The Tatton Weekly

Bonds' gain is equities' loss

16 October 2026

This week's topics:

Bonds cracking the AI trade

Budget suffers from the government's own gilts

The global diesel pressure point

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New season of Traitors released, Steve Sack, 14 October 2026

Bonds cracking the AI trade

In recent months, we have written extensively about the impact of rising bond yields on the economy and capital markets. This week, something remarkable happened: yields went into reverse, as demand for bonds jumped – while stock markets had a tough time. Before now, the problem for bonds was always that investors were so positive about potential equity returns that they were reluctant to adjust portfolio allocations from stocks into bonds. So, have fixed income yields finally reached a level to tempt investors across from equity markets? Or, has equity optimism itself waned?

Investors finally tempted by bond yields

Start with the good news: government bond yields fell sharply everywhere, taking the pressure off beleaguered bond holders and government finances. Counterintuitively, the fall was prompted by a surprisingly strong 3.7% US consumer price inflation report. Worryingly for the Federal Reserve, there were clear signs that high energy prices are bleeding into non-energy components. Yields initially rose on the data – as one would expect – but quickly reversed once investors concluded that the Fed would probably react hawkishly, raising interest rates this month rather than the previously expected December hike. That dampened economic growth prospects.

Indeed, it was long-term real (inflation-adjusted) yields that dropped – suggesting that long-term inflation would probably be unchanged, only with lower growth (reflected in real yields). With disappointing retail sales data and falling consumer confidence, energy inflation is clearly hindering growth in the world's largest economy.

While government bond yields fell, yields on some important tech companies' bonds actually rose. This coincided with a drop in global equities – particularly big tech stocks. Small and mid-cap stocks did well by comparison and, regionally, the UK was one of the few markets to finish strong.

UK equities were buoyed by surprisingly strong GDP growth numbers for August. Economists expected previously strong growth to turn slightly negative but, yet again, the UK grew another +0.1%. This is becoming a theme: media commentators and some economists paint a dismal picture of Britain, only for the data to show things are not so bad.

Still, the dominance of tech stocks in global indices meant that equities overall suffered. Was the stocks-for-bonds shift about yields? We suspect it was more about (perceived) dimming prospects for stocks themselves.

