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Market View
AI momentum drives equity markets higher in Q3

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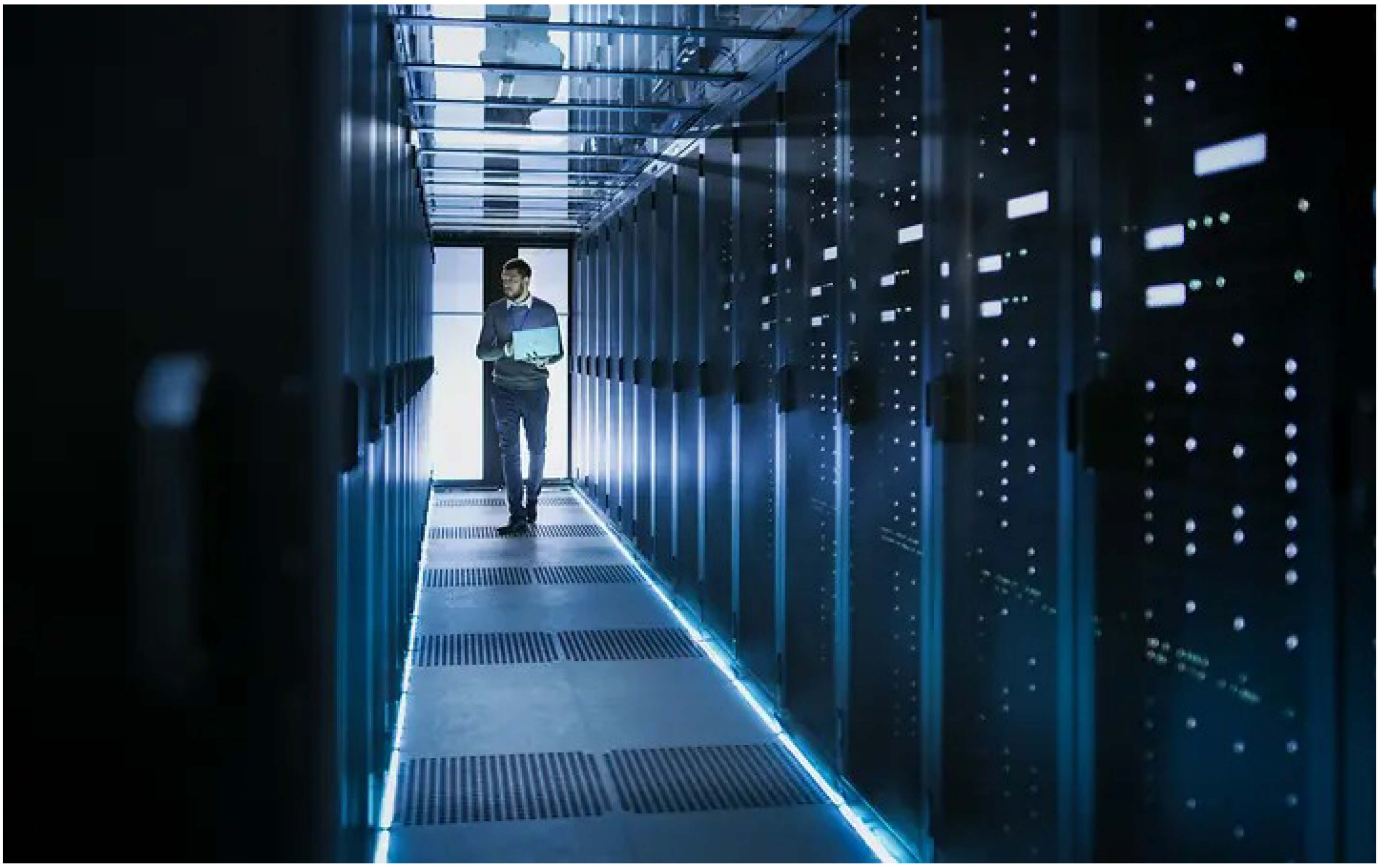

At a glance

- Global equities rallied in Q3 on back of strong earnings and continued AI investment.
- Fed cut rates for first time this year, and signalled further easing ahead.
- Inflation pressures resurface due to new tariffs but Fed is more worried about employment.

US equities climbed higher in the third quarter led by AI-related technology companies, although the rally extended beyond the US, with China, Japan and the UK all posting strong returns. Europe, after a strong first half the year, lagged other markets as political turmoil in France impacted investor sentiment.

A combination of strong earnings, easing tariff tensions and falling US bond yields helped lift equities globally. In September, the Federal Reserve (Fed) cut rates for the first time this year and signalled further cuts were imminent, reflecting concerns the US labour market is softening. Short-dated bonds delivered strong returns, while long-dated government bonds lagged.

