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The October Outlook

Market Stance

CURRENT MARKET THEMES

Greater confidence in a favourable environment for corporates and low inflation has led to more stretched valuations in credit and equities

Commentary

- Global economic growth appears to be moderating slightly, but there is little evidence of a sharp slowdown.
- Inflation expectations as discounted in bond markets imply little or no deterioration
- The equity market rally has been less confined to the US AI theme: commodity stocks and Chinese equity returns have also been firm

Upshot

- Aggressive pricing in equity and credit markets implies greater sensitivity to developments which challenge the established soft landing narrative

AI AND FINANCIAL MARKETS

The AI theme has been a key driver of equity returns for well over a year, with suppliers and end-users both benefiting

Commentary

- The new technology is likely over time to be transformational for many economies
- However, this theme is now much more aggressively priced: potential beneficiaries are on very extended PE multiples
- Ambitious capital spending plans from many large firms may not in aggregate allow for the expected returns to be delivered

Upshot

- We continue to back this theme in portfolios, while also ensuring adequate diversification across other sources of return

STAGFLATION RISKS

The 'Long Read' explores the risks of higher inflation and slower growth in the UK and the US, driven not by a surge in commodity prices, but directly by the policies of the respective governments

Commentary

- The recent acceleration in UK inflation largely reflects government measures: increases in labour taxes, the minimum wage rise and higher indirect taxes and administered prices
- US inflation has yet to respond materially to tariffs, slower labour force growth and the fall in the dollar, but the risk is rising

Upshot

- Given current pricing in financial markets, the emergence of a less favourable macro environment could challenge the rally in risk assets

SARANAC MULTI-ASSET POSITIONING

There are no immediate catalysts for the prevailing 'risk-on' market phase to unwind, but risks can build over time

Commentary

- We retain the exposure to gold as a hedge, a material exposure to market-neutral hedge funds, and a higher level of equity hedges than usual
- Gains on uranium equities have been realised following the exceptional rally
- Equities remain the largest contributor to risk, but at a lower weight than in a lower risk environment.

Upshot

- Portfolio structure reflects the need to maintain exposure to market risk, but with sufficient diversification to allow for adequate returns to be realised in a more challenging market environment.

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The Long Read

How important are stagflation risks in the US and the UK?

SNAPSHOT

Stagflation risks are becoming more visible across major economies, though their drivers differ.

In the UK, inflation has accelerated despite weak growth, largely due to policy measures such as higher energy caps, food regulation and labour costs. These pressures should ease into 2026, but near-term volatility remains.

In the US, tariff increases, labour supply constraints and dollar weakness are creating a slow build in inflationary risk, even as growth moderates. While AI-related investment continues to support activity, these benefits are concentrated and may not offset broader macro headwinds. Rising wage pressures and delayed tariff pass-through could challenge the soft-landing narrative.

For investors, this environment reinforces the need for diversification, selective hedging and flexibility in portfolio construction, with a preference for sectors offering structural growth drivers.

1. Inflation risks driven by policy-makers not commodity prices

Returns to investors in multi-asset portfolios are typically best supported when economic growth is stable or accelerating, and inflation is stable or falling. Significant challenges can therefore emerge in periods of 'stagflation', in which economic activity is weakening, and inflation is accelerating. This was illustrated in 2022, when rising commodity prices and bond yields combined with escalated recession concerns to deliver one of the worst outturns for multi-asset investors in several decades. Keen historians of financial markets will be aware of similar environments in the 1970s.

Stagflation concerns have become more evident in recent months in many market analyses. In this note, we provide more background as to why this has occurred, focusing on the UK and the US. In both cases, stagflation risks are indeed becoming more prominent. However, it is important to recognise that such risks come in degrees. The most damage to markets is typically done when a stagflation shock is global, in particular a widespread surge in oil and other commodity prices, as in 2022 on the Russian invasion of Ukraine. Such a commodity price shock seems more of a tail risk than a central position at this point in time.

