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The July Outlook

Market Stance

A BUOYANT EQUITY MARKET, LED BY EARNINGS

The first half of 2026 saw strong equity market performance

Commentary

- The global economy is in a cyclical upswing, though this remains narrowly concentrated in AI-related US spending; growth in Europe and China has stayed comparatively subdued
- Oil prices have fallen sharply, and the move looks likely to be sustained, easing inflation pressure and reducing the odds of aggressive monetary tightening across developed and emerging markets

Upshot

- Global equities look moderately stretched in aggregate rather than broadly overvalued, as strong earnings growth has allowed valuations to de-rate even as prices have risen

INFLATION RISKS ARE FADING, NOT GONE

The stagflation scare looks to be behind us

Commentary

- Stagflation risk was elevated while Middle East hostilities were underway, but the worst of that episode now looks to be in the past
- Some cyclical inflation risk persists in the US, reflecting a tight labour market and AI-related demand for chips and energy, pointing to modest upside risk to US rates next year rather than a renewed tightening cycle
- UK and European rate paths remain data-dependent with no major moves expected, while the case for tighter policy in Japan is strengthening as the Bank of Japan continues to lag the curve

Upshot

- Rate risk has shifted from a stagflation shock to a cyclical US inflation story, with Japan the notable exception where the policy gap looks set to narrow

AI CAPEX: HOW LONG CAN THE BOOM RUN?

The single largest swing factor for markets

Commentary

- US AI spending has not yet rippled through meaningfully to Europe or China
- The durability of the US investment boom is not fully transparent: financing demands on corporate cash flow and uncertain profitability are emerging constraints, and pockets of speculative activity, including leveraged AI-themed ETFs, add to the risk

Upshot

- The investment surge could plausibly continue into next year; a correction in the AI theme looks more likely to prompt rotation into other sectors than a broad, index-level sell-off, provided macro conditions stay moderately supportive

SARANAC MULTI ASSET POSITIONING

Finding the right balance in a narrow market

Commentary

- Equity weight is calibrated to participate during a rising market while offering more protection should conditions deteriorate, counterbalanced by above-average weights in alternatives and fixed income.
- Within fixed income, we are avoiding very long-dated bonds, given concerns about fiscal sustainability and the risk of steeper yield curves, whilst maintaining high-quality credit exposure

Upshot

- Portfolios concentrated in the leading AI companies have likely performed well, but that same concentration now represents a meaningful risk - in the United States but also in parts of emerging markets, where a small number of semiconductor firms dominate indices

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The Long Read

Mid-Year Review & Outlook 2026

SNAPSHOT

At the start of 2026, the consensus expected a benign year for the global economy. Central banks had begun to ease, inflation was moving back towards target, and the main question among investors was the pace of rate cuts rather than their direction. That outlook has changed. The conflict in the Middle East briefly pushed oil above $120 a barrel, central banks halted their easing cycles, and investment spending in artificial intelligence has become a significant point of differentiation between economies.

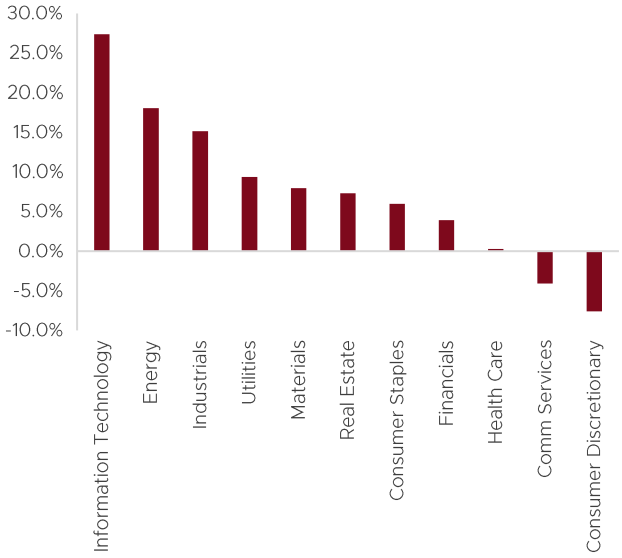
The result is a clear divergence between regions. The United States has continued to grow at a solid pace, supported by investment in AI infrastructure and owing to its position as a net energy exporter. Many other economies, with less exposure to the AI investment cycle and greater dependence on imported energy, face a combination of weak growth and elevated inflation.

Equity markets: a broadening AI rally

A small number of large technology companies have driven the majority of index returns this year, with the technology sector rising in excess of 27% in the first six months of 2026. This dynamic has been both a source of strength and a risk: index-level performance increasingly reflects the earnings of a narrow group of firms rather than the broader market, let alone the performance of underlying economies.