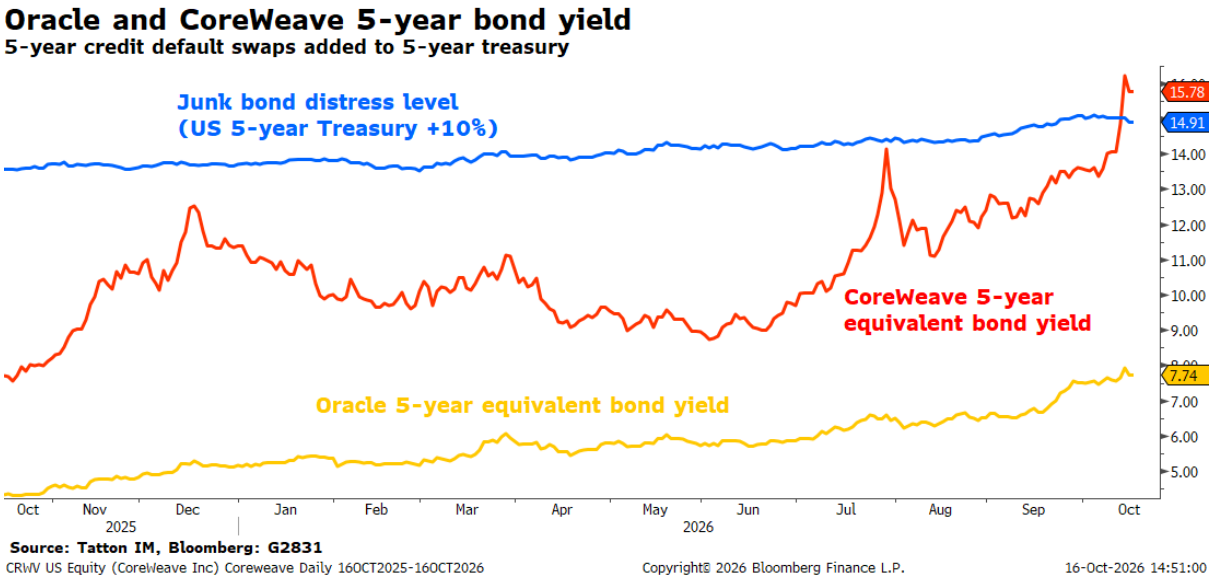
A crack in the AI perma-growth story

Aside from the growth numbers, the main reason UK stocks outperformed is Britain's relative dearth of big tech companies. International investors are said to see the FTSE 100 as a hedge against the AI investment theme – although the World Economic Forum's outlook, published this week, said that much of the UK's surprisingly strong growth and productivity looks AI-related. UK equity holders will not mind that dissonance as long as foreign investors keep buying, of course.

The UK's outperformance is also evidence that this week's shift was about waning optimism in AI's seemingly never-ending profit growth, rather than high real yields. There were high-profile stories about slower demand for AI-related computing power – coinciding with (or possibly causing) a sharp increase in borrowing costs for datacentre providers like Oracle and CoreWeave.

CoreWeave's corporate bonds even reached 'distressed' territory (defined as a 10 percentage point yield risk premium above US treasury bonds), when its 5-year bond yield breached 15% (graph below).

It is unclear how accurate the rumours about slowing 'compute' demand really are. As we wrote last week, the metrics by which we should assess AI-related firms' success are opaque, even to



seasoned investors. That is a problem: so much of the market's tech optimism rests on poorly understood indicators.

In the long-term, it might well turn out that the 'slowing compute' story was unfounded, and that spending on AI is just as strong as earlier in the year. But what matters for the short-term is the effect that the narrative has on already nervous investors. We are coming to the end of yet another strong year – and some investors are looking for excuses to crystallise their profits.

You could argue that optimism was already waning, given that AI share prices have lagged earnings growth all year (meaning earnings-per-share valuations have fallen). But this still feels like a significant new dent in markets' AI optimism – perhaps the first real crack in the perma-growth story.

Currency volatility hurts but – maybe – earnings will soothe

The fall in US real yields and share prices coincided with a sharp drop in the value of the dollar – especially against sterling. Given bond movements (yields dropping on Fed hike predictions), the dollar's fall might seem a little odd. It goes against the standard explanation of currency moves, which says that money flows to wherever short-term savings rates are rising.

The standard explanation is not always right, at least regarding marginal interest rate changes in large economies. Instead of interest rate policy, currencies are more often moved by the flow of capital into financial assets – and that flow is usually dictated by wherever long-term investment returns look brightest. The drop in real yields, theoretically, means a decline in growth expectations, which is why the dollar dropped practically in lockstep.

Currency volatility is a specific issue for international investors. For UK-based investors, for example, a weaker dollar makes the sell-off in US stocks worse. If currency volatility continues, investors might feel more nervous and start preferring their own domestic markets. If that happens, the biggest risk for US markets is that foreign (especially Japanese) investors, who hold significant capital in US assets, repatriate their money. This is not happening yet, but the longer currency volatility goes on, the bigger the risk.

The antidote to those nerves, as ever, is corporate earnings growth. We have only just begun the third quarter reporting season, but the early results are strong – particularly from chip production equipment maker ASML. Economic growth was strong last quarter, so analysts expect Q3 earnings growth to beat the already heady Q2 numbers. The only slight concern here is that AI firms' reports might disclose (if only in footnotes) more liabilities (debt) than investors previously realised – because of new long-term lease obligations. That could make investors even more squeamish. But ultimately, strong results should dispel some AI fears. It just depends how investors react to them.

Budget suffers from the government's own gilts

Chancellor John Healey faces a difficult autumn budget at the end of this month. UK government debt is higher than it has ever been during peacetime, and the Institute for Fiscal Studies (IFS) think that, if the chancellor fulfils his previous commitments to defence, it would create a £35bn fiscal hole. That is partly why the influential think-tank predicts that those commitments will not be met in full, noting that "the OBR's forecast is likely to show that the Chancellor is still on track to meet his fiscal rules before any changes in policy."