By contrast, US and UK stagflation risks appear to be generated more by specific policy measures and so are potentially more time limited. In addition, these cycles are not synchronised: in the UK, inflation is likely to fall back into next year, while over this period US inflation is likely to accelerate even while growth slows. Importantly, the market impacts seem different. In the UK, higher inflation has been to a significant extent the result of government measures, which have pushed up the price level and caused economic growth to slow in response, not external shocks or the result of a strong business cycle. In the US, the main impact of tariff imposition and labour-force reductions have yet to be felt, and could lead to a less benign inflation environment into 2026.

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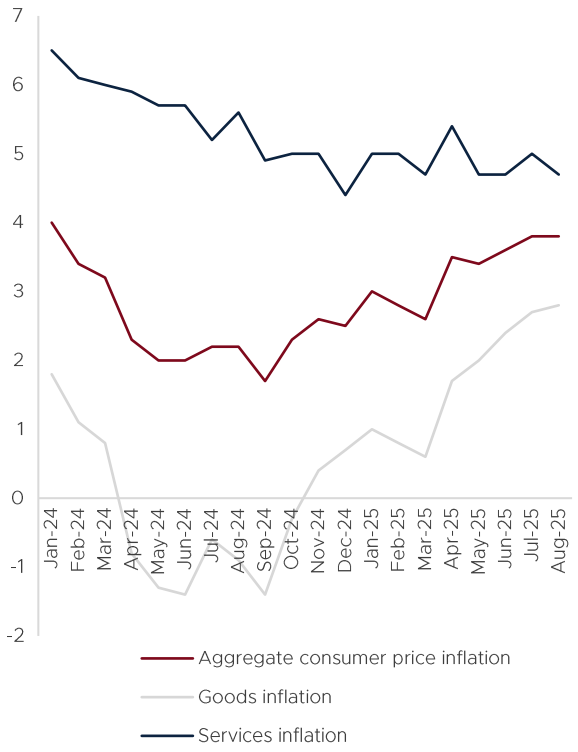
CHART 1

UK inflation accelerates



[1]Source: Bloomberg/Saranac

2. UK Inflation acceleration largely policy-driven

In the UK, a 'mild' stagflationary environment has emerged over the course of this year. Economic growth has remained very subdued, at only a little over 1%. However, this weakness has not prevented a significant pick-up in inflation, from some 2% last spring to 3.8% more recently. Services sector inflation has fallen, while remaining elevated, but there has been a significant increase in goods prices (chart 1).

This pick-up in inflation has some peculiarly British causes. The OFGEM price cap for the typical household was some 10% higher in the third quarter than a year earlier, and energy prices are likely to remain elevated.

In addition, food price inflation accelerated to almost 5% in August, up from only around 1% in mid-2024. Food prices have been driven higher partly by global trends, but also by higher labour costs, reflecting the higher minimum wage and the rise in employers' national insurance contributions. Additional regulations from October are likely to exacerbate this rising trend, with producers incurring higher responsibility for waste management. Food price inflation could well reach 5.5% by year end.

CHART 2

UK economic growth slows

[2]Source: Bloomberg/Saranac

However, the rise in inflation goes beyond higher food and energy prices, as the rise in labour costs has been widespread across goods-producing industries and services. Indeed, the significant

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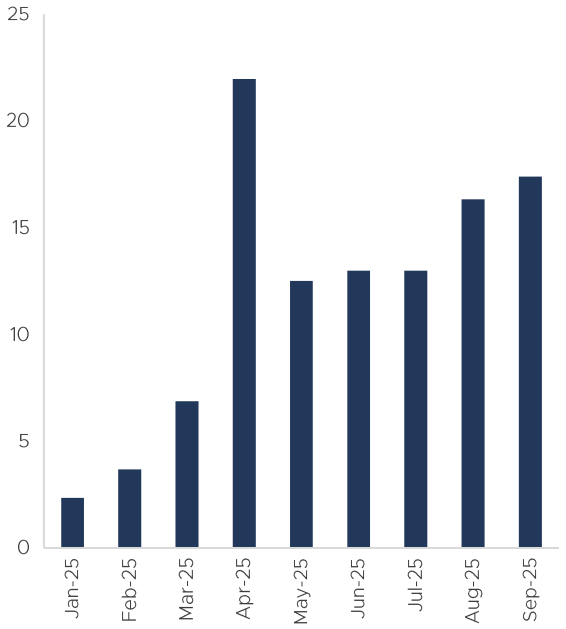
moderation in services sector inflation which was clearly underway in 2023 and 2024 has since stalled, levelling off a bit below 5%. However, at present around 0.5% is being added to services sector inflation by a wide range of administered prices, for example sewerage charges, bus fares, vehicle excise duty and VAT on private school fees.

