Investment Views

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BUTTERFIELD

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AI Continues to Drive Market Momentum

- Fading energy shock supporting growth
- AI shifts from chatbots to agents
- Technology hardware prices soaring

The second quarter was a strong one for global equities markets. After a sell-off in March due to the Middle East conflict, global equities rose 9.6% in April, 4.6% in May, before a relatively flat -0.7% in June. This saw global equities 13.8% higher over the quarter in US dollar terms, bringing the performance for the first half of 2026 to a healthy 9.0%. Global stocks have generated positive returns in 13 of the last 15 months. This is by no means unique in historical terms, but certainly a very positive run of performance.

Fixed Income markets stabilised after a challenging month in March when the Middle East conflict caused interest rate expectations to shift from pricing rate cuts to rate hikes. Sovereign bond yields at the short end of the yield curve moved higher (prices fell), but this was offset by coupon income. Sovereign bonds saw small positive returns, while corporate credit and Emerging Market Debt outperformed, returning around 3-5%. Corporate fundamentals remain healthy and money flowed into some of the riskier areas of the bond market, which supported returns.

Artificial Intelligence (AI) continues to be a key driver of equity markets. It has become such a dominant force across a wide range of industries that it is impossible to write about equity markets without covering AI. We have written extensively about the “Magnificent 7” mega cap technology companies driving markets in recent years, but this group of stocks was actually close to flat in the first half of the year. The AI theme now reaches far beyond just the large technology companies.

That AI requires cutting edge semiconductors and a lot of reliable power is now a story well told. The key development in the second quarter was an evolution in the thinking around how much additional technology hardware is needed to power the AI revolution. The original way in which AI was used was like a chatbot. For example, consumers could have a “conversation” with an AI application, such as ChatGPT. Users would ask a question and the model would answer based on the data that they had been trained on. Rather than a simple chatbot, the focus is now on AI agents.

AI agents don’t just chat, they act. Users can give it a goal, and it independently makes a plan, gathers information, uses tools, and completes the task from start to finish with little to no help from humans. For example, instead of saying “write me a line of code to create a button on a website”, you can ask an AI agent to build you a website and review, test, and improve at each stage of the process. This process involves more than just cutting-edge semiconductors. It requires computer memory and storage. It also requires a Central Processing Unit (CPU), which coordinates tasks and tells other parts of the system what to do.

9.6%

The amount global equities rose in April

We have seen a surge in demand for this technology hardware and supply has not been able to adjust quickly. The basic laws of supply and demand mean that the prices have had to adjust meaningfully higher. This has led to very large upgrades to earnings estimates for the companies selling this hardware. The Technology sector rose a remarkable 33.7% in the second quarter, well ahead of all other sectors.

There is however a flipside to this, as it means higher input costs for other companies who need to buy this hardware. Apple CEO Tim Cook has recently said: “this is a hundred year flood… I’ve never seen anything like it in any area in over 40 years… unfortunately, price increases are unavoidable”. Apple has recently increased their prices for many consumer products from 15-25%. Some market analysts suggest that the new iPhone may see a price hike of $200.

While AI took a lot of headlines in the second quarter, the fading of geopolitical risk from the Middle East was another catalyst supporting global growth and stock markets. Oil plunged from $118 to $73 as tensions eased and oil flows from the Middle East recommenced. This was negative for commodity prices, but for most companies and all consumers, energy is an input, so lower prices help ease inflationary pressure. Gold fell 14%, the weakest quarter since 2013. Higher real (after inflation) interest rates and a firmer US dollar dragged down sentiment. Gold has had a remarkable run in recent years though. Hedge funds had a good second quarter, with many trends, themes, and dispersion providing opportunities.

Confidence Returns, Risks Remain

- US front-end yields rise as Fed turns hawkish
- Falling oil price helps compress volatility
- Credit recovered and the dollar strengthened

Few quarters have seen the market narrative change as quickly as this one. Investors entered April focused on the Iran war, disruption around the Strait of Hormuz and the risk that higher energy prices would become a broader inflation shock. By June, attention had shifted back towards monetary policy and growth. Oil prices have fallen, volatility has compressed and risk assets have recovered. Credit and equities responded positively, but government bonds remained more cautious as investors reassessed the outlook for inflation and monetary policy.

