

Simone Kyriakou (Host):

Welcome to the Asset Allocator podcast. I'm Simone Kyriakou, editor of *FT Adviser*.

This and future editions of the Asset Allocator podcasts are going to be a little bit different, coming now to you in both audio and visual form. Just head over to the Asset Allocator feed to find out a little bit more.

In this week's episode, we're going to be looking at why economists and investors have been reacting very differently to events in the Middle East. We're also going to be exploring why persistently high gilt yields are having such an impact on your clients and their portfolios. And we're going to be questioning whether the AI trend—the megatrend of AI—can continue into 2026 and beyond.

Joining me here in the studio today is Joe Little.

Joe Little (Guest):

Hello.

Simone:

Joe Little is the chief strategist at HSBC Asset Management, and we're very pleased to have you with us. Thanks a lot.

Joe:

Thank you.

Simone:

Should we get straight into it?

So you have said that economists and investors seem to be reacting very differently—or feeling very differently—about the events in the Middle East. And they're perhaps operating in almost two different worlds right now. Could you explain why this is?

Joe:

So men are from Mars and women are from Venus. Which one is which?

Economists and maybe investors, as you say, are in different worlds at this point in time. If you think about markets making new highs—a really rapid recovery following the geopolitical shock that we saw in late February and early March—there's been a real rapid recovery in markets. Emerging markets performing very, very strongly as well across currencies and stocks and bonds.

And then you reflect on the environment that economists are describing, who are very worried about the landscape. And it jars with that strength that we see in markets and low volatility, because economists remain very concerned over prices obviously spiking.

Simone:

Yes. Big consequences for how we think about growth and inflation.

Joe:

It's also been a historical trend that large spikes in oil prices have preceded recessions—economic downturns. We have inflation back on the scene. Central banks are thinking about hiking interest rates, or maybe wondering if they need to hike interest rates.

So the environment looks a lot more complicated from the perspective of economists. And then you end up with this tension: yes, of course, high policy uncertainty, high geopolitical uncertainty—lots of things to worry about on the economic front—but markets doing very well.

Simone:

Thank you very much. Is that just a momentum thing?

Joe:

Part of what's happened is that we've seen very, very strong news on profits. And that is, of course, concentrated in areas like technology—but not exclusively so. Materials, financials, and some spillover areas around the AI theme are also benefiting.

But that strength in profits is really keeping the whole show on the road. So markets can be resilient to macro, political, geopolitical uncertainty as long as two things hold.

Firstly, profits growth remains intact—and as I say, it looks stellar so far. And secondly, if bond yields and the cost of capital can remain reasonably well behaved.

So if we don't see the return of the bond vigilantes—which I know maybe you want to talk about shortly—

Simone:

Yeah, absolutely.

Joe:

—then that keeps markets underpinned and in a positive, supportive place. It's that combination of strong profits growth, but the handbrake of higher bond yields not really acting as a drag on markets. And that's what we've seen so far.

And so, as you say, you end up with this apparent paradox of markets hitting new highs while headline writers at the FT—and also economists—are worrying a lot about all of the uncertainty that we see in the economic and political landscape today.

Simone:

Can both sides be right?

Joe:

That's exactly true. You can have a situation where macro uncertainty, policy uncertainty sustains—and yet markets climb the wall of worry.

And in a way, that's what we saw last year: the Liberation Day tariffs—an awful lot of uncertainty. Question marks around how things would play out in terms of trade policy, where tariffs would finally settle.

And what happened instead is markets climbed the wall of worry. Profits growth was showing strong momentum, strong performance broadening out from just technology. And the Fed and other central banks were cutting rates, of course, which acts as an oxygenating factor for investment markets.

So you had that tension all year: policy uncertainty, but low volatility and markets.

Simone:

Absolutely. And I guess everyone's right at some point with 20/20 hindsight.

[Podcast interlude / teaser]

Coming up on the podcast: uncertainty of gilt markets and the AI hype. Join us after this message.

Segment: Gilt yields and the UK bond market

Simone:

Joe, we touched earlier on the uncertainty of the gilt market. And who would have thought a decade ago that gilt yields would be higher than they've ever been since the Bank of England's independence? It's a very curious world we're operating in right now. Could you shed a bit of light on that?

