

Capital Markets Update

OCTOBER 2026

Rising energy prices stemming from Middle East tensions and resilient economic activity prompted several major central banks to raise interest rates in Q3. This, in turn, put further pressure on sovereign bonds. Equities nevertheless approached new highs, supported by strong corporate earnings.

Global themes

Global growth has been more resilient than expected despite the ongoing conflict in the Middle East and higher energy prices. Economic activity generally exceeded expectations in Q2, while the J.P. Morgan Global Composite PMI rose to its highest level in more than three years in September (Chart 1), pointing to continued momentum in Q3. Against this backdrop, consensus forecasts for global growth have risen to 2.6% in 2026, only slightly below expectations prior to the US-Iran conflict, while growth forecasts for 2027 have increased to 2.7%.

The AI-led investment cycle is supporting growth, boosting demand for semiconductors and data-centre infrastructure, while partly offsetting weakness from trade uncertainty and tariff-related headwinds. This is particularly beneficial for the US and technology- and semiconductor-exposed Asian economies. It's also masking weaker performance in more rate-sensitive sectors of the major economies, such as housing and autos.

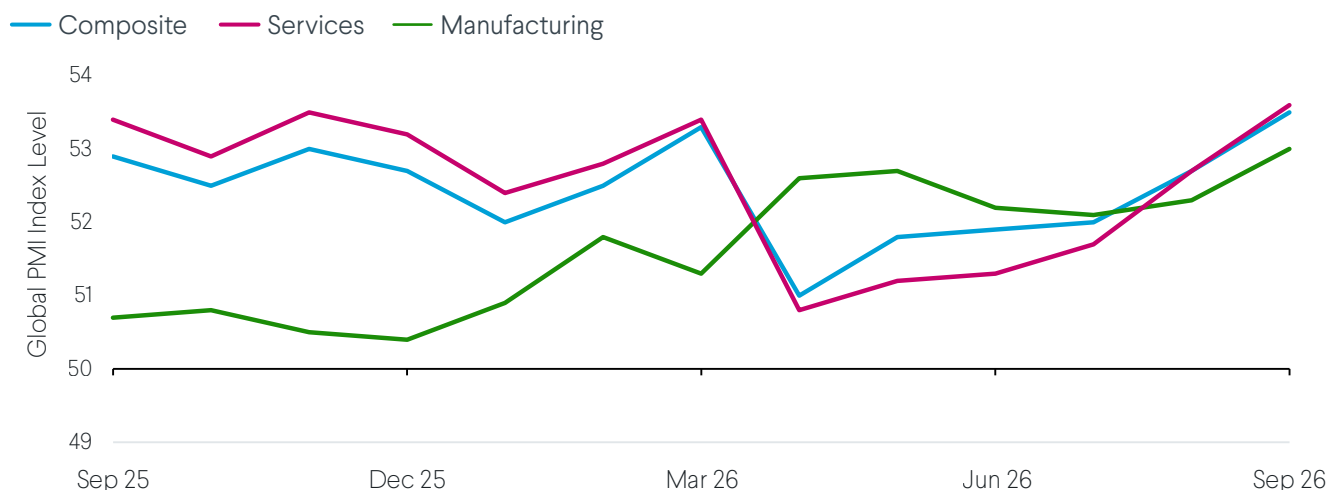
While labour markets are holding up well, moderating wage growth and persistently elevated inflation could slow growth in household purchasing power. This could widen the gap between a resilient corporate sector, particularly the technology sector, and a weaker consumer profile.