CHART 1

Global Sector Returns (YTD Total Return)



[1]Source: Saranac / Bloomberg

However, in contrast to last year, the strong performance of AI stocks is no longer just a feature of the US equity market. South Korea's Kospi has risen by 98% this year, and Taiwan's stock market by around 63%, overtaking India to become the world's fifth largest. The driver is the semiconductor supply chain that underpins the AI build-out, again led by relatively few large companies that make up a disproportionate portion of market-capitalisation-weighted indices.

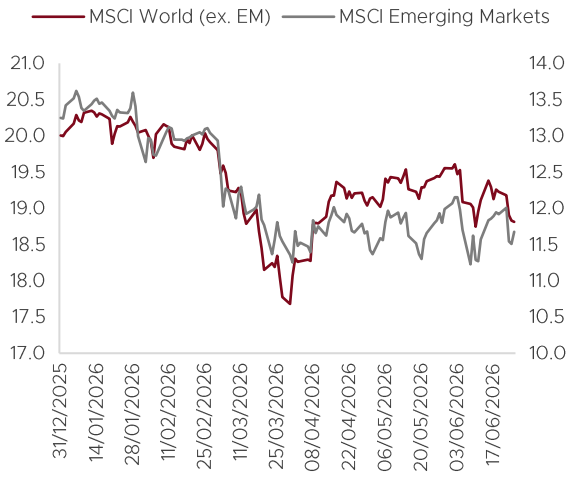
The Long Read

And whilst valuations have risen, they remain at or below those of the US market, with Taiwan trading at close to 20x forward earnings and Korea materially lower, which has supported continued inflows. Investors holding the broad market are nonetheless making a concentrated bet on demand for AI hardware, and index-level returns say more about a small group of exporters than they do about broad domestic strength.

Importantly, regardless of whether we look at the US or Asian technology sectors, strong share price returns have predominantly been driven by exceptionally strong growth in earnings, rather than multiple expansion. As a result, the forward earnings multiple on the global equity index has edged down over the year, from around 20x to 19x, as unusually strong AI-driven earnings growth expectations have outpaced prices. The multiple on the MSCI Emerging Markets index has fallen further still, from about 13x to 11.5x. On the face of it the market looks cheaper than it did, although there are legitimate questions as to the sustainability of those earnings in future years.

CHART 2

Global (ex. EM) and Emerging Market Index Multiples



[2]Source: Saranac / Bloomberg

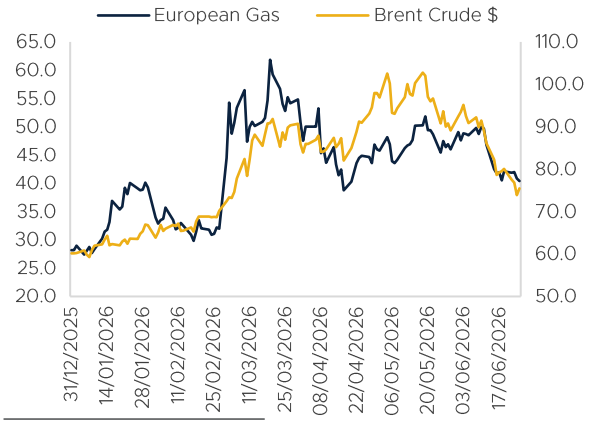
Macroeconomic backdrop

Arguably the most consequential event of the first half was the conflict between Iran, the US and Israel. Hostilities that began in late February led, by early March, to the effective closure of the Strait of Hormuz, through which roughly a fifth of the world's oil and a large share of its liquefied natural gas passes. At the height of the disruption an estimated 10 to 14 million barrels a day of exports were stranded, one of the larger supply interruptions in the history of the oil market. Brent crude, which had traded around $70 before the conflict, rose above $120, whilst European gas prices roughly doubled as the loss of liquefied natural gas cargoes compounded already low storage levels.

Higher energy prices passed through quickly to broader inflation. Headline inflation, which had been falling, began to rise, and five-year inflation expectations in the United States increased. Estimates suggested that oil sustained near $100 would reduce global growth by roughly 0.2 percentage points and add around 0.7 points to headline inflation. Bond markets repriced accordingly: the rate cuts previously priced in for 2026 were gone, and investors began to price the possibility of rate rises.

CHART 3

Oil & Gas Prices



[3]Source: Saranac / Bloomberg

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A ceasefire in April and a framework agreement in June subsequently allowed traffic to flow through the Strait again. As tankers returned and Gulf producers increased output, oil fell back towards its pre-conflict level. By late June Brent was trading near $73 and the US benchmark had fallen below $70, close to 40% below its wartime peak. However, restoring the supply-demand equilibrium will take time, as shipping volumes and insurance costs have been slower to recover.

