RATHBONES

Monthly Digest

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Quantum states

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We caution against taking too defensive an investment stance. That's because we believe markets will look through negative effects in the short term, as long as they expect resolution in the long term.

Quick take:

- The new era of uncertainty shouldn't scare us out of sensible long-term investing.
- The price of oil will have an extra risk premium added to it, even after the Iran war ends.
- Corporate earnings look set for a great year.

An opinion piece in the *Financial Times* earlier this year struck a chord with me. The author, Armen Sarkissian, is an arresting combination of two things: a former President of Armenia and a theoretical physicist.

Sarkissian postulated a world in which uncertainty has become the norm. He drew on his experience to describe a "quantum" world in which "outcomes are probabilistic rather than deterministic" – essentially, it's much harder to know what will happen, even if you know what the inputs are. And in this world, "observation itself alters reality."

Investors have actually long dealt in uncertainty, weighing risk against opportunity in constructing portfolios. But Sarkissian's point was that the inputs which we have to evaluate when making these decisions, especially in politics, are increasingly uncertain. He gave the example of Greenland. If the norm that no Nato power ever threatens to take the territory of another is dissolved, this suggests we're now in a world that's much harder to understand and predict.

Sarkissian further invoked the work of Anglo-Polish sociologist Zygmunt Bauman, who described our current condition as "liquid modernity". Ours is a world in which we can go to bed in one political reality and wake up in another; a world in which structures melt faster than they can be rebuilt. When politics is so polarised, news headlines are so sensational, and it's not unusual to witness share prices move up or

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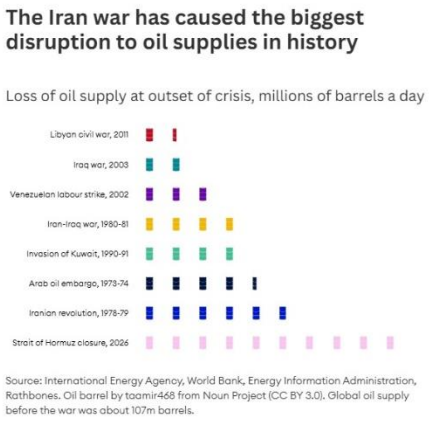
down more than 10% in a single trading session, I find this framework useful. But regardless of the uncertainty, we shouldn't be scared out of sensible long-term investments.

Ripples from the Gulf

Our stance throughout the Iran conflict has been that the current situation is not to anyone's benefit, and one has to have a modicum of faith that we're not headed into some form of mutually assured destruction. With this in mind, we haven't reduced overall market exposure, especially as any further rallies could be quite sharp and immediate on any firm news of a resolution. We've already seen that happen a couple of times.

As May opens, we're encouraged that the US and Iran appear still to be in negotiations, with the ceasefire still on. But it's not abundantly clear what either side will settle on as being sufficient to declare victory. For Iran this could be a lifting of sanctions and an acceptance that the current leadership can remain – and to generate revenue from ships passing through the Strait of Hormuz. This could potentially be achieved under the guise of reparations.

For the US the key objective appears to be some sort of oversight of Iran's nuclear capabilities, plus a commitment not to produce nuclear weapons. For now, these seem the key sticking points. As for the timing of an agreement, Iran is probably prepared to show more patience than the US – and that strengthens its ability to argue for better terms. For US President Donald Trump, the clock is ticking on the countdown to November's mid-term Congressional elections. He'll want to put the economy on a strong footing to maximise the Republican vote. But don't be surprised if we see further escalation before the denouement.



There are plenty of potential risks in this situation. And they may well increase exponentially, if the Strait of Hormuz remains closed. We're now at the point when cargoes of oil and other vital commodities that had left the Gulf before the hostilities have reached their destinations – and there are few cargoes left to come. We could soon be witnessing not just higher prices but also actual

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shortages. That could have a greater negative economic effect.

Although the oil price tends to dominate headlines, other commodities in short supply because of the Strait's closure include urea, ammonia, and sulphur, all of which are key components of fertiliser. This is just as the northern hemisphere's spring planting begins. Butane and propane, which are also affected, are important fuels in Asia and Africa, primarily for cooking. Helium is critical for cooling semiconductor manufacturing equipment and MRI scanners.

