HYMANS ROBERTSON

Capital Markets Update

Autumn 2025

Despite rising tariffs, resilient global growth has allayed fears of a sharp economic slowdown. But inflation is above target in both the UK and US, driven by persistent domestic pressures and the effects of rising tariffs, respectively.

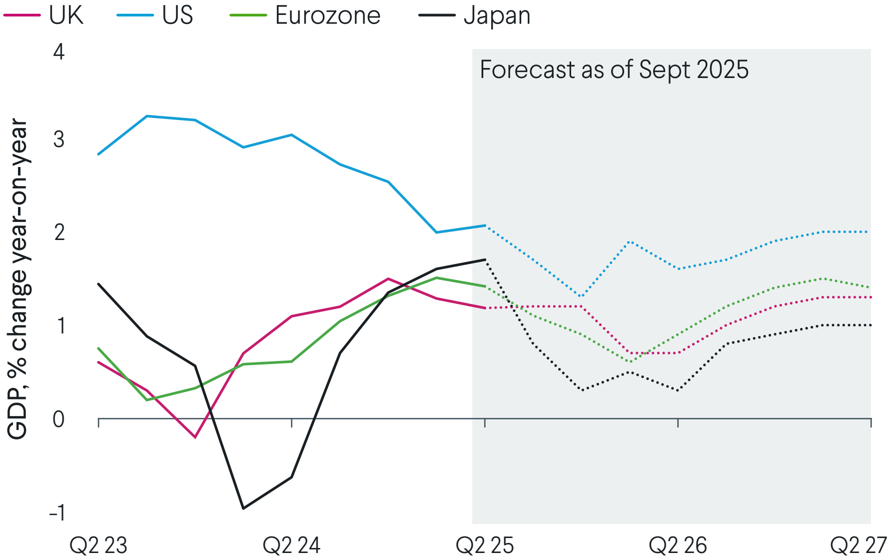
Global equities rose 8.1% in the third quarter (Q3), supported by easing trade tensions, renewed AI optimism and rising expectations of US interest-rate cuts. While US sovereign yields fell, yields elsewhere climbed amid expectations of increased government bond issuance.

Global themes

Global growth in the first half of 2025 was partly supported by solid business investment and frontloaded orders ahead of US tariff hikes. However, growth is set to slow modestly in the second half as tariff effects deepen (Chart 1).

With frontloading behind us, non-US exporters now face higher tariffs and compliance costs. Meanwhile, US importers, having drawn down inventories, must choose between absorbing costs or passing them on to consumers. Lingering uncertainty is also expected to impede business investment.

Chart 1: Global growth is expected to slow modestly in 2025 and 2026, largely due to the US



Source: LSEG Datastream, Consensus Economics

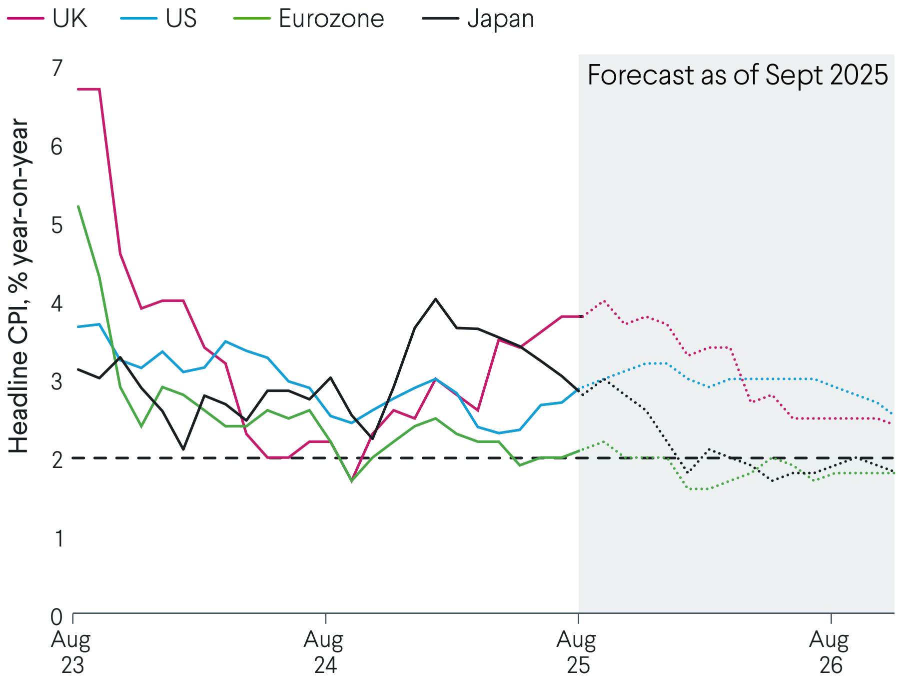
Chris Arcari
Head of Capital Markets

Consensus forecasts put global growth at 2.4% in both 2025 and 2026, down from earlier projections and below 2024's 2.7%. However, a deeper slowdown is unlikely, thanks to ongoing US AI investment, delayed effects of rate cuts, moderately supportive fiscal policy in the US and Europe, and strong corporate and household balance sheets. Slower US job growth also reflects weaker labour supply, not just softer demand.