Chris Arcari

Partner and Head
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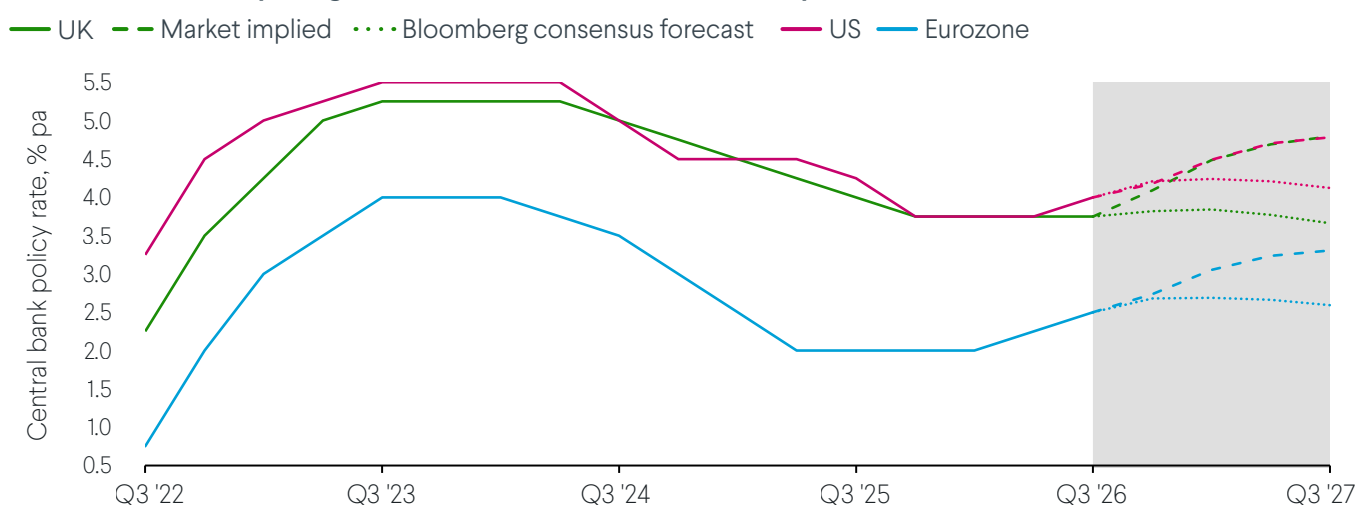
Chart 1: The J.P. Morgan Global Composite PMI is consistent with above-trend global growth



Source: Bloomberg

Headline and core inflation remain above target across most major economies, while resilient activity and renewed energy pressures have reinforced expectations that interest rates may stay higher for longer. While central banks would typically look beyond temporary supply-side shocks, underlying inflation is elevated and growth has been stronger than expected. Higher market interest rates and bond yields may help tighten financial conditions, but they could also reflect expectations that the neutral rate has risen. Against this backdrop, more policy tightening by the major central banks is possible; this is a more likely prospect than it was earlier in the year.

Chart 2: Markets are pricing in more rate hikes than economists expect



Source: Bloomberg

That said, we don't expect a prolonged hiking cycle. Higher borrowing costs and slower wage growth should weigh on household demand, reducing the risk of persistent second-round inflation effects and limiting the overall extent of further policy tightening. Indeed, market-implied policy rates suggest a more hawkish policy path over the next 12 months than is reflected in consensus forecasts (Chart 2). This is particularly the case for the Bank of England (BoE). Markets appear to be pricing in a significantly more aggressive path for interest rates than is implied by either economists' forecasts or recent BoE communications. While the Monetary Policy Committee has adopted a hawkish tone in response to inflation risks, recent statements suggest a willingness to tighten rates further (if required), rather than a clear intention to deliver the degree of tightening currently priced by markets.

Looking ahead

Strong earnings growth is supportive of equities and credit in the near term, and further gains would not be surprising against such a backdrop. At the same time, renewed Middle East tensions and higher energy prices may keep upward pressure on inflation, interest rates and bond yields.

However, with limited evidence of significant second-round inflation effects, tighter financial conditions may ultimately help contain inflationary pressures as we move into 2027 and 2028. While the near-term outlook for bonds is challenging, current yields already reflect a considerable amount of tightening. Any easing in inflation pressures could therefore prove supportive.

Equities face a different challenge. Strong earnings growth expectations are already reflected, at least partly, in elevated valuation multiples. Corporate profitability is also close to record highs relative to GDP, leaving cyclically adjusted valuations looking particularly stretched. As a result, further gains appear increasingly dependent on the delivery of earnings growth at rates rarely sustained outside the recoveries that follow recessions.

