0% in 2026 and 2.8% in 2027, while official figures will continue to show much stronger growth. Exports of chips, computers and green-tech products remain the main driver, and fiscal spending should give a lift in the final months of the year, but excess capacity will keep fuelling price wars. Inflation is expected to average just 0.4% next year, and only 30bp of rate cuts are expected by end-2028.

Asset Allocation Views

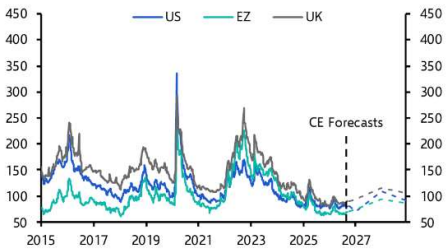
Bonds – Government bond yields surged across developed markets in Q3, mostly because higher energy prices and strong US data pushed up near-term rate expectations. The sell-off looks overdone: with energy prices expected to drop back and most central banks set to tighten by less than markets discount, DM government bonds should generate good returns over the coming year or so, with a further lift from safe-haven demand if the AI bubble bursts. Ten-year Treasury and gilt yields are forecast to fall to 4.25% and 4.50% respectively by end-2027.

Corporate bonds – Credit spreads remain exceptionally low by historical standards, leaving little room for further outperformance against 'safe' assets, and heavy AI-related bond issuance has increased the asset class's direct exposure to the tech cycle. Spreads are expected to widen in 2027 as the bursting AI

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bubble weighs on risk appetite, but the rise should be muted by historical standards. With risk-free yields falling, corporate bonds should still deliver decent returns and outperform equities, albeit without much extra reward for the risk.

Chart 17: Option-Adjusted Spreads Of FTSE Investment Grade Corporate Bond Indices (bp



Equities – The AI boom is increasingly on borrowed time. Valuation measures look stretched, earnings expectations appear optimistic, and both market capitalisation and earnings are unusually concentrated in a handful of companies, leaving the market vulnerable to any loss of confidence in the hyperscalers' capex plans or a further rise in bond yields. Gains are still possible over the rest of this year, but all major indices are projected to fall in 2027, with the largest falls in the US and Korea. Europe, with less AI exposure, is expected to be the best-performing region as the bubble bursts, and most markets should recover a large part of their losses by 2028.

Chart 27: Share Of S&P 500 Accounted For By 10 Largest/Most Profitable Companies (%)



Emerging market equities – Emerging-market indices outside Asia have been helped by firmer commodity prices, a support that should unwind as those prices fall back. Tech-heavy Korea and Taiwan are most exposed to an AI reversal. Chinese equities have not benefitted especially from the boom so far, partly because key chip and compute firms are unlisted or lightly weighted in the index, but would gain at the margin from any further inflation of the AI bubble and suffer somewhat if it bursts.

Property – REITs have lagged ordinary equities since late July as higher yields made their bond-like income less appealing. Valuations are not compelling: the dividend yield on US equity REITs is now slightly below the S&P 500's earnings yield, a gap historically consistent with marginal underperformance over the following decade. Structural shifts continue, with health care and data centres gaining ground at the expense of traditional sectors such as office and retail.

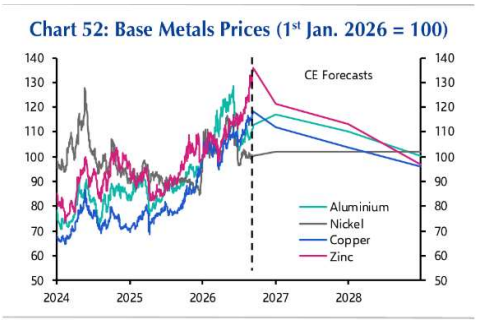
Currencies – The US dollar has strengthened since mid-August and may rise a little further in the near term while interest rate differentials favour the US, with sterling also exposed to domestic political and fiscal uncertainty. Further out, a peak in US equities and a slowing US economy should mark a turning point, and the dollar has plenty of scope to weaken. The yen is expected to rebound in 2027 and 2028.

Commodities – Commodity prices have generally surged amid the US–Iran war and look set to remain high this year, but Capital Economics' forecasts are more bearish than the consensus and imply poor returns over the coming years as prices fall back.

Energy products have delivered strong returns, while the related rise in Treasury yields has kept a lid on precious metals and returns from industrial metals have been steady.

Supply disruption should keep the oil market tight over the coming months, with Brent forecast to end the year at $100pb. Once shipping constraints ease, Gulf producers should restore output quickly, and Brent is forecast to fall to $70pb by end-2027 and $60pb by end-2028, although lasting damage to refinery capacity will slow the fall in refined product prices. Risks to European gas prices are skewed to the upside this winter following the loss of Qatari LNG supplies.

Industrial metals – Demand is being supported by the AI infrastructure build-out and could get fresh impetus from the green transition given high energy prices, while the war is also disrupting supply. Prices are forecast to fall, but to remain high by recent standards.



Precious metals – Gold has held up better than rising real yields would suggest, helped by central-bank buying and resilient risk appetite. However, it has increasingly traded like a risk asset, and Capital Economics expects it to fall as the AI boom turns to bust, to $4,000 per ounce by end-2026 and $3,600 by end-2027 – below a consensus that expects further gains. Silver is expected to fall even further, as high prices are already prompting solar users to switch to alternative metals.



Final Word

Our central message this quarter is selectivity. The recovery in markets has been real, but it has also been narrow: leadership remains concentrated in a small group of AI-related companies trading at demanding valuations, and history suggests the final phase of such booms rewards discipline more than enthusiasm. We are participating in the growth on offer – increasingly through diversified exposure – while deliberately declining to concentrate client portfolios in the most crowded corners of the market.

In bonds, the restoration of genuine income is the most important development for long-term investors in a decade, and we believe it is best captured at short and medium maturities, where yields are attractive and the structural pressures building on long-dated government bonds – heavy issuance, sticky inflation and fading central-bank support – carry less force. We also see a growing case for the physical enablers of the technology build-out – power, grids, data centres and infrastructure – which stand to benefit from the AI investment cycle at more reasonable valuations than its most celebrated names.

As ever, our portfolios are built to weather a range of outcomes rather than to depend on one. If tensions in the Gulf ease and the AI cycle extends, diversified portfolios will participate; if either disappoints, the emphasis we place on income, quality and genuine diversification is designed to protect.

Scot Laing (CFP™ Chartered FCSI)

Managing Director

Sources: Capital Economics; Bloomberg; FE Analytics

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