Even so, "public finances will remain in poor health," according to the IFS. Interestingly, its report this week highlighted a policy that hinders the government's finances and, by extension, hurts UK bonds: the government's accounting rules on quantitative tightening (QT).

QT's double whammy on gilts

Quantitative easing (QE) was the Bank of England's (BoE) program of buying UK government bonds (gilts) after the 2008 financial crisis, and again during the pandemic. QE pushed up bond prices and, inversely, compressed gilt yields – so its reversal, QT, increases yields. Most major central banks have slowed or stopped their QT operations in the last few years, but the BoE has kept selling bonds. That is one of the reasons why gilts have underperformed other nations' bonds in recent years, resulting in higher debt costs for the treasury and a more challenging fiscal position.

QT impacts the budget because it (probably) pushes yields higher – but that is not the only impact. The IFS, in its 'Green Budget' (named after a policy proposal 'Green Paper', not the environment), pointed out that QT also incurs extra costs on the government due to the way in which bonds' asset values are recorded on the BoE's balance sheet – or rather, off its balance sheet.

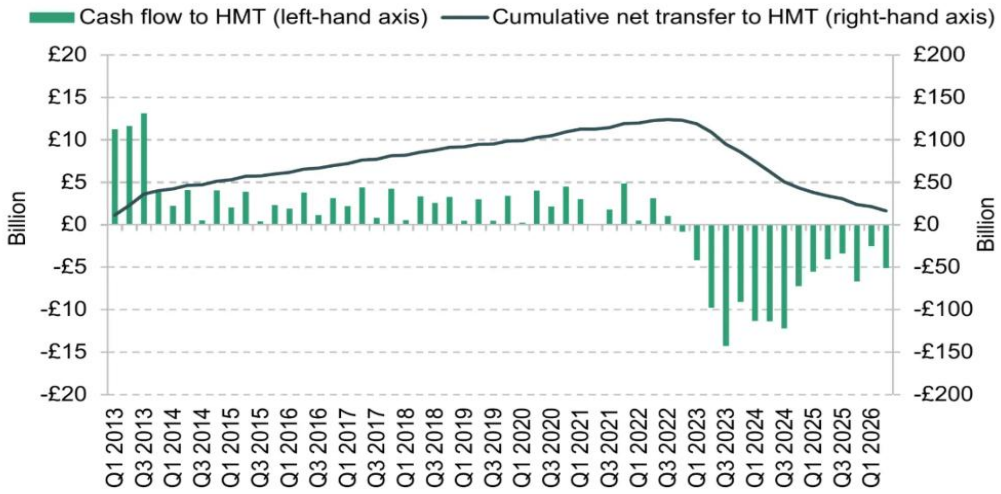
The BoE holds its gilts on a legally separate Asset Purchase Facility (APF), which is indemnified against value fluctuations by the government. Any gains the APF makes on its gilt holdings are paid out to the treasury, but on the flipside, any losses have to be covered by the treasury as well. Many countries have similar legal arrangements in accounting terms (e.g. gains or losses for French bonds are recorded on the French government's balance sheet, to Jean-Luc Mélenchon's chagrin) but the UK is unique in that these gains and losses are actually paid out and impact day-to-day government spend.

This arrangement is a policy decision. It worked very well during the QE era: the BoE's bond purchases not only helped government finances by compressing yields but also led to higher revenues from the APF. As the IFS's chart on the next page shows, that double whammy now works in reverse. Since late 2022, the treasury has paid around £30bn a year (!) to the APF, due to losses incurred on its own bonds.

The government's gilt-y conscience is a kind of fiscal rule

Payments to the APF are a strain on UK finances, one that most other countries avoid. We should not overstate the impact on gilts; it is just one of the many reasons that gilts often underperform.

