Investment Views

August 2026

BUTTERFIELD

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Lessons on Leverage

- Leveraged investors behind AI sell-off
- Other areas of the market performed well
- Cheaper AI models are coming

After a very strong run of performance for stocks linked to Artificial Intelligence (AI), July saw some painful drawdowns. Semiconductors bore the brunt of the selling, with The Philadelphia Semiconductor Index falling almost 30% from peak to trough. It's important, however, to keep this in context. The index is still up 60% between the start of the year and the end of July, and recovery has been seen late in the month and through early August, so the sell-off has stabilised.

While there has been a lot of volatility in stocks linked to AI, there has been notable strength in other areas of the stock market. Six of the eleven main sectors of the market made positive returns in July, with Energy and Financials doing particularly well. The wide dispersion between different stocks in the market helped keep overall stock market volatility well contained. Said simply, while some previously high-flying stocks linked to AI fell, many other areas of the market performed just fine, so at a headline level equities finished July close to unchanged.

As stocks linked to AI fell, the challenge for investors was to determine exactly what was driving the sell-off. Broadly speaking, stocks can move due to fundamental factors (what is a business worth) or technical factors (who is buying and selling right now). There were a few news stories that appeared to be negative for stocks linked to AI. There has been a rise in the level of debt to help fund data centre construction, so this is seen as a risk. Another headwind has been worries about new open-source AI models. These are seen as a potential threat to US-based AI companies charging more for access to their own models. Lastly, there has been a concern that companies have been spending a lot of money by racking up bills for computing power based on heavy use of AI tools, and would look to cut costs.

While all of these concerns have a degree of truth, and may have been the catalyst for the sell-off, the real culprit seems to have been technical. Lots of hedge funds have been active in AI stocks, buying semiconductor companies and short-selling stocks they believe could be disrupted by AI. Hedge funds tend to use leverage (borrowed money) to amplify their returns, and as semiconductor stocks started to fall, some hedge funds were forced to reduce or sell their exposure to limit losses.

One fund in particular, called Situational Awareness, made headlines as it offloaded a lot of AI linked stocks, which contributed to prices falling rapidly. The fund is managed by a 25 year-old, Leopold Aschenbrenner, and got into difficulty in the same week in July as his wedding day. This made for entertaining content on social media, but his early vision on how AI would play out was proven very much correct. His fund grew from $225 million in 2024 to a peak of around $45 billion; a remarkable rise. While he made some very good investment calls, this is a reminder of the power of leverage. What worked spectacularly well in the good times, reversed dramatically when prices fell. Leverage magnified these losses and a $45 billion fund rapidly became a $10 billion fund.

30%

The amount
The Philadephia
Semiconductor index
fell from peak to trough

The good news for financial markets is that investors with cash stepped in and bought, as prices of AI linked stocks fell. This helped to stabilise AI stocks. With other areas of the market well insulated from AI, the MSCI World index ended July up 0.5% in US dollar terms and down slightly by 1.1% in sterling terms. What felt like a real rollercoaster month at the individual stock level turned out to be far less eventful at a headline level. This demonstrates the importance of diversification and we have exposure to all eleven sectors of the stock market, which has been helpful for portfolios.

Optimism Persists Despite Higher Yields

- Long-term yields rise as energy and fiscal concerns intensify
- Central banks remained cautious amid mixed growth and inflation signals
- Geopolitical tensions continued to shape the global outlook

July was a difficult month for developed-market government bonds, as higher energy prices, renewed geopolitical risk and concerns over fiscal sustainability pushed yields higher. The sell-off was concentrated further out the curve, suggesting inflation and policy credibility mattered at least as much as expectations for near-term central-bank rates. Interest-rate volatility also rose during the month.

Two-year US Treasury yields rose from 4.18% to 4.29%, while the 30-year climbed from 4.95% to 5.27%, its highest level since 2007. In July, the Federal Reserve kept rates unchanged at 3.50%–3.75%, although three policymakers voted for an immediate increase. The sharp rise in longer yields, despite the more hawkish expected policy path, reflected greater concern over inflation and the compensation investors require to hold long-dated debt.

Higher yields also fed through to households, with US 30-year mortgage rates approaching 6.8%, near a one-year high. Corporate

bonds were relatively resilient, although investment-grade and high-yield spreads widened modestly and investment grade funds saw outflows.

A notable credit development was the wave of technology-sector borrowing to finance AI infrastructure. Amazon launched a $25 billion bond sale in July, while Alphabet, Meta and Oracle had issued around $194 billion in 2026 by early July. Demand remained substantial but became more selective, with new issues requiring larger yield concessions. Alongside heavy government borrowing across developed markets, this is increasing competition for fixed-income capital and may place upward pressure on yields, potentially crowding out weaker borrowers at the margin.

The government-bond sell-off was broad-based, with some of the largest moves in Europe. Italian 10-year yields rose by almost 40 basis points, Swedish yields by around 36 basis points, while French and German yields also moved materially higher. UK 10-year gilt yields finished just above 5%. The ECB and Bank of England both kept rates unchanged. In the UK, three policymakers voted for a hike as the Bank balanced weaker growth against the risk that higher energy prices would keep inflation elevated.