UK inflation might therefore continue to accelerate in the short-term. However, a more favourable trend is likely to emerge during next year. Many of the UK-specific factors which have pushed inflation higher in recent months will have a one-off effect on prices and will cease to affect inflation measures from next spring onwards. At the same time, weak growth appears to be creating some slack in the labour market, and spare capacity in the economy more generally. If growth remains subdued – and it is now slowing (chart 2) - disinflationary pressures could more clearly emerge into 2026, and it is feasible, if still slightly optimistic, that the 2% target could be reattained next year.

CHART 3

US tariff rate rises sharply (%)



[3]Source: Bloomberg/Saranac

How has this more challenging inflation backdrop affected UK asset prices? The most obvious effect has been on UK gilts. Although shorter-term yields have fallen as the UK base rate has declined, the deteriorating inflation background has slowed speed of UK rate cuts. This has been supportive of sterling, particularly against the Japanese yen and US dollar, it has also contributed to subdued relative performance of UK fixed income in recent months.

3. The US: tariffs, labour supply and the dollar

Stagflationary threats in the US have remained largely in abeyance to date, but these pressures are building, reflecting the imposition of tariffs, repatriation of foreign workers and the weakness in the dollar.

The overall effective tariff rate has risen to 17.4%, the highest since the 1930s (chart 3). On conventional relationships, this would add ~1.5-2% to the US price level and reduce growth by some 1%. However, to date such trends have not demonstrably surfaced (chart 4). While consumer price inflation has remained elevated, it has not deteriorated in recent months. Price pressures in sectors most affected by tariffs, such as household furnishings and recreation, have strengthened, but not to the extent that they have materially affected aggregated inflation data. Given the wide range of tariffs applied in different sectors, and the different responses of producers within them, the tariff impact is far from uniform.

We are sceptical that these pressures will remain in abeyance. To date, overseas exporters appear to have cut prices somewhat to maintain presence in US markets. In addition, domestic importers appear to have built up inventories prior to the tariff increases, dampening the incentive to raise prices in the short term. In addition, they appear to have accepted lower profit margins on more recent tariff increases, by not passing on the full tariff rise. We expect these delays to price increases to fade into next year, raising risks to the near-term growth environment.

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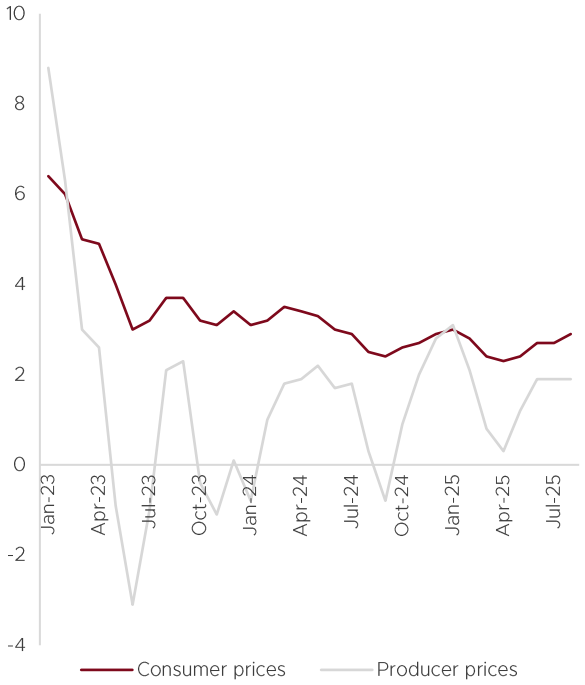
CHART 4