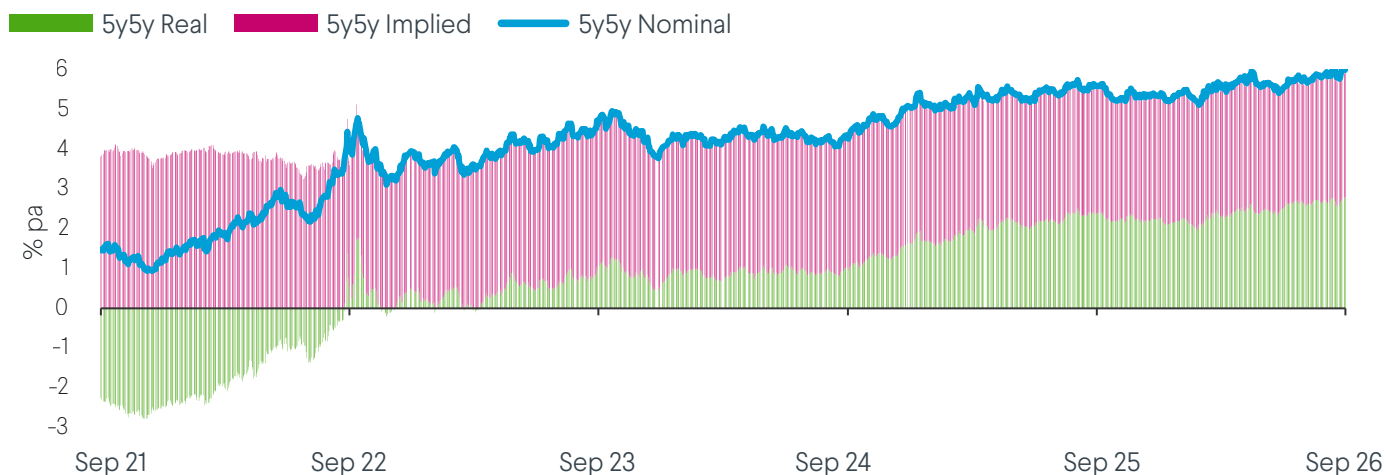
The near-term earnings support for equities is real, as are the inflationary headwinds facing bonds. However, for medium-term investors, it's becoming increasingly difficult to ignore the combination of elevated equity valuations and bond yields that are high by post-GFC standards.

While the cyclical backdrop is supportive of risk assets, medium-term return prospects increasingly favour bonds as higher yields enhance expected returns, and equity valuations appear more demanding.

Government bonds

UK government bond yields rose materially in Q3, with the UK 10-year yield up 0.7% pa, to 5.4% pa, as investors reassessed the outlook for inflation, interest rates and economic growth. While growth moderated in Q2, economic activity was more resilient than expected, prompting upward revisions to growth forecasts. At the same time, inflation rose during Q2 and is expected to stay above target in the near term. This has reinforced expectations that rates may need to remain higher for longer to contain inflationary pressures. Consequently, gilt yields have risen across much of the curve, reflecting increases in both real yields and inflation expectations.

Chart 3: Forward real yields rose more than forward inflation expectations in Q3



Source: Bank of England

The combination of resilient growth and higher inflation presents a challenging near-term backdrop for nominal gilts, while providing somewhat greater support for index-linked gilts. However, higher yields have further improved medium-term return expectations. At 6.0% pa, the five-year spot yield expected in five years' time (the so-called five-year, five-year forward) appears increasingly attractive relative to long-term growth and inflation expectations. Equivalent real yields have risen to 2.7% pa, which is attractive by the past decade's standards.

While the near-term path for yields may be volatile, we believe gilt valuations are becoming increasingly attractive. Relative valuations are also more supportive for nominal gilts than index-linked gilts, as market-implied inflation continues to incorporate a sizeable premium above our long-term inflation expectations. We remain cautious on the longest-dated bonds where forward yields decline, suggesting limited compensation for extending duration despite bearing greater exposure to inflation, fiscal and policy uncertainty.