Joe:

Yeah, it's really captured everybody's attention. And wherever I go around the UK talking to professional investors, everybody wants to talk about this topic. So I'm glad you raised it.

Maybe three things behind the move that we've seen.

Firstly, of course, we've had the energy shock.

Simone:

Yes.

Joe:

And that's really shifted the game in terms of how traders are thinking—and economists are thinking—about the short-term rate outlook.

If you remember back to January, February, most analysts were expecting the Bank of England to be cutting rates.

Simone:

That's right.

Joe:

Or two cuts was the sort of consensus view. But that swung rapidly around. And investors are now anticipating three hikes from the Bank of England. Frankly, I'd be surprised if that gets delivered. But it reflects the challenging supply shock environment that we're in with energy prices and commodity prices more generally spiking higher with the Middle East crisis.

Simone:

So you're saying that's one part of the equation. But certainly there's also been a bit of a flight to safety.

Joe:

Yeah. The second part of the way I would think about it is the reality of the UK at this juncture is that internationally it's seen as a bit of an inflation problem—or inflation challenge.

We've been stuck in the UK at 3% inflation now. If you were coming from Mars to look at the economic data and the first thing you did is have a look at the UK CPI and you're asked to guess what the inflation target was, you wouldn't guess 2%.

Simone:

No. You'd think about three.

Joe:

Yeah—say about three. So it could be that three is the new two.

Simone:

Well yeah. Could it be?

Joe:

It certainly seems maybe for the UK, Australia, and to a certain extent the United States—although maybe the bond vigilantes aren't being quite as strict with the Treasury market as elsewhere.

The reality is the UK maybe looks a little bit more inflation prone. To a degree that's always been true. But the debates that investors are having around the debt position, around UK productivity, around what might be happening in the political sphere—of course—don't help that discussion when we see higher inflation rates in the UK.

And the third part of it is really quite interesting because we are riders on the storm in the UK bond market. We are sensitive to what's going on elsewhere—particularly what's happening in the Treasury market.

In the context of the Middle East crisis, the inflation challenges globally that follow from that—at least in the short term—Treasury bond yields are rising as well.

So part of the way to understand higher yields in the gilt market is connected to the rising yields that we're also seeing in the Treasury market. But gilts are rising a bit faster.

In bond investing we sometimes say there's like a yield beta—there's a higher sensitivity in the gilt market to what's going on versus what we see elsewhere. The rule of thumb has been that for every ten basis points higher the Treasury yield moves, the gilt yield is moving higher about 15 basis points.

So the bond vigilantes are here in the UK bond market. And maybe they're encouraged by the fact that we don't have policy architecture which is suppressing bond yields—which is already something that's in play in Europe. The ECB uses the transmission protection instrument to kind of keep yields capped across the eurozone.

So: a shift in the rate environment; a sense that the UK has become a bit inflation prone; and the idea that maybe there's not quite the same coordination around policy measures which are adding a cap at the moment—have created a situation where gilt yields are now the highest they've been since Bank of England independence.

Simone:

But it's not a problem in a way for investors because it gives them—gives institutional investors, discretionary fund managers—more tools to put into their portfolios. Defined benefit pension schemes are all running excellent surpluses at the moment as a result. So for many people, it's a bit of a welcome relief, isn't it?

Joe:

The rising cost of capital is not great for growth, and it's not great for animal spirits or for economically sensitive asset markets. It's probably not great for stocks if it goes too far.

But the good news is nobody really funds themselves off 30-year gilts.

Simone:

Right.

Joe:

We tend to fund ourselves shorter in the UK—at shorter-term maturities in the curve. The question then is whether or not, if the Bank of England is delivering those hikes that the market is anticipating—and as I say, I'd be surprised—but if that does happen, then how do longer-term gilts react?

Do they rally—because inflation credibility is restored? Or is there a spiralling challenge as those inflation questions become deeper and larger for investors, and maybe even a bigger concern about longer-run inflation credibility resumes?

Simone:

It's quite a blunt policy lever.

Joe:

Yeah. What I would say is that in markets, of course, things will always surprise you. But one fact that we do see time and time again is that the best signal of future return in bond markets is when you have high levels of yields and you have an upward sloping yield curve.

So the yield on a 30-year or a 10-year bond is higher than the five-year or a two-year bond yields. And both of those attributes are true in the UK today.