Third-quarter business surveys suggest a severe slowdown is unlikely. Global sentiment surveys indicate above-trend growth, despite a slight September dip. Manufacturing expanded in August, complementing strong service-sector performance, and the expansion was broad-based across regions. Meanwhile, business sentiment recovered to a seven-month high. But job growth stalled, raising questions over how benign recent labour market weakness is and growth sustainability.

Headline CPI inflation is expected to stay above target in the UK and US over the next year (Chart 2). In the UK, elevated wage and services inflation (both at 4.7%), combined with weak productivity, pose challenges to the Bank of England's (BoE) 2% goal. In the US, tariff-related price pressures are likely to build as importers deplete inventories and pass on costs.

Chart 2: Inflation in the UK and US is expected to stay above target until at least 2027



Source: LSEG Datastream, Consensus Economics

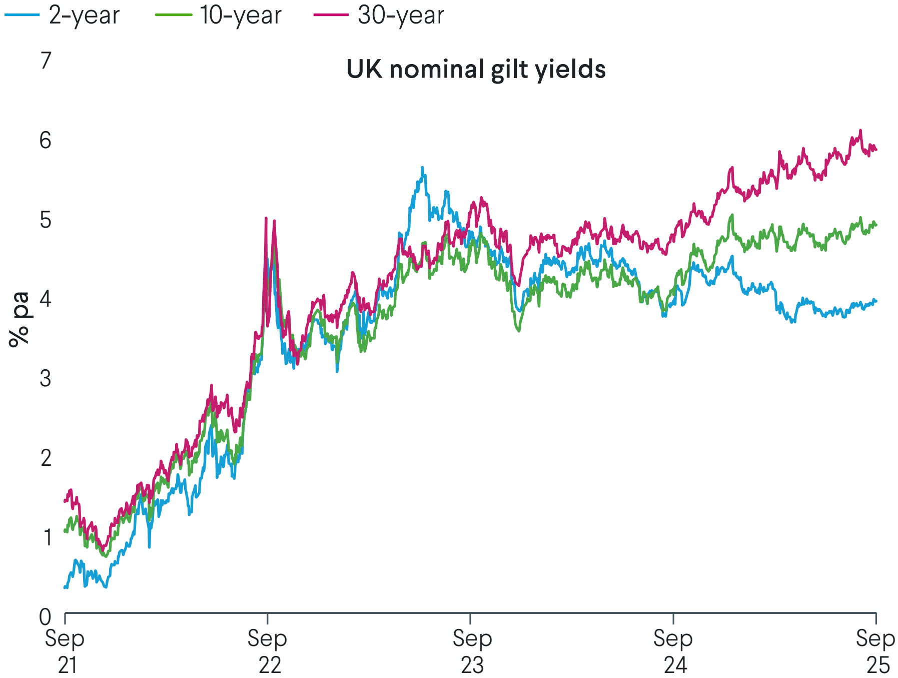
Markets are pricing in over 100 basis points of Federal Reserve (Fed) rate cuts by end-2026, reflecting a view that the Fed will prioritise employment over inflation. In contrast, after the BoE's narrow August rate cut to 4.0%, only one more cut is expected in the next year – reflecting persistent inflation and a policy rate seen as only mildly restrictive. The market's expectation of a cautious BoE feels warranted, but the Fed may struggle to justify the scale of cuts unless growth and inflation slow more than forecast.

Government Bonds

The UK economy is experiencing slightly below-potential GDP growth and persistent inflation. This has led to higher short-term yields in Q3, although expectations of future rate cuts are keeping them relatively stable. At the long end of the yield curve, heavy government bond issuance and declining institutional demand are pushing yields up, causing steepening across advanced economies.

The BoE's move to slow quantitative tightening and reduce sales of long-dated gilts may ease some pressure, but the overall technical environment remains difficult. While overseas investors are stepping in to replace traditional buyers including pension funds and insurers, they are demanding higher yields. Despite this, 10-year gilt yields around 4.9% are still seen as attractive, even after adjusting for persistent term premia.

