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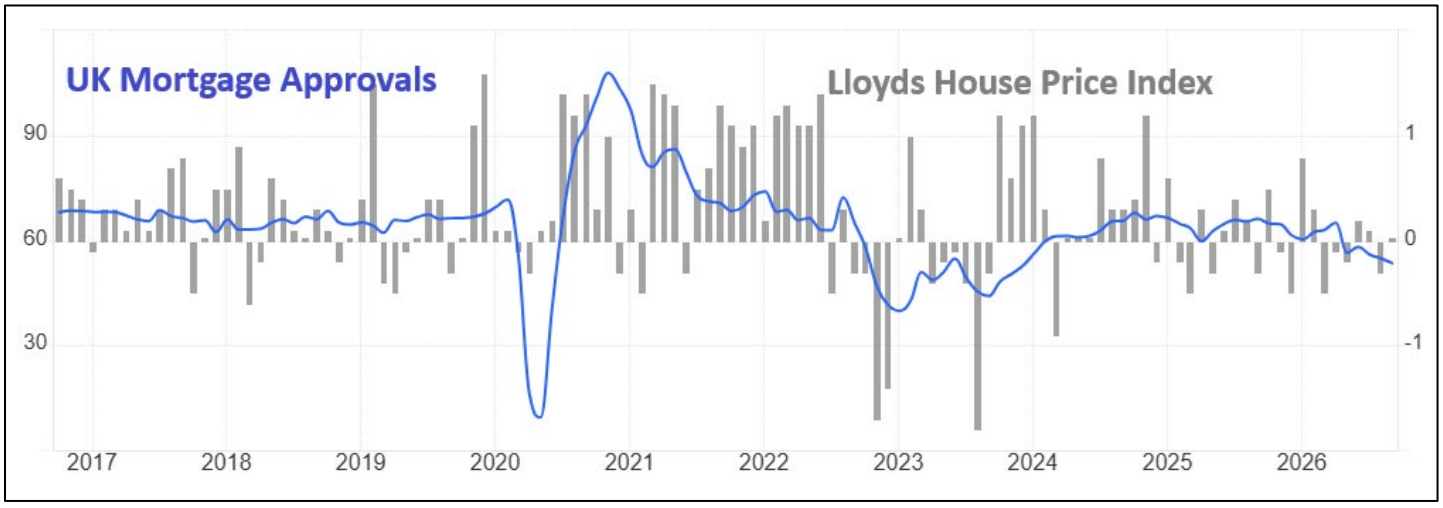
# Market View

**October is often the most difficult month for markets and so it proved again this year. November has started with the US midterm elections, which saw a big vote in favour of the Democrats as high gas, diesel and food prices hurt US consumers. The Iran conflict is clearly deeply unpopular in the USA, however, the reopening the Strait of Hormuz is down to the Iranians. Trump is desperate for a deal, will the Iranians now give him one? Trump has threatened escalation, though talks do seem to be underway. This remains a pivotal event for markets and will dictate the future direction of inflation and interest rates. For the US economy, there are now fears that AI data centres could be reined in, as they were an election issue. Furthermore, the US debt ceiling may well now be fixed, as budgets will be very hard to agree on. Trump has veto powers, so markets now expect nothing politically to be agreed. Impeachment will be difficult unless Republicans turn on Trump, investigations into financial irregularities are now highly likely. Overall, for markets, it's mixed news. But the midterms are now out of the way and that is positive.**

**Central banks, faced with rising inflation figures, have started to follow the bond markets and move official interest rates higher. Markets must take notice when trends change and globally the interest rate trend has officially turned negative. However, this is not in response to excess growth but to an oil supply shock, which could be reversed if the Straits reopen. Markets can easily get "bored" and have now priced in a prolonged closure of the Strait of Hormuz and higher inflation. Inflation expectations, a key Federal Reserve indicator, are moving higher. An Iran deal that looks permanent would now be a positive shock to markets. The "artificial intelligence trade" is starting to falter. This is always going to be a volatile sector, as it is all expenditure and no revenue yet, valuations are based on what is known as "hope value". It is becoming clear that AI will be transformative for global industry and commerce, but just when and by how much is guesswork. Another hike in the Federal Funds rate to 4.25% in December is now priced into markets. The Bank of England is being forced to follow. Headline inflation in the UK is being dragged up by electricity and gas prices and UK consumers, already under pressure, are likely to be hit even harder. The recent Budget did nothing to mitigate this pressure. The UK economy is dependent on the housing market and the news is not all good.**