Quarterly cash flows from APF to HM Treasury and cumulative value of total transfers from APF to HM Treasury



Source: Barclays Research, Institute for Fiscal Studies

Contrary to widespread commentary, gilt yields are not high because Britain is uniquely bad at budgeting. As we have argued before, the main problem is that the gilt market is imbalanced – with too many long-term and inflation-linked bonds. This is compounded by the BoE's continued QT. But at least those problems do not hurt the budget in actual cashflow terms.

Indeed, you would think that the biggest benefit of having your outstanding debt skewed towards the long-term is that short-term changes to borrowing costs should have relatively little day-to-day impact. The fact that the government has to pay for value fluctuations on its own bond reverses that long-term outlook into the here and now. Given that the whole setup is a policy decision – enshrined when QE began in 2009 – why does the government not just change this policy?

Well, you could argue that the government paying the APF is a kind of deterrence against fiscal profligacy – just like the 'fiscal rules' that successive governments have imposed on themselves to reassure bond markets. The treasury is deliberately making it harder for themselves so that the intangible effects of bond yields have a direct impact on its day-to-day operations.

The US treasury, for example, does not have this setup for its bonds, so changes in its bond yields have a less direct impact on its ability to spend. You could see this as a boon for US government finances, but you could also see it as a detriment to fiscal prudence over the long-term. Perhaps the US's fiscal position would not be as stretched as it is (far more stretched, in primary budget terms, than the UK) if it had such a rule.

Indeed, over the last month, US and French bond yields have risen faster than gilts, on the back of fiscal fears. That is no great comfort to Downing Street – gilt yields are still rising in absolute terms – but it at least shows that bond traders recognise the benefits of fiscal rules.

Markets probably wouldn't mind breaking this one rule

That being said, we ultimately think that the fiscal deterrence argument we laid out above is fairly weak. The fact that the government has extra skin in the game when gilts sell off might give gilt investors some extra confidence in long-term fiscal discipline, but in the short-term it just makes the fiscal position look worse than it otherwise would be. That, combined with the gilt markets' structural imbalances, makes gilts highly reactive – volatile, in other words – to events like the current energy crisis.

Essentially, the long-term discipline argument fails to account for emotional, self-fulfilling panic that often grips gilt traders. As such, if the government changed or altered the cash transfer policy, this might actually help gilts. Many would argue that this short-term fiddling can come at the expense of long-term stability but, given how volatile gilts have been in recent years, we could just as easily respond: what stability?

There is no sign that Chancellor Healey will change this particular policy in his 28 October budget. But given that the government wants to fund extra spending – and seems reluctant to either cut other areas, raise taxes or borrow – technical adjustments, like aligning gilt accounting practices to global standards, might be all that is left. Commentators typically scoff at such fiddling, but it can be more important than you think.

The global diesel pressure point

Nowhere is the 2026 global energy shortage more apparent than in diesel prices. Wholesale diesel has more than doubled in price since the US and Israel started their war on Iran, and pump prices are at record highs across the world. Global supply shortages have put diesel at the centre of a geopolitical storm – starting with potential US export bans and now culminating in the Trump administration's relaxation of Russian sanctions. Why are politicians, and markets, so focussed on just this one type of fuel?

Wars exacerbate the diesel premium

Diesel did not use to be more expensive than other petroleum distillates. In fact, before 2004, average diesel prices were often cheaper than regular gasoline. The situation changed 20 years ago. Regulatory requirements, designed to make diesel less bad for the environment, increased the cost of producing high-quality diesel and made refineries less profitable. Meanwhile, the relatively higher fuel efficiency of diesel engines, in conjunction with rapid expansion of global supply chains significantly increasing transport volumes over the last two decades, led to a steady increase in global diesel demand – particularly in the US, Europe and China.

Because of its importance to long-haul transportation and heavy industry, diesel also became much more of a globally traded commodity than other refined oil products. In combination, these factors created a persistent premium and a truly global market for the price of diesel.