Chart 3: Rising issuance and waning institutional demand continue to drive longer term yields higher.



Source: Bank of England

Index-linked gilts are benefiting from a slightly more supportive backdrop, with weaker growth and higher inflation making them more attractive from a fundamental perspective. Ten-year real yields have climbed to around 1.7% pa in Q3, which is attractive relative to our assessed fair value.

However, the technical environment is becoming more challenging, partly due to the global AI investment boom, which is increasing competition for capital and pushing real yields higher. As a result, the outlook is balanced between nominal and index-linked gilts: nominal gilts offer slightly better valuation, but index-linked gilts have stronger fundamental support.

Robert Kotlar
Senior Investment Research Analyst

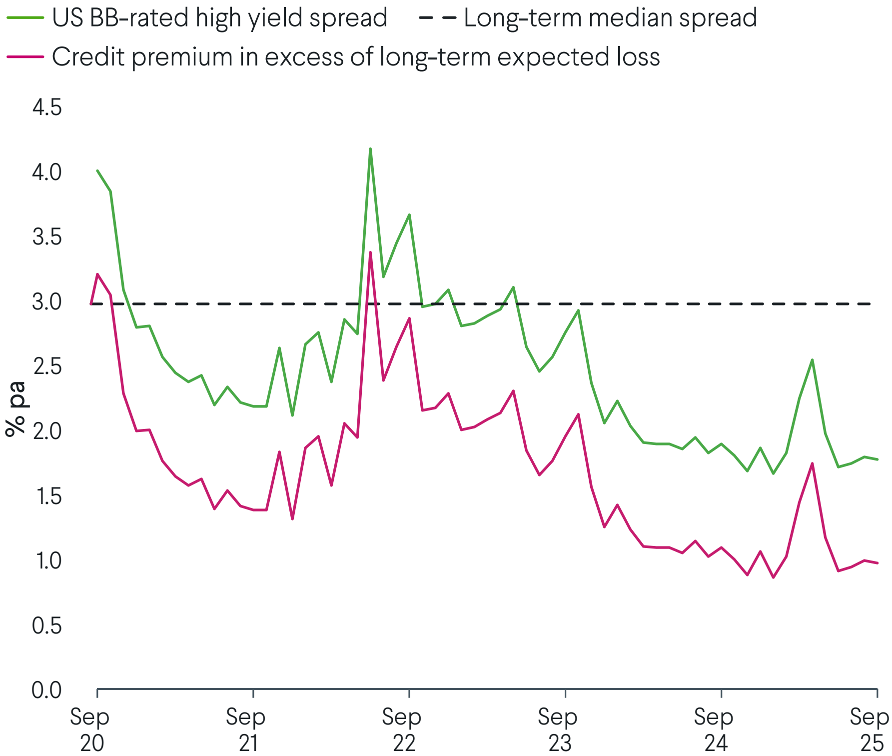
Credit

Corporate fundamentals remain relatively robust. Net leverage is higher than when yields were last at these levels, but debt affordability, as measured by net interest coverage, remains healthy due to robust earnings growth and a relatively gradual rise in effective interest rates.

Investment-grade credit spreads fell further in the third quarter to increasingly tight levels relative to history, which might make short-term investors a little more cautious. However, they still provide buy-and-hold investors a premium over long-term losses to default and downgrades. Furthermore, high all-in yields mean medium-term absolute risk-adjusted returns still look relatively attractive.

In speculative-grade credit markets, where spreads are even tighter relative to their own history, and the risk of losses greater, credit risk premia look increasingly thin. As a result, even allowing for attractive underlying government bond yields, and the relatively benign near-term default outlook, we are becoming more cautious on the outlook for speculative-grade corporate bonds.

Chart 4: Thin credit risk premia in speculative-grade corporate bond markets warrant caution.



Source: ICE Index Platform, Hymans Robertson, EIOPA – European Insurance and Occupational Pensions Authority, https://eiopa.europa.eu/.

David Watson
Investment Research Consultant

Equities

Aided by resurgent AI optimism, easing trade tensions and US interest-rate cut expectations, the MSCI All World Total Return Index rose 9.7% in Q3, bringing year-to-date gains to 10.6%. However, US dollar weakness reduced returns for unhedged sterling investors.

Rising valuations and market concentration – especially in the tech-heavy US market – are drawing comparisons with the dotcom bubble. However, while valuations are elevated, today's tech sector is more profitable, and cyclically adjusted price/earnings ratios remain well below early-2000 levels.