So it could be that although there's a lot of anxiety around current headlines and a lot of challenges at the moment for the UK, if you've got a medium-term time horizon, there's quite an interesting opportunity to compound at almost 6% for ultra-long-term gilts.

Segment: AI, market breadth, and what comes next

Simone:

Well, let's go back to what you were saying about growth and look at AI.

We saw in 2024, 2023, 2025 AI was doing extraordinarily well. Anything connecting to it—companies announcing a new AI tool or developing new AI structures—momentum was incredible. But we've seen that tail off a little bit in 2026.

Do you think we're still going to see a macro trend? Do you think the AI hype will continue, or do you think maybe we've just ridden that wave too much now?

Joe:

2025 was really fascinating because AI was there, but there were other moving parts to the

stock market as well. We called this a broadening out. There was a sense that the rising tide could lift all the boats.

That reflected a set of conditions in the global economy and in investment markets which were really friendly to other parts of the market catching up a little bit with AI or following the leader: good global growth, benign inflation, rate cuts from central banks, weaker dollar.

But since the start of the year, it's been a little bit more tricky. We've got the return of geopolitics. We've got this big oil and commodity shock. So inflation worries are back to the fore.

There is a challenge then around the growth outlook. The US is energy independent, but Europe, South Asia, Southeast Asia—big reliant energy importers—so a big challenge to GDP outlook in those economies. And as we've already mentioned, we've got the prospect of rate hikes.

So it becomes a little bit of a challenge for thinking about how different equity sectors and parts of the stock market behave, because investors are really looking for resilient and reliable growth.

Part of the reason why we've seen a rapid recovery in stock markets since the Middle East crisis is connected to a renewed belief again in the AI megatrend.

So the stock market rally has been quite narrow. There's a few leaders, but not many followers at this juncture.

The big question is whether the market can continue to perform, but with performance broadening out across other sectors. Is that something we can buy into again in 2026, or is it just a 2025 story that's now in the history books?

We need to see that pattern of broadening in order to have a healthy bull market—that's the healthy attribute those bull markets are based on.

So I think that's such a key question now: the extent to which the rally continues and can broaden.

Simone:

And the news can get obscured because things like the commodity spike—gold and silver did so well in January and February—and the news almost gets drowned out. Then suddenly it's results season and you're thinking, "Oh, wait a minute—Meta is announcing results, or Nvidia is announcing results." I almost forgot they existed because everyone's talking about gold or commodities or everything everywhere all at once.

Joe:

Yeah, we've had quite a few film references, right.

Simone:

Yeah, yeah.

Joe:

It does feel like a dizzying experience for investors. That's how it feels in the trenches.

It's clearly a different environment now versus parts of 2025. But I think there are still reasons to be hopeful in terms of the market outlook at this point.

AI is performing. The multiple associated with the AI sector is rising, but it's not so elevated at this point. So there's still maybe room for gains there.

We can also think about the AI sector more globally. Korea and Taiwan have performed very strongly. But Asia technology is available as a way into the tech theme for investors at much lower multiples.

And emerging markets not only have a tech angle, but also a materials angle.

Simone:

That's right—with LatAm energy exporters as well.

Joe:

And that index is only trading on 12 times forward earnings. So if we can be comfortable with that earnings prospect, that's not such a high price to pay for a set of sectors that can still do well in this environment.

Even in the US, we've seen in the recent profit season industrials, banks, infrastructure, utilities all showing signs of strong profits delivery for investors. So it's not quite true to say it's all about AI.

Simone:

Yeah.

Joe:

But in phases it does feel a little bit like that.

One thing we can also reflect on that might be similar to last year is what happens with the dollar.

Simone:

Yes, of course—that's a big part of the story for Europe.

Joe:

And also in the emerging market space, if the dollar can weaken, that helps support the growth and flow environment and investor sentiment across a whole host of emerging markets and rest-of-the-world parts of the system.

One of the impressive features we've seen since the start of the Middle East crisis has been how rapidly emerging market currencies have recovered versus the dollar. So maybe that's something to watch too. It can be a big source of support for global equities outside of the US.

Simone:

Fantastic. Well I'm sure we'll come on to emerging markets with you on a future edition of the Asset Allocator podcast. Thanks a lot.

Join us next week on Asset Allocator in either video or audio format.

For now, thank you very much again to Joe for joining us, and thank you for watching us. Until next time. Take care.