Heavy government and corporate bond issuance, elevated inflation uncertainty, and a more price-sensitive investor base are likely to keep term premia elevated and contribute to continued volatility, particularly at longer maturities. However, the BoE's decision to retain its longest-dated gilts while continuing quantitative tightening elsewhere may provide some support.

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Robert Kotlar
Senior Investment
Research Analyst

Credit

Investment-grade credit spreads widened modestly during the quarter amid elevated issuance, including sizeable issuance from large technology companies, some of which is supporting AI-related investment.

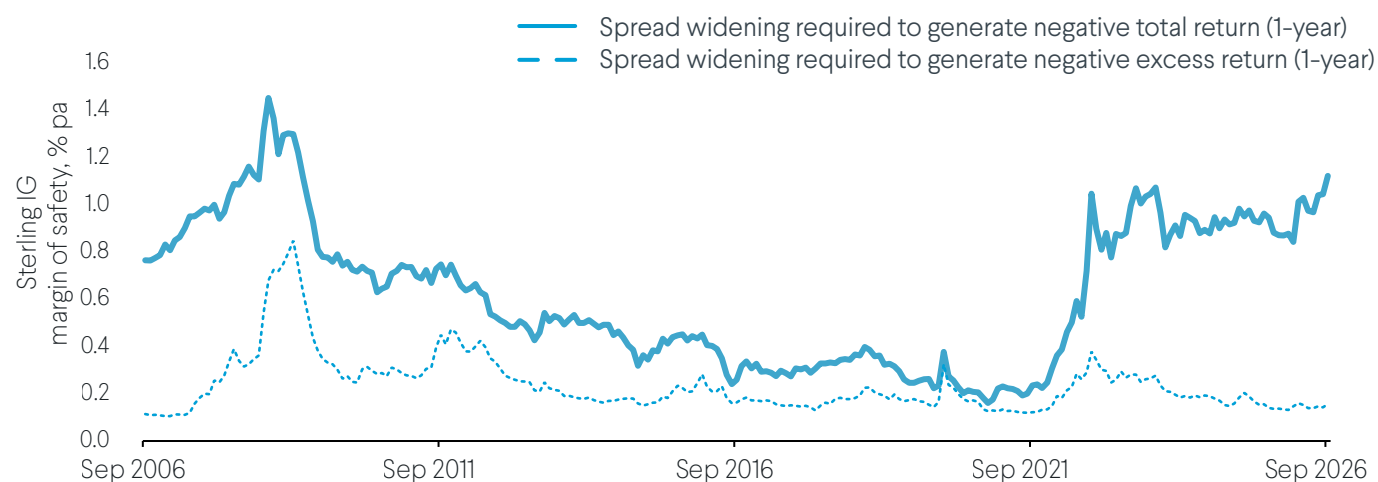
While spreads are wider than earlier in the year, they are very tight by historical standards. Investment-grade credit continues to be supported by a relatively healthy fundamental backdrop and resilient economic activity. Earnings growth should help corporates absorb gradually rising refinancing costs.

Tight spreads limit the scope for further spread-driven returns. At current levels, even a modest widening could cause investments with shorter holding periods to underperform gilts of an equivalent duration. However, higher government bond yields have improved all-in investment-grade credit yields. While spreads offer less compelling relative value, they continue to provide some compensation for expected downgrade and default losses. As a result, the absolute return outlook remains reasonable for longer-term investors.

The outlook is less compelling in speculative-grade credit. While default rates are broadly contained, spreads continue to provide limited compensation for economic uncertainty, a potential worsening of fundamentals and market volatility. Higher financing costs have had a faster and more pronounced impact on lower-quality and floating-rate borrowers, with weakness increasingly concentrated in the CCC-rated segment of the market. Although current all-in yields are broadly in line with our neutral return expectations, tight spreads suggest market volatility could create more attractive entry opportunities over time.