US inflation remains elevated, but no sharp acceleration



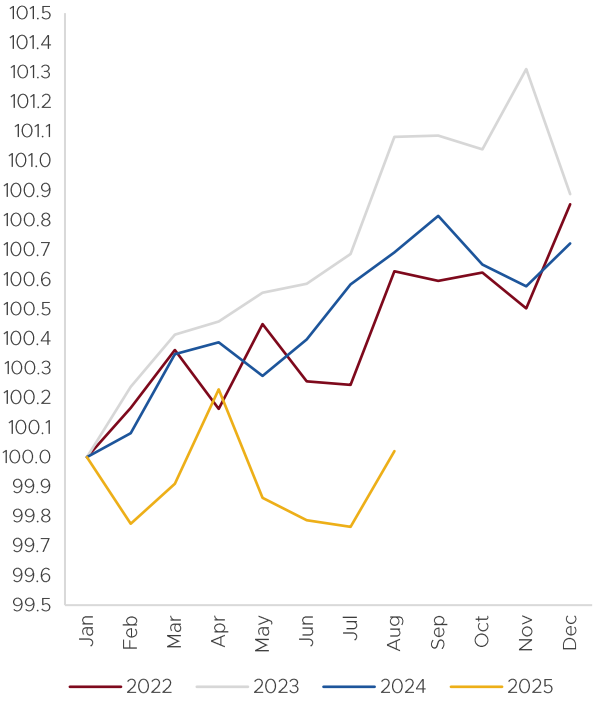
[4]Source: Bloomberg/Saranac

Labour market developments could reinforce these trends. Immigration into the US has ground to a halt this year, having accounted for around half of the increase in labour supply in the US in recent years. In aggregate, labour force growth has ground to a halt (chart 5). At the same time, there is an ongoing repatriation of some classes of foreign workers. Constraints on growth have begun to appear in some industries, such as leisure, hospitality and construction as a result. Wage rises in these areas have accelerated, and price increases are likely to follow. These sectoral stagflation pressures could well feed through to the broader economy into next year, although a slow burn impact rather than a sudden 'hit' is more probable.

A final threat to the US inflation outlook is the weakness in the US dollar, which has fallen by around 10% against a basket of major currencies so far this year, although it has been more stable since April. The US is not a particularly open economy, so the scope for dollar weakness to generate inflation is limited. However, the magnitude of the dollar weakness is now sufficient for some impact to emerge, particularly in the context of the other inflationary impulses discussed.

CHART 5

US Labour force growth (Jan = 100)



[5]Source: Bloomberg/Saranac

4. Rising macro risks into 2026 could test market consensus around a soft landing

Markets are currently pricing a relatively benign outlook for inflation and the growth environment. The Fed appears set to ease, and the rebound in the equity market in recent months suggest that

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concerns over a weaker growth environment are not central to positioning for many investors. Indeed, the probable acceleration in economic growth in the third quarter to well over 3%, and the absence of a material acceleration in inflation suggests that stagflationary concerns are not central. Indeed, there has been more focus on the AI theme in terms of market behaviour, given the surge in economic activity in this space.

In part this buoyancy reflects the fact that imports of computers, smartphones, semiconductor chips and other electronic components are critical components of this supply chain, and they are exempt at present from many of the new tariffs – in contrast the higher prices faced by farmers, manufacturers and consumers. Tariffs are making it more expensive to build or buy many things unrelated to advanced electronics, so consumers and businesses are being incentivised into the AI ecosystem. The general uncertainty over tariff levels going forward may constrain investment outside this favoured area, and tariffs may also be extended to, for example, foreign-produced chips.

However, this support to growth from AI notwithstanding, more significant economic tensions – higher inflation and slower growth - are building in the US, potentially setting the scene for a challenge to the soft landing environment currently being priced by many investors.

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Saranac Partners was founded in 2016 as a private office for investments and more. As an independent firm, we combine the capability of traditional financial institutions with a personalised approach that offers more. We serve a community of individuals and families across the UK, Europe and Middle East with specialisations in strategy, investments and financing.

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