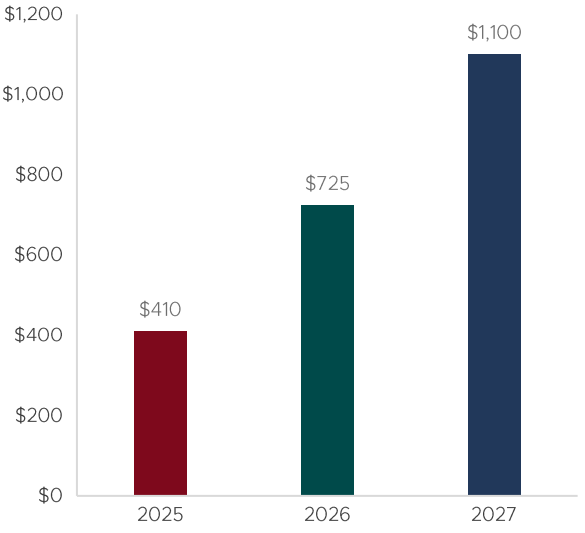
Remarkably, the energy shock only had a limited effect on the broader macroeconomic backdrop in the United States. Meanwhile, equity markets reached record highs during the conflict, and first-quarter corporate earnings were strong: S&P 500 earnings grew by close to 18% compared to the prior year, and the index's return on equity reached a record of around 22%. Two factors account for this economic and market resilience.

The first is energy. The United States is a large net exporter of crude and refined products, exporting close to 13 million barrels a day at the height of the crisis. Higher oil prices raise costs for net importers but transfer income to net exporters. The same shock that weighed on European growth therefore benefited parts of the US energy sector, which offset some of the drag elsewhere in the economy.

The second, and more significant, factor is artificial intelligence. Investment in AI infrastructure has become large enough to affect the wider economy. Capital spending by the largest technology companies in 2026 is estimated at between $670bn and $770bn, close to their combined operating cash flow. This spending enters the real economy directly, through data centres, semiconductors, power equipment and construction, and beneficiaries of the build-out are estimated to account for more than half of expected earnings growth in the S&P 500 this year. Few other economies have an equivalent source of investment-led demand. A note of caution, however: with spending now close to or above operating cash flow, further growth is increasingly funded by debt and equity issuance, and rising depreciation is expected to weigh on the sector's returns in the years ahead. The profitability of the sector therefore depends on the returns the technology ultimately generates.

CHART 4

Hyperscaler capex on Artificial Intelligence ($bn)



[4]Source: Saranac / Bloomberg

Where exposure to AI is limited and dependence on imported energy is high, the same energy shock had the opposite effect. Europe is the obvious example. The euro-area economy contracted slightly in the first quarter, by around 0.2%, and energy inflation across the bloc has peaked above 11%. Forecasts now centre on around 1% growth for the year, with headline inflation near 3%, a combination that has complicated the policy choices facing the European Central Bank, which raised rates by a quarter point in June, citing early evidence that higher energy costs were feeding into broader prices. Elsewhere, the Bank of England faces a similar position, with UK inflation moving back towards 3% and previously expected rate cuts now priced out.

The Long Read

Higher rates meet higher deficits

The change of leadership at the Federal Reserve may well mark a turning point, not necessarily in terms of the direction of policy, but certainly as far as the modus operandi of the FOMC is concerned. Kevin Warsh was sworn in as the seventeenth chair in late May, succeeding Jerome Powell and taking over with headline inflation still above 4% and an FOMC that has become decisively more hawkish through the course of the year. Warsh is regarded as an inflation hawk, favours a smaller balance sheet, and is in the process of revamping many of the processes and frameworks investors have grown used to. For example, forward guidance is all but gone, inevitably increasing volatility at the shorter end of the yield curve.