US Treasuries were the clearest expression of that tension. The yield curve flattened, as short-dated bonds sold off sharply, with the 2-year yield ending June around 4.18%, nearly 40bps higher over the quarter. The 10-year ended closer to 4.5%, leaving the front and middle part of the yield curve to do most of the repricing. The move reflected resilient US activity, but also a reassessment of interest rate policy under new Fed Chairman Kevin Warsh. At his first meeting, the Fed left rates unchanged at 3.50%–3.75%, reaffirmed the 2%

inflation objective, and removed forward guidance from the policy statement. That communication shift matters. Under the previous regime, markets often traded the Fed's reaction function as much as the data itself. Warsh appears to be changing that. The Fed is less willing to cushion markets with guidance and more willing to let incoming data speak for itself. That may improve discipline over time, but it removes an important volatility dampener. Payrolls, inflation, oil prices and financial conditions may now have a larger immediate impact on rates, currencies, and risk assets. The Fed is offering less policy comfort and asking markets to price more uncertainty themselves.

Earlier in the year, markets were discounting roughly 50bps of Fed cuts for 2026. By late June, that had moved to around 40bps of hikes. That is a major change in the discount rate facing risk assets. It has not led to a deterioration in risk appetite because US nominal growth remains firm and still expected to run above 5% this year. Inflation markets sent a more reassuring message, but not a clean one. Market-implied inflation compensation fell sharply as oil prices reversed and the Hormuz risk premium faded, with the largest move at the short end. But inflation breakevens are not pure inflation forecasts and move with oil, liquidity and risk appetite. Consumer inflation expectations remain more worrying and are usually a better guide to whether inflation pressure is becoming embedded.

Oil fell sharply into quarter-end as the Strait of Hormuz reopened and supply concerns eased. But the decline in crude has not fully reached consumers. US gasoline prices have fallen, but at around $3.80 per gallon nationally they remain high. Markets may be quick to price lower crude prices, but households respond to pump prices. Until gasoline prices fall more decisively, the hit to disposable income, inflation expectations, and political pressure will remain.

$3.80

The price per gallon of US gasoline

FIXED INCOME

Outside the US, the picture was uneven. Europe and China saw weaker growth, while Japan and the US held up better. Most G10 longer dated government bond markets outperformed Treasuries. Japan remained the weak link. The Bank of Japan is still moving slowly relative to yen weakness, imported inflation and pressure on government bonds. UK economic data was steadier than Europe, but political risk has risen. Prime Minister Starmer's resignation has shifted attention to Andy Burnham, his likely successor, and to the next government's fiscal stance.

Lower volatility across fixed income and currency markets helped stabilise broad risk sentiment. Credit spreads tightened during the quarter, while ultra-long US Treasuries remained range-bound despite the sharp repricing at the front end. The US dollar rallied against most G10 currencies, as US real yields rose and the Fed shifted more hawkish. China and parts of emerging markets were more resilient, while the Canadian dollar was among the weakest performers. Lower energy prices removed an important support, and upcoming US-Canada-Mexico trade negotiations remain a risk.

Fixed income offers attractive risk-reward opportunities, particularly after the move higher in short-dated yields. However, inflation, policy and geopolitical risks remain unresolved, and the margin for error in credit is limited. Short and intermediate maturities remain preferred to excessive long-duration exposure, especially where fiscal risk remains elevated. Credit can still perform if volatility stays compressed, but tight spreads offer limited protection if growth weakens, oil rises again or the Fed tightens further. Risks in the third quarter include the 60-day Hormuz arrangement expiring in August and a potential US interest rate hike in September.

The AI Beneficiaries Have Broadened

- AI infrastructure boom continues
- Earnings estimates revised substantially higher
- Taiwan and South Korea dominating Emerging Markets

The second quarter began with many investors questioning why equity markets were doing so well in the face of an oil price shock from the Middle East crisis. Higher energy prices are damaging for economies, as inflation squeezes businesses and consumers, while also putting upward pressure on interest rates. Two factors really drove the recovery. Firstly, markets look forward and were pricing in an expected recovery of oil flows out of the gulf region. Secondly, the buildout of infrastructure to power the AI revolution continues at breakneck speed.