The medium-term outlook also assumes losses from downgrades and defaults stay broadly in line with historical averages. Sector-specific technological disruption could still weaken issuer fundamentals and credit quality over time.

Chart 4: Credit spreads have retraced earlier widening



Source: Bloomberg

Higher all-in yields provide a meaningful cushion against spread widening, but the outlook relies on defaults and downgrades staying broadly in line with historical experience.



David Watson
Investment
Research Consultant

Equities

Despite rising sovereign bond yields placing pressure on equity valuations, global equities gained in Q3 as strong earnings growth more than offset the de-rating effect. Earnings expectations also increased, particularly in the tech and tech-adjacent US mega-caps and emerging market companies exposed to AI-related capex spending.

However, despite the de-rating of trailing and forward price-to-earnings multiples seen in recent months, cyclically adjusted price-to-earnings ratios are elevated. Recent earnings growth has been very strong and expectations for full-year earnings per share growth for 2026 and 2027 have risen to 29% and 15%, respectively, for the MSCI World. These forecasts rise even further, to 36% and 17%, once emerging markets are included. However, earnings growth has historically been highly cyclical, and this level has rarely been seen outside of recoveries from recessions and severe earnings drawdowns (Chart 5).

Chart 5: Current earnings expectations are unusually strong by historical standards



Source: Shiller. Y-axis truncated for extremely strong post-GFC recovery.

Nascent signs of improving productivity growth, particularly in the US, may support stronger earnings potential. AI-related investment, resilient economic growth and a shift in market composition towards higher-margin companies could also contribute. However, current forecasts leave limited room for disappointment. This brings into focus the sustainability of the earnings growth seen in recent years and forecast over the coming years. Investors will need to assess whether recent earnings strength reflects lasting improvements in profitability or a more cyclical boost from the current AI-driven investment cycle, where spending by hyperscalers is supporting unusually strong earnings growth among suppliers across the technology ecosystem. The latter would suggest that any reversion in earnings, which appear elevated relative to longer-term trends, could pose a headwind to medium-term returns.

High realised and forecast earnings can mask elevated long-term valuations, leaving markets vulnerable if profit expectations fall short.



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Property

The UK property market delivered a total return of 5.6% over the 12 months to end-August, driven entirely by income returns. Industrial and retail capital values rose 0.7% and 1.5%, respectively, but this was offset by a 3.1% decline in offices.

Although nominal rents continue to increase, rental growth is broadly flat in real terms. Development activity remains subdued due to elevated construction costs, while the highest-quality assets continue to command rental premiums.

Retail is a relative bright spot. Sentiment is stable, with vacancy rates of 5% broadly in line with long-term averages. In contrast, industrial vacancy rates have risen to 11% and are above historical norms, reflecting a combination of weaker tenant demand and additional supply. Office vacancy rates have improved, falling from a peak of 26% to 21%, but remain elevated relative to long-term averages.

The net initial yield was unchanged at 5.3% pa during the quarter. The reversionary yield declined slightly from 7.1% pa to 7.0% pa, suggesting marginally less rental upside is implied by current valuations.

Transaction activity remains subdued, with investment volumes this year continuing to fall below both five- and ten-year averages. Lower market liquidity continues to limit price discovery, although the absence of widespread forced selling has helped support valuations for higher-quality prime assets. Investors continue to withdraw capital from some pooled property funds contributing to ongoing selling pressure, causing some to suspend or defer payout of redemptions. Recent fund mergers have facilitated orderly exits for redeeming investors.

While property valuations appear broadly reasonable and income yields are attractive relative to history, subdued transaction activity and weak liquidity continue to limit conviction. Returns are therefore likely to be heavily reliant on income, with prospects varying materially across sectors and asset quality.

Property returns are still heavily reliant on income, with prospects varying materially across sectors and asset quality.



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If you'd like to discuss what these market themes mean for your portfolio, please contact your usual Hymans Robertson consultant or any member of our capital markets team.

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