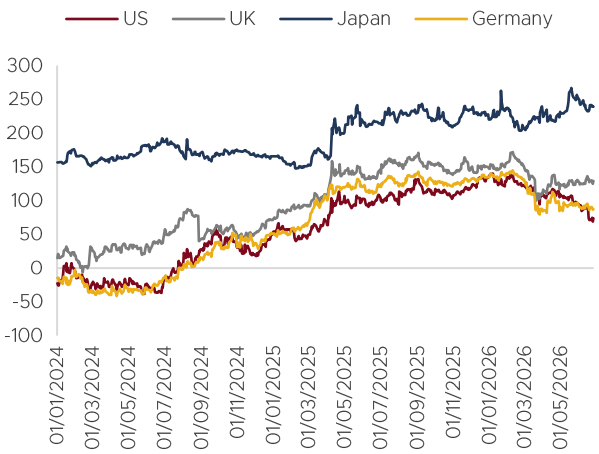
All this has clear implications for asset allocation. The fall in oil prices has removed the immediate case for emergency tightening, reducing the risk of aggressive rate rises. However this does not mean that the easing cycle that began in 2025 will resume. With underlying inflation persistent, a chair focused on bringing inflation back to the Fed's 2% target, and an economy that does not require additional stimulus, the most likely outcome is for rates to remain higher for longer. Investors who positioned for a steady decline in interest rates may need to reconsider that assumption, which has implications for both the cost of capital and the valuation of long-duration assets.

The other half of the story is fiscal. Public borrowing has risen across the major economies, and for reasons that look structural rather than temporary. In the United States, the tax and spending package passed in 2025, the One Big Beautiful Bill Act, made the 2017 tax cuts permanent and is projected to add around $3 trillion to federal deficits over the next decade. The federal deficit is already running close to 6% of GDP, net interest costs now exceed $1 trillion a year, and the conflict with Iran has added further emergency military spending. In Europe the driver is defence: following the move to a higher NATO spending target and the reform of Germany's constitutional borrowing limit, governments are raising military budgets materially, with aggregate euro-area defence spending expected to rise from under 2% of GDP towards 2.5% and Germany funding a substantial rearmament largely through new debt issuance. In each case the result is the same, namely more government bonds for the market to absorb.

This feeds into bond markets through the term premium, the additional yield investors require to hold long-dated debt rather than rolling a series of short-term securities. As the supply of bonds rises, and the Federal Reserve continues to shrink its balance sheet, that premium has been rebuilding, pushing long-dated yields higher even as the policy rate is held steady. The consequence is a steeper yield curve, with the long end under more pressure than the short end, punctuated by bouts of volatility whenever fiscal sustainability returns to the foreground. For investors this reinforces the case for caution at the long end: the income available on bonds has improved, but so has the risk that rising term premia and questions about the debt trajectory inflict capital losses on the longest maturities.

CHART 5

Yield Curves (Spread between 2Yr and 30Yr Bonds, Basis Points)



[5]Source: Saranac / Bloomberg

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The Long Read

AI, productivity and inflation

Beyond the shorter-term impact of artificial intelligence on investment spending and stock market returns, there are longer-term economic implications that need to be explored. The case for AI is not only that it raises corporate profits but that it may, over time, lower inflation whilst raising productivity and allowing greater output.

In the short term however, AI is more likely to add to inflation than to reduce it. The build-out is raising the price of advanced chips and computing power, and its demand for electricity is adding to pressure on power markets and energy costs at the same time as the oil shock. Central banks have already begun to note semiconductor-related price pressures in their data. The disinflationary effect, by contrast, is not yet evident in reliable data. Productivity gains appear in individual cases but have not yet registered in national statistics, and companies expected to benefit from adopting AI, as distinct from those supplying the infrastructure, have so far underperformed those building it.

The reasonable conclusion is that AI is currently adding to inflationary pressure, whilst its potential to reduce inflation remains a future prospect. That potential is significant, however, and supports a constructive view on returns on capital over the coming decade. Importantly, this is likely a multi-year theme, and probably one that spans more than a single cycle. It will not alter the course of central bank policy for the remainder of this year, and neither will it lead to an imminent, broad-based economic boom that sees meaningful increases in corporate profitability.

Saranac positioning

Portfolios concentrated in the leading AI companies have likely performed well, but that same concentration now represents a meaningful risk - in the United States but also in parts of emerging markets, where a small number of semiconductor firms dominate indices. Meanwhile, an environment of higher policy rates favours investments in shorter-duration fixed income, where carry makes up a larger portion of total returns, whilst the renewed energy shock is a reminder that real assets and diversification into commodities, hedge funds and other weakly correlated assets are worthwhile in a portfolio construction context.

Against this backdrop, our multi-asset portfolios have somewhat less exposure to equities than usual, and we are mindful of expectations priced into some areas of the technology sector. We have also introduced protection through equity index put options and VIX call options to hedge against equity market volatility. Within fixed income, we are avoiding very long-dated bonds, given concerns about fiscal sustainability and the risk of steeper yield curves, whilst maintaining high-quality credit exposure in portfolios. Finally, portfolios continue to have a meaningful allocation to diversifying assets - commodities and uncorrelated hedge funds - that should generate returns less reliant on the broader economic environment.

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