

Healthy bull market to digest gains

As we head into the second half of 2026, we see the peace talks between the US and Iran as a clear positive for the long-term equity bull market, alleviating a key risk in our bear case i.e. a post-summer surge in crude oil prices should the Strait of Hormuz remain shut through the season.

That said, the recent rally has been sharp, with global equities [based on the MSCI All Country World Index] up nearly 17% in three months from their in late-March through to end-June. This suggests the positive factors behind the rally could be mostly priced in at this point.

Investors are, after all, forward looking: the market's view has been that the White House firmly favours an offramp from the US-Iran war ahead of the mid-term elections, and that the larger driver of the bull remains the structural AI theme.

Long-term fundamentals of AI-driven equity bull largely sound

In terms of our equity view, given rapid AI adoption and a firm earnings outlook, we believe the bull market's long-term fundamentals remain largely intact.

Notwithstanding some limited pockets of exuberance, we do not see widespread evidence that the broader market is in an AI bubble currently. Unlike the dotcom bubble of the 1990s, which was driven by soaring price-to-earnings (P/E) multiples with little earnings growth, today's AI-driven rally largely rests on robust earnings growth, while valuation multiples have in fact stayed mostly flat.

The Magnificent Seven illustrate this well: their share prices have risen about 20% since early 2025, yet their average forward price-to-earnings valuation multiples has fallen from over 30x to about 24x, as earnings growth have outpaced price appreciation.

Nor do we see much evidence for the bearish argument that this growth rests on an AI-capex bubble. First, surging token spending suggests AI monetisation is starting to scale, and the hyperscalers behind most capex remain highly cash-generative with healthy order books. Second, given that most of them have track records of sound capital discipline, it is telling that they have invested steadily even in recent periods when the market punished their shares due to over-investment fears. Finally, with the Fed Funds rate at 3.75% and the 10Y US Treasury (UST) yield at 4.5%, this is not an "easy money" environment, and the cost of capital is another hurdle that enforces investment discipline.

Inflation is a wild card for markets

Since the pandemic, the S&P 500's forward earnings yield has converged towards the 10Y UST yield, as inflation has become a dominant macroeconomic factor, as it was in the 1980s and 1990s. Equity prices could thus come under pressure should long-dated yields rise on higher inflation, which is why we see inflation risks - closely tied to crude oil and the Middle East conflict - as a wild card for markets in 2H2026.

Despite recent US-Iran friction, if the White House broadly succeeds in normalising oil transit through the Strait of Hormuz, the resulting fall in crude prices will clearly ease inflationary pressures. This is much needed - since the war began, US CPI's month-on-month gain has jumped to 0.9% in March, easing only marginally to 0.6% in April and 0.5% in May. Should inflationary pressures remain elevated by year-end, we could see volatility emerging in risk-asset valuations.

Healthy bull market could digest gains over near-term

While the long-term AI-driven bull market remains largely intact, over the near-term it could take some time to digest the sharp gains made since late March. Although timing near-time market swings is impossible, several signals give us pause. First, the US call/put ratio points to highly bullish sentiment, which historically is a contrarian indicator. Second, rising levels of margin debt leaves the market more prone to volatility; and third, the rally's narrow breadth signal near-term vulnerability, though a sustained broadening beyond today's handful of AI leaders would ease the risk of a shakeout in 2H26.

Given the overwhelming market focus on the AI theme, it can be easy for investors to lose discipline on managing concentration risks and ensuring diversification in their portfolios. As they stay invested for the long-term, this is an opportune time to assess the risks of over-concentration in specific markets, sectors or single stocks, and ensure portfolio resilience against volatility risks.

Favouring quality and carry in fixed income

In fixed income, spread compression and carry supported total returns in the first half of 2026. Credit was resilient with every segment posting positive year-to-date returns, and High Yield (HY) and Emerging Markets (EM) bonds outperformed their Investment Grade (IG) and Developed Markets (DM) counterparts.

We see rates volatility and dispersion as the key themes into 2H2026: the Fed's rate path and the mid-term elections will shape narratives, while shifting inflation and labour dynamics, plus reduced Fed guidance, could lift volatility.

We look for spreads to widen moderately as the UST curve flattens, leaving carry an important support and credit selection paramount. We continue to favour high-quality credits and stay Neutral on duration. In DM, we prefer IG over HY given late-cycle dynamics and HY's unattractive relative valuation. Within EM corporates, we are Neutral on Asia and Latin America (Latam) and Underweight CEEMEA (Central and Eastern Europe, the Middle East, and Africa). Within EM sovereigns, we favour Latin America over CEEMEA and Asia, with opportunities in selected African sovereigns.

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