That premium widened dramatically after Russia invaded Ukraine in 2022, as Russian refineries were hit by sanctions. Diesel markets eventually settled, but have been destabilised again this year by the Strait of Hormuz crisis, as further supply was cut off from global markets. Last week, JP Morgan researchers reported an "exceptionally large transatlantic arbitrage", pulling US diesel supplies into the undersupplied European market.

That is why the International Energy Agency (IEA) predicted this week that diesel prices will rise further from their record highs. The refined fuel has become the major pressure point in global energy markets – demand coming from everywhere, but supply from only a few key areas. Its importance to all kinds of economic activity means that demand is also sticky; people cannot easily substitute it for other types of fuel. That amplifies the inflationary impact on producer prices in particular.

Diesel is a (geo)political issue

Diesel's economic importance has made the current shortage a geopolitical issue. Last month, President Trump threatened to ban US diesel exports to help with domestic shortages. The threat was probably designed to make the European Union release its own diesel supplies. If so, it worked: G7 nations agreed to draw 100mn barrels of crude oil and diesel at the start of October.

The White House did not stop there in its bid to get diesel flowing. Last Friday, Trump announced that Russia had agreed to release 300,000 tonnes of diesel "to the American and global marketplace". This will lift US sanctions on Russian exports in exchange for Moscow promising to pump more diesel out to the world – though the 300,000 tonnes quoted amounts to less than a single day's consumption in the US. Paradoxically, this happened only a few weeks after Trump had signed energy sanctions against Russia that threatened other nations with secondary sanctions should they not adopt the same.

Trump has tried to project strength throughout – emphasising that the US is the world's largest diesel exporter and could largely live off its own production. But enacting an export ban would be politically challenging. Major oil companies – many of whom are Trump backers – are strongly against the idea, and argue that it would undermine the incentive to expand refining capacities, ultimately worsening energy security in the long-term.

Just a few weeks out from the midterm congressional elections, diesel is a delicate problem for the president. For example, energy-producing US states have been some of the worst hit by rising energy prices – because they use so much diesel. Shortages hurt rural, diesel-using Republican voters, but an export ban would equally hurt the profits of diesel producers in those states.

Don't count on reserve releases to fix the market

Trump will understandably see the G7 commitment to release 100mn barrels as a win, and will hope that welcoming Russian exporters back into the fold increases supply and stabilises diesel prices. The IEA's latest projections suggest that the last part of that equation might not be so easy.

JP Morgan's report, for example, suggests that the supply increase from Europe is overstated. The 100mn figure, in their view, includes previously promised reserve releases as well as new supply. European leaders effectively packaged some of the barrels they already agreed to release in a previous IEA agreement as new – though JPM note that the new terms give greater importance to diesel reserves specifically. If that is right, it will help the diesel market somewhat, but probably will not be enough to rectify the global shortage.

Europe still retains significant reserves of diesel and crude oil, and is reluctant to release them. That makes sense: the reserves are designed for acute fuel shortages, not price emergencies. There is a fine line between those two scenarios, of course, but for a continent that neither produces nor refines much of its oil, it makes sense to leave some in the tank.

The upshot is that we expect diesel to remain a pressure point for the global economy until the Strait of Hormuz blockades are lifted. Global growth has been surprisingly resilient in the face of the US-Iran war but the longer it goes on, the more likely these pressure points become apparent. Reserve releases can help in the short-term but, as the IEA and others have warned, nations cannot keep releasing reserves forever.