Moreover, a quarter of the world's supply of aluminium, an important lightweight metal used for construction, transport and packaging, originates in the Middle East. It accounts for about 10% of a solar panel's weight, so the lack of availability will hinder the transition to greener energy. On the same theme, a typical 3-megawatt wind turbine contains roughly 3 tonnes of aluminium.

UK consumers have already experienced higher petrol and diesel prices at the pump – and higher airfares. But the impact of Middle Eastern events might not be fully felt until holiday flights are cancelled more frequently, as jet fuel is rationed. The global number of flights has already fallen by around 3%. A decent chunk of this is flights beginning in or routed through the Middle East.

Leaning towards de-escalation

You might well ask why we're not taking a more defensive stance. Our answer: we continue to believe that investors, and therefore financial markets, will look through negative effects in the short term, as long as they expect resolution in the long term.

In thinking about the best course of action, we've constructed various scenarios, giving each a numerical probability: what's the chance it will happen? We still place the greatest weight on de-escalation. That means a re-opening of the Strait of Hormuz, although perhaps only a gradual increase in traffic to previous levels. This might see the price of oil return to $80 a barrel in financial markets, down from above $110 at the moment.

Even so, that will be higher than before the war. This is partly because, having released barrels from their petroleum reserves to ease shortages, governments will need to build them back up again. It's also because, even after the war, financial markets will continue pricing in a risk premium – an extra amount of dollars for every barrel, because the risk of another bout of severe disruption now looks more likely.

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One factor working in investors' favour, though, is the growth of corporate earnings. With the first-quarter results season now in full flow, it's clear that many industries entered the period with a good head of steam. Looking further ahead, the current consensus forecasts show very strong growth – almost 20% – in global annual earnings for 2026. That's largely down to technology, thanks to the capital expenditure on data centres and AI. That said, these estimates depend on the highly uncertain outcome of negotiations between the US and Iran.

Happy in the long term (like Goethe)

For many people, the biggest challenge of the last couple of months may well have been to remain committed to their investments in the face of an almost incessant barrage of negative headlines. Unfortunately, to return to the theme with which I began this essay, we might have to get used to this being 'business as usual'. To repeat some things we've already said this year: we characterise ourselves as investors and not traders; and we continue to recommend that regular savers remain committed to their planned investment schedule. Maybe, in this day and age, a successful investor's life will feel in retrospect like that of the German writer and polymath Johann Wolfgang von Goethe. When asked about his life he said it had been a happy one but he couldn't remember a single happy week!

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Regional highlights

US. In the US, consensus expectations were for year-on-year earnings growth of 12% for the first quarter. We're well ahead of that, so far. Reporting companies have beaten consensus expectations in 80% of cases. After underperforming relative to the rest of the world in 2025, US equities have rediscovered their mojo. This is largely because of renewed enthusiasm for data centre investment as signs emerge that AI is gaining more traction with corporate customers. This thesis was confirmed by results from the biggest technology companies.

The US should be more insulated from events in the Middle East, largely owing to its self-sufficiency in energy. It might not completely avoid higher global prices, but it doesn't face the same risk of supply shortages.

And, of course, US-listed companies are at the forefront of technology developments, especially in AI. More are planning to list on the stock market soon, including Elon Musk's SpaceX and the AI innovators OpenAI and Anthropic. SpaceX alone could offer investors $75 billion worth of shares, more than three times the size of the current IPO record holder, the oil company Saudi Aramco.

UK. UK equities lagged behind global indices in April. The large weighting of oil companies in the UK market was unhelpful, with the oil majors succumbing to profit-taking as investors sensed an end to the hostilities. The more defensive pharmaceutical sector was weaker too, and consumer staples also lost ground. These are three of the four largest sectors, accounting for around 43% of the market capitalisation. Financials, the biggest sector (24%), was the best performer after technology – but sadly, technology comprises no more than 1% of the market. Contrast that with the US (over 40%, if one includes de facto technology companies classified in other sectors, including Amazon, Tesla, Alphabet and Meta), Emerging Markets (32%) and even Europe (10%).