Equities rise despite weak jobs data

The S&P 500 finished the quarter up 8.1% and the tech-heavy Nasdaq rose 11.4%. However, a disappointing July jobs report weighed heavily on equities in early August, as the US added fewer jobs than expected and unemployment rose. Previous months' payroll gains were revised lower, amplifying concerns about the labour market as President Trump's economic plans took hold.

Jobs growth remained muted with nonfarm payrolls – an important measure of monthly job creation – increasing by just 22,000 in August, down from 79,000 in July and below the 75,000 expected. Additionally, the Bureau of Labor Statistics revised down employment figures for April 2024 to March 2025 by nearly one million jobs, an average of about 75,000 fewer jobs per month.[1]

UK and European equities had a solid quarter, with the FTSE 100 rising 7.5% and STOXX 600 3.5% in Q3, but the standout was China. The Shanghai Composite advanced 13.9% in the third quarter and Hong Kong's Hang Seng gained 12.5%, as renewed optimism over Chinese technology companies buoyed equities. Japan also posted solid performance after the country's ongoing corporate reform and shareholder-friendly policies gained momentum, led by new government incentives to target shareholder returns. The Topix rose 11% in local terms.

Earnings saw significant AI spend and tariff impact

Companies reported strong earnings fuelled by the AI boom. Indeed, some of the world's largest companies are investing sums greater than the GDP of many mid-sized countries to capitalise on this opportunity. In the second quarter, Alphabet, Amazon, Apple, Meta and Microsoft collectively spent over $92 billion on capital expenditures, some 68% more than what they spent in the same quarter last year.[2] However, it remains unclear when this investment will deliver sustained top-line expansion.

Tariffs trickle through to inflation data

Alongside weak jobs data, the Fed faced inflationary pressures from tariffs, which became more evident in pricing data. The latest Consumer Price Index (CPI) figure published on 11 September rose to 2.9% from 2.7%, underscoring ongoing Fed challenges in bringing inflation back to its 2% target. While tariffs typically cause a temporary rise in inflation, the jury is still out on what impact tariffs will have on inflation.

Central banks pass on the baton

The quarter saw a shift in central bank policy. The Bank of England (BoE) – which cut rates in August by 0.25%, representing the third cut this year and bringing the rate to 4% – held firm at their September meeting, and indicated they may keep rates steady for the foreseeable. Meanwhile, after holding rates all year despite pressure from the White House, the Fed finally lowered rates by 0.25% and signalled more cuts are likely before year-end.

During the quarter, dissent grew among Fed members over the direction of interest rates. Trump was outspoken on social media in advocating for rate cuts, and his latest pick to join the Fed appears ready to deliver. In his first meeting, Stephen Miran dissented and voted for a 0.50% cut, later saying that interest rates should come down to around 2.5% down from 4.25%.[3] Trump's ongoing pressure to lower rates has reignited the debate surrounding the Fed's independence. As the quarter ended, the US government shut down after failing to compromise on the budget, which will see key labour data delayed, further complicating the picture for the Fed.

Short-dated bonds rise

Short-dated government bonds had a strong quarter. While two-year Treasury yields rose to nearly 4% in July, they fell back down to 3.6% at the end of quarter. Similarly, the benchmark 10-year Treasury yield rose to 4.48% earlier in the quarter before declining to 4.15% following the Fed's September rate cut. In contrast, long-dated government bonds were little changed in the US. Globally, yields on longer maturity debt rose as fiscal concerns flared up in France when President Emmanuel Macron had to elect a new president given discontent surrounding the proposed budget cuts. This underscored the difficulties governments face in implementing spending cuts across developed economies.

Conclusion

Despite persistent challenges such as softening US labour markets, ongoing inflationary pressures and global trade uncertainty, equities delivered strong returns in the third quarter due to robust corporate earnings and easing tariff concerns. Central banks signalled a more accommodative stance, yet divergences remain as policymakers navigate a complex macroeconomic backdrop. As we enter the final quarter of the year, investors will be watching closely for further clarity on monetary policy, the robustness of corporate profitability and the evolving impact of geopolitical developments.

[1] Deutsche Bank

[2] Bloomberg

[3] Miran Says Interest Rates Should Fall to 2.5 Percent - The New York Times

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Sanjay is a founding Partner of LGT and is Chief Investment Officer. With over 30 years' of investment experience, he is responsible for the implementation of the firm's investment process through oversight of the investment research and asset allocation positioning decisions. Sanjay chairs the Investment Committee and is a leading spokesperson for LGT Wealth Management.