Tatton
Investment Management

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Global Equity Markets	16-Oct			Technical	Valuations			
Market	Level	% 1 Week	% 1 Week (GBP)	Short Medium	Div YLD %	LTM PE	NTM PE	10Y AVG NTM PE
UK FTSE 100	10883	+3.0	+3.0	→ →	3.1	14.0	13.6	12.6
UK FTSE 250	24544	+1.3	+1.3	↗ ↗	3.4	8.2	14.4	13.0
UK FTSE All-Share	5860	+2.8	+2.8	→ →	3.2	13.3	13.7	12.5
FTSE Small x Inv_Tsts	6998	+3.1	+3.1	↗ ↗	3.9	15.6	10.4	9.8
EU STOXX ex UK	816	+1.6	+1.1	→ →	2.9	17.0	17.2	15.1
France CAC 40	7967	+2.0	+1.5	↘ →	3.3	15.5	15.2	14.1
Germany DAX 40	25688	+2.2	+1.7	→ →	2.5	17.5	17.8	13.4
US S&P 500	7745	-0.6	-1.5	↗ ↗	1.1	23.6	21.6	19.1
US NASDAQ comp	26506	-2.9	-3.7	↗ ↗	0.5	30.8	27.3	26.2
Japan Nikkei 225	65324	-5.4	-6.0	→ ↗	1.4	21.2	24.1	18.8
World Bloomberg	2630	-0.7	-1.6	↗ ↗	1.5	20.4	18.7	16.7
China Bloomberg	1195	-2.4	-3.3	↘ ↘	2.5	13.1	13.6	12.5
Emerging Bloomberg	1719	-4.7	-5.5	→ →	2.2	14.4	11.0	12.4

FTSE100 Top 6		S&P Global Top 6	(GBP terms)	Global Sectors			(GBP terms)
Company	%	Company	%	Sector	%	Sector	%
Autotrader	+12.4	Fair Isaac	+15.1	Tech	-7.0	Staples	+4.4
JD Sports Fashion	+10.2	Rheinmetall	+14.9	Financials	+1.0	Energy	+2.4
Melrose Industries	+9.9	Givaudan	+14.2	Health	+3.0	Materials	-0.6
Kingfisher	+8.7	Rightmove	+12.5	Discretionary	-0.6	Utilities	+1.1
BT	+8.6	Autotrader	+12.4	Industrials	-1.0	Real_Estate	+0.5
Diageo	+8.6	Equifax	+11.3	Communicatic	-1.1		

FTSE 100 Bottom 6		S&P Global Bottom 6	(GBP terms)	Fixed Income		
Company	%	Company (GBP terms)	%	Govt bond	%Yield	1 wk chg
Antofagasta	-10.5	SK Square	-25.7	UK 5yr Gilt	4.93	-0.07
Polar Capital Technology IT	-9.5	Coherent	-25.6	UK 10yr Gilt	5.35	-0.09
Computacenter	-7.5	Hewlett Packard Enterprise	-24.9	UK 15yr Gilt	5.63	-0.10
Scottish Mortgage IT	-4.8	Lumentum	-24.8	US 10yr Treasury	5.08	-0.18
Rio Tinto	-4.7	SK hynix	-24.7	France 10yr OAT	4.77	-0.08
Balfour Beatty	-4.5	Ciena	-24.4	Germany 10yr Bund	3.40	-0.08
				Japan 10yr JGB	2.93	-0.08

Currencies			Commodities			UK Mortgage Rate Estimates		
Pair	last	%1W	Cmdty	last	%1W	Rates (LTV c.75%, no fee)	16-Oct	16-Sep
USD per GBP	1.336	+1.0	Oil Brent $:bl	105.38	+1.5	UK BoE base rate	3.75	3.75
GBP per EUR	0.843	-0.4	Gold $:oz	4189	+0.0	2yr fixed	5.26	4.92
USD per EUR	1.126	+0.6	Silver $:oz	57.64	-5.4	3yr fixed	5.23	4.77
JPY per USD	157.79	-0.4	Copper $:lb	661.3	-1.3	5yr fixed	5.17	4.78
CNY per USD	6.686	-0.1	Alumnm $:mt	2987	-2.2	10yr fixed	5.45	5.25
USD per Bitcoin	81,843	-1.1	Agriculture BBG	60.92	-2.3	Standard variable	6.58	6.58

Where possible, prices taken levels at 16 October 3:00 PM and 09 October 3:00 PM. Mortgage rates from moneyfacts.co.uk
LTM PE is the index price as a ratio of last 12 months earnings.
NTM PE is next 12 months earnings, adjusted for historic analyst overoptimism.

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document. The value of your investments can go down as well as up and you may get back less than you originally invested.

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