## The Budget and UK Mortgage Rates source: Tradingeconomics.com

The most important feature of the recent UK Budget was that it did not do any further significant harm to the UK economy. Gilts were unchanged on the day, which is important as Gilt yields set mortgage rates. As consumers face a higher tax burden (due to frozen tax bands), significantly higher energy costs and increasing unemployment, higher mortgage rates are very unwelcome.




The blue line in this chart represents the Bank of England's mortgage approval index, which is declining sharply. The last time it moved below zero was during the recession following the invasion of Ukraine, caused by an energy shock and rising interest rates. House buyers are already reacting to higher mortgage rates and deciding to wait. The Lloyds Bank (Halifax) House Price Index has been essentially unchanged since the last general election and is thus likely to head lower. The risk of a UK recession is increasing.

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Lower interest rates are needed, but these depend on inflation, which in turn depends on the reopening of the Strait of Hormuz. The UK Government is a passenger in the global cycle, which is set by the US Federal Reserve and can do little to change the trend. It can, however, avoid making things worse. The two Reeves Budgets did make things worse; the first Healey Budget doesn't appear to have done so this time. Gilt yields have stabilised, with the 10-year gilt yielding 5.25%, helped by a rally in US Treasury bonds. Nevertheless, with two- and five-year fixed-rate mortgages now firmly above 5%, the UK economy is likely to slow further from here.

## Current Quarter Earnings Growth source: Morgan Stanley/Deutsche Bank

| S&P 500 3Q26 EPS Growth | |
|---|---|
| Sector | Growth Reported |
| Energy | 167.7% |
| Information Technology | 179.6% |
| Communication Services | 46.5% |
| Materials | 51.9% |
| Industrials | 49.6% |
| Utilities | 11.2% |
| Real Estate | 10.5% |
| Financials | 8.0% |
| Consumer Staples | 5.2% |
| Consumer Discretionary | 7.4% |
| Health Care | 7.8% |
| S&P 500 | 38.3% |




The third-quarter US earnings season is breaking records for growth. Data centre spending and oil refining profits are driving spectacular levels of growth, with even the slowest-growing sectors delivering historically high growth rates. The second chart shows annual growth for the average S&P 500 constituent, which is well above average and cannot be explained by either oil or AI. We are now in the middle of the cycle. Whether it rolls over depends on inflation and interest rates. Markets have been driven by the MAG7 and AI spend but this growth is so high that it simply cannot be maintained. Investors are moving to the other 493 companies in the index. A comparison of the MAG 7 with "the rest" now shows that these other non-tech sectors are starting to outperform significantly. The likes of Amazon, Alphabet (Google) and Meta (Facebook) have reached the stage where they need to deliver returns on the trillions of dollars invested in AI data centres.

## Markets

**Traditionally, US equity markets rally after midterm elections. When Barack Obama suffered a similar landslide loss, equity prices rose 10% in the following 12 months. Generally, less government interference is good for equity markets. There may be some concern that many new Democratic senators will be left leaning, but given the current political gridlock, this should not have too much direct impact on the US economy. Iran and the reopening of the Strait of Hormuz remain the dominant issue. Inflation should fall rapidly if a deal is reached, but it will now be too late for Thanksgiving and Christmas. AI stocks have already fallen ahead of the vote, masking good performances from a wide range of other sectors. Investors do though continue to back AI with fresh investment of c$100 billion and the IPO of leader Anthropic is imminent, but a few signs of frustration are emerging. AI-driven scientific breakthroughs are needed to reignite enthusiasm among new investors. Markets can become impatient and risk defaulting to the "tech bubble" roadmap of 2000. Valuations are, however, much lower than they were then and the route to significant returns is clearer. Nevertheless, markets have, for now, moved on from AI; whether this is temporary or not depends on the news flow. Markets are back to focusing on the basics: interest rates, inflation and earnings growth. They are starting to be concerned that only one of these key drivers is presently positive. November though usually marks the start of positive seasonality for equity markets.**

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