Nonetheless, sustained high valuations depend on continued strong tech earnings. Markets, particularly the US, are vulnerable to AI-related disappointments. At these levels, valuations imply a more subdued medium-term return outlook ahead than the blistering pace set in recent years, which keeps us cautious on global equity markets. Additionally, the US appears most fully valued, reinforcing the case for diversification beyond US-centric indices.

Chart 5: Today's more profitable tech sector means valuations are far less frothy than in the dotcom era

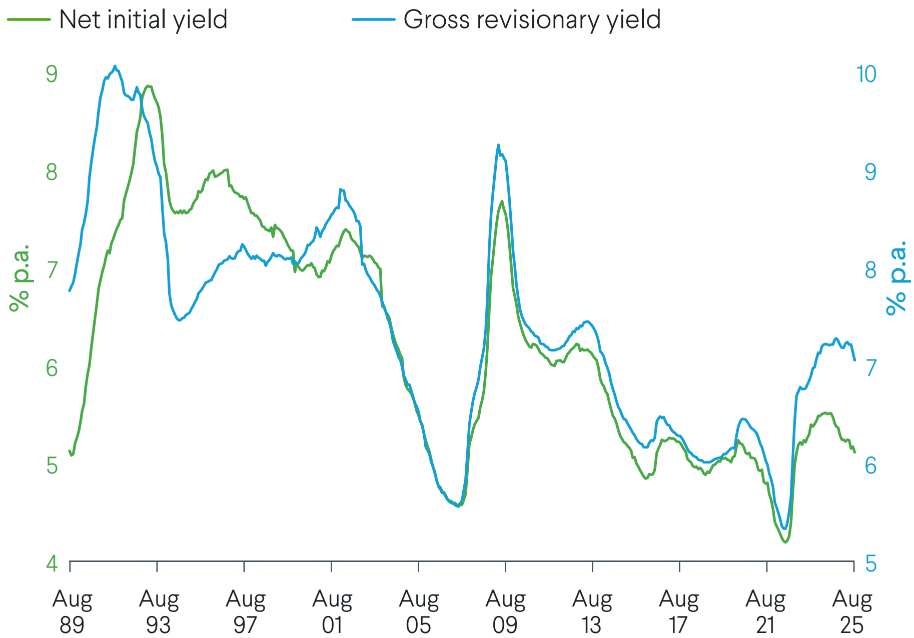
Source: LSEG Datastream

Matt Firth
Investment Research Associate Consultant

Property

Rents are rising across the retail, office and industrial sectors. However, aggregate annual rental growth is below CPI inflation, at 3.4% relative to 3.8%. While rental growth is slowing from historic highs in the industrial sector, the rate of growth is improving in the retail and office sectors. Income remains a significant proportion of returns at 5.8% over the year to end-August, while the total return of the MSCI UK Monthly Index was 8.7%. Vacancy rates are above historical averages across the sectors but have declined recently. This is mainly due to a reduction in office vacancies, although these are nearly double their long-term average at 24%. Industrial vacancies have been rising.

Chart 6: Reversionary yields in UK commercial property indicate potential for further capital growth



Source: MSCI IPD Monthly

Property yields compressed slightly at the end of Q2 and were stable over Q3. Net initial yields (based on current rents) at 5.2% pa are still below gross reversionary yields (based on future estimated rental value) of 7.1% pa, indicating some potential for capital growth. Market sentiment is improving, with agents reporting optimism across several sub-sectors. However, transaction volumes remain low, and some pooled funds are experiencing ongoing redemptions. The UK government's proposed ban on 'Upwards Only Rent Reviews' could affect future rental growth and valuations, but this policy is still in its early stages and is subject to change.

Viran Patel
Investment Research Associate Consultant

Conclusion

Global growth is set to slow but has proven resilient, despite rising US tariffs and uncertainty. Tariff pressures are building, but AI investment, fiscal support, rate cuts and strong private balance sheets are providing a solid cushion.

Our medium-term caution on risk markets stems less from near-term fundamentals and more from stretched valuations. Both equity and credit markets appear expensive relative to historical norms and fair value estimates based on long-term earnings and loss assumptions.

High global equity valuations are largely driven by the tech-heavy US market. While strong tech earnings justify some premium, valuations assume sustained growth and leave the US exposed to AI disappointment. Even with a lasting premium, the US appears fully valued – supporting the case for regional diversification beyond that provided by US-dominated global market-cap-weighted indices.

Attractive sovereign yields support corporate bond returns, but tight spreads offer little compensation for credit risk.

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