Investors await the results of the 7 May local elections, which might well define the next moves for sterling and gilts (and hence influence equities). Keir Starmer's position as premier will be under pressure if Labour performs poorly, as polls predict. We think a result that triggers a leadership change would not be received well by investors if it took the party further left in tax and spending policies, which could weaken the public finances.

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Last month I tried to end my UK comment on a more upbeat note by looking at London's success in attracting investment from large technology companies, notably those involved in AI. Further good news has since emerged, with Anthropic (the developer of the Claude family of large language models) signing a significant lease. There were also reports that Project Prometheus, Amazon founder Jeff Bezos's AI Lab, is looking to take space in King's Cross, which is turning into a veritable AI hub.

We can also point out that the total value of takeovers announced this year for FTSE 100 companies reached almost £30bn in April. Offers for insurance agent Beazley, financial service company Schroders, and testing company Intertek were joined by an approach for energy business DCC. Corporate buyers continue to find attractive targets in the UK.

Europe. We've recommended reducing exposure to European equities. The eurozone's economies remain exposed to higher commodity prices and potential shortages and, overall, didn't enjoy particularly strong momentum even before hostilities began. Eurozone GDP expanded by just 0.1% in the first quarter of 2026, relative to the final quarter of 2025.

This is something of a disappointment because we'd previously seen increased fiscal stimulus, notably in Germany, as a growing tailwind to renewed growth. There was also potential for a more benign regulatory regime to emerge from Brussels to encourage innovation and cross-border consolidation. These factors may well gain the upper hand again in the longer term. But for now, discretion is the better part of valour.

That said, we can still find European companies able to benefit from positive global themes. There are many companies that are leaders in their fields or even, in some cases, unique. They retain important positions in our portfolios. One example is ASML, the Dutch company that makes the equipment for manufacturing semiconductors. Without its expertise, the data centres powering AI would be empty shells.

Emerging Markets. The biggest winners in the first two months of 2026 became the biggest losers in March. And then, in April, they bounced back strongly, with AI and semiconductor demand the driving force. Taiwan's Taiex index jumped 23% (having fallen 10% in March), largely thanks to the performance of the Taiwan Semiconductor Manufacturing Company. In the process, Taiwan's stock market capitalisation surpassed that of the UK's!

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South Korea's Kospi index rose more than 30% (having fallen 19% in March), thanks to burgeoning demand for memory chips. For a broader comment on emerging markets, please look out for an article in this month's *Investment Insights* magazine.

Fixed Income. The Bloomberg Global Aggregate Bond Dollar Index rose 1.3% in April. The sterling-hedged version returned just 0.3%. Neither regained the ground lost in March. Bond yields remain high because of concerns about inflation and large fiscal deficits. The month ended with a flurry of central bank meetings. None of the big four (US, UK, Europe, and Japan) raised interest rates. But all emphasised their vigilance on the inflationary threat. For example, the Bank of England published new inflation estimates in the form of scenarios rather than a central forecast. All of these suggested a need for tighter policy. The worst-case scenario envisages the oil price rising and staying at around $130 per barrel with inflation rising to 6.2%. This would entail a base rate increase in the range of 66 to 151 basis points (practically between two and six quarter-point increases, or a range between 4.25% and 5.25%, vs the most recent peak of 5.25% and the current 3.75%). Futures markets are pricing in a quarter-point base rate hike in July, with another to follow in the autumn.

Within fixed income, we've recommended increasing holdings of inflation-protected index-linked gilts at the expense of conventional gilts. We're not necessarily forecasting much higher inflation. Instead, this is more about taking out an insurance policy against that risk. As before, we advise investing in shorter-dated instruments to avoid the risk of higher volatility, which exists because longer-dated bonds' prices are more sensitive to movements in the yield. It may well be that at some future date we'll take advantage of this phenomenon to increase duration (buying more longer-dated bonds) if we believe that yields are set to fall substantially. But we don't think there's an immediate opportunity. The All UK Conventional Gilts index has delivered a total return of -2.2% over the last three months and 0.3% over the past year. Index-linked gilts returned -1.3% and 1.6% over the same periods. Emerging market bonds produced a total return of 2.2% in sterling over the three months to end April (18.2% over 12m). Global high yield bonds delivered 0.4% (8% over 12m) in sterling terms.

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