Japan was another important focus. Japanese Government Bond yields stayed close to multi-decade highs amid buoyant nominal growth and a hesitant pace of further Bank of Japan tightening. The BoJ kept its policy rate at 1%, although one member favoured 1.25%. Currency markets were very volatile: the yen rallied sharply late in the month following intervention after falling to four-decade lows, while the Norwegian krone benefited from higher oil prices. The broader US dollar weakened over July as softer US inflation data periodically reduced expectations for near-term tightening.

Energy remained central to the fixed-income story. Middle East tensions erupted again and disruption around the Strait of Hormuz

40bps

The amount Italian 10-year yields rose

FIXED INCOME

kept crude and refined-product prices elevated. US gasoline prices rose, while the difference between the value of refined fuels such as gasoline and diesel and the crude oil used to produce them rose. This unusually wide spread highlighted tight refining capacity and showed that fuel-price pressure reflected not only crude prices but also shortages further down the supply chain. The US continued drawing on the Strategic Petroleum Reserve under its 172-million-barrel release programme, leaving inventories near their lowest level since the early 1980s, reducing the buffer against further disruption.

Trade policy added another source of inflation uncertainty, as the US announced new tariffs on a broad range of trading partners late in the month. Macro data, however, was more balanced than the bond sell-off suggested. US inflation indicators moderated, while growth momentum looked firmer in Europe and Japan. China was mixed, with second-quarter growth slowing and manufacturing activity slipping back into contraction, while UK and US activity was comparatively softer.

July's sell-off also improved valuations across parts of fixed income. Long-dated US inflation-protected securities ended the month with real yields close to 3%, their highest level in 20 years. This offers a potentially attractive source of long-term inflation protected income, although longer-duration TIPS remain sensitive to changes in real rates.

Overall, July reinforced that global bond markets are being driven by more than central bank policy rates. Energy security, fiscal credibility, inflation uncertainty and the growing financing requirements of the AI investment boom are increasingly influencing long term yields. These forces may keep volatility elevated even if policy rates change only gradually, but the repricing has also left parts of high-quality fixed income offering significantly more attractive long-term income than in recent years.

Record Breaking Earnings

- AI pain but software gains
- Financials performing well
- AI driving earnings, but not entirely

When reviewing global equity markets, it is difficult not to start with technology. The sector accounts for around 30% of the market, a figure that has doubled over the last 20 years. The weakness in Semiconductors has been discussed above, but what was interesting is that it was not all bad news for technology stocks. Software and Services stocks, which account for just under 10% of the S&P 500, returned a healthy 12.3% in July. This marks a reversal of fortunes from earlier in the year when semiconductors performed much more strongly than software. This dispersion was also notable across different regions. The US stock market has a lot of exposure to software stocks, and this meant it outperformed global technology stocks. The US technology sector fell 3.0%, while technology stocks outside of the US fell 13.6%.

Emerging Markets felt the pain from the sell-off in technology hardware. Asian stock markets, such as South Korea, have performed very well over the last year but suffered in July, falling almost 20%. While this was a painful correction, the region's equity market is still up 65.6% for the first seven months of 2026. Index concentration, i.e. stock market indices being dominated by a small number of large stocks, has been a theme in a number of regions. Emerging Market stock indices have become particularly concentrated, with a handful of AI hardware companies driving index performance.

Like the US market, there was a lot of dispersion within Emerging Markets. While stocks linked to AI in South Korea and Taiwan fell, we saw much better performance in other regions. After a challenging first half of the year, Chinese stocks rose 8.7% in July, while Indian equities also generated a small positive return. This again highlights the importance of diversification by investing in different regions of the world.

Through the volatility in equity markets, underlying company earnings have been remarkably strong. Earnings growth for the S&P 500 is tracking at around 50% compared to the previous year. These profits included some gains made by companies on their shareholdings of other companies. Alphabet (Google), for example, reported a large gain from their shareholding in SpaceX, which listed on the stock market earlier this year. Research by Goldman Sachs suggests that when you exclude these gains and focus on underlying corporate profits, the growth was around 31%. This is still very strong.

Earnings have been so strong that in aggregate, US companies are reporting earnings that are 29% above estimates. According to FactSet, this is the largest quarterly earnings beat since they started tracking data in 2008. The only quarter that comes close was Q2 2020, when earnings beat estimates by 23%. This was when the economy received a lot of government support during the pandemic.

8.7%

The amount Chinese stocks rose in July

While stocks linked to AI have taken up a lot of the headlines, the median stock saw earnings growth of 14% compared to the previous year. Furthermore, earnings growth in Europe has also been strong, jumping 22% in the second quarter and reaching double digits for the first time in nearly four years. Earnings were driven by Energy and Materials, so it was not just a Technology story.

Financials have also performed well, with earnings growing by 19% globally over the last year. Financials have benefitted from a solid economic backdrop, a pickup in trading revenue, and from an increase in acquisitions and initial public offerings. Markets were expecting interest rate cuts prior to the Middle East conflict, but the conversation has shifted towards whether interest rates will rise. Banks have benefited from this environment, while loan books and investment portfolios are being reinvested at higher yields than loans made during 2021 and 2022.

Overall, the sharp fall in AI linked stocks in July was painful, but it came on the back of a very strong run, so can be seen as a healthy development. We continue to watch the risks around AI, but strength in other parts of the market, like financials, has been encouraging, as has the strength in corporate earnings.

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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)	ALTERNATIVES (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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