Discussing the performance of equity markets without mentioning AI is essentially impossible. The theme has permeated so many different areas of economics and markets. It has shaped industry performance and regions with exposure to the theme have outperformed. In the second quarter, the Philadelphia Stock Exchange Semiconductor Index surged by 88%, for its best three-

month period on record. June was a volatile month for Technology stocks, but the first half of the quarter saw some remarkable returns. Profit estimates for Technology stocks have risen sharply, especially for the companies selling the “picks and shovels” for AI. This has been described as similar to a gold rush, and there has certainly been a sense of urgency around technology hardware.

Sectors like Industrials, Materials, and Utilities have also benefitted from the AI buildout. Data centre projects are underway at scale in the US and they require significant materials, construction expertise, and reliable power. For example, companies selling electric components, power generation equipment, or utility service providers have performed especially well. Demand for electricity has inflected higher recently, after a 20-year period of flat demand. This is putting a strain on both prices and the power grid. It has also become a political issue, with consumers seeing higher bills due to data centre demand. This has fuelled a backlash in some areas, as consumers are paying more for electricity at the same time as worries that AI will replace jobs in the labour market.

Earnings growth for the S&P 500 reached a remarkable 27% in the first quarter, compared to the previous year. This included some one-time gains, for example technology companies holding shares in private companies that increased in value. Excluding these, Goldman Sachs estimates that earnings growth was still 17%, which was 5% higher than expected at the start of the year. The consensus forecast for second quarter earnings growth is higher still, at 22%. The normal pattern is for analysts to expect strong earnings growth at the start of the year, then revise expectations lower so that companies can “beat” expectations. This year, estimates have been increased, and companies in aggregate have handily beaten those expectations.

27%

S&P 500 earnings growth for the first quarter

There has been a lot of dispersion under the surface of these earnings estimates. Stocks linked to AI infrastructure are expected to contribute nearly 60% of S&P 500 EPS growth in the second quarter. The median stock in the index is expected to grow earnings by 9%, which is still healthy growth, but clearly more muted. South Korea and Taiwan have been notable beneficiaries of the AI infrastructure buildout. Equity indices in the two regions returned 64.4% and 46.9% respectively in the second quarter. Companies that specialise in the hardware that is in furious demand now for AI have soared. So much so that the top three stocks in Emerging Markets now account for almost 30% of the index.

China and India have long been the largest regions in the Emerging Market index, but that has now changed. Taiwan now accounts for around 28% of the index, while South Korea is close to 21%. The combined weighting of the two regions is almost 50% of the index. The overall index has therefore become very much exposed to the AI buildout. This helped drive a 24.0% return of Emerging Market equities in the second quarter. Emerging Markets excluding China rose an even more impressive 34.5%.

Beyond AI, it was a difficult quarter for the Energy sector, which fell 13.4%. This was driven by lower oil prices, as Middle East tensions eased, but followed a strong first quarter when the sector was by far the strongest in the market, returning 36.9%. Conversely, the Financials sector performed well, returning 12.0%. Financial Services had a challenging start to the year as worries around private credit and AI disruption hit the sector. Banks sold off in March when markets fell, but bounced back in the second quarter. Falling interest rates are a risk for banks, so a combination of higher rates and a brighter economic outlook as oil prices fell was a positive. Overall, we maintain exposure to all 11 sectors of the equity market, but are conscious that markets are highly exposed to the AI factor, so continue to monitor this closely.

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Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy

	UNDERWEIGHT -	+ OVERWEIGHT
Asset Allocation	FIXED INCOME (MODEST UNDERWEIGHT) EQUITIES (MODEST UNDERWEIGHT)	ALTERNATIVES (MODEST OVERWEIGHT) CASH (MODEST OVERWEIGHT)
Fixed Income		EMERGING MARKET DEBT INFLATION PROTECTION SHORT DURATION HIGH YIELD
Equities Regional		JAPAN EMERGING MARKETS EX CHINA
Equities Sector	CONSUMER DISCRETIONARY REAL ESTATE	UTILITIES

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