



The **Tatton** Weekly

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9 October 2026

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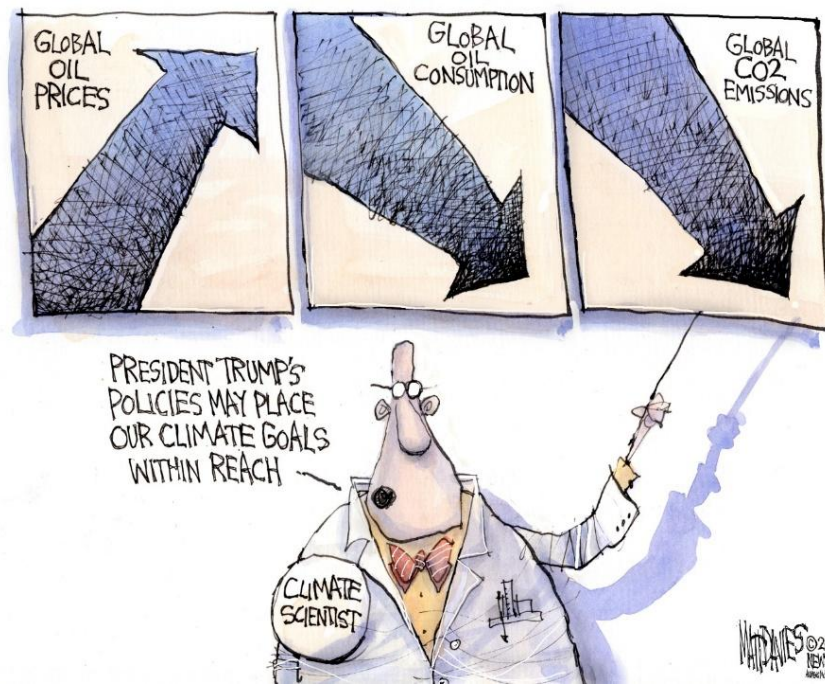
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Unforeseen side effects, Matt Davies, 2 October 2026

Bond yields put the AI trade on notice

US tech stocks continue to dominate market moves – but even they did not have an especially strong week. Markets are a little nervous that big tech's extraordinary earnings growth might have peaked. Those nerves led to volatility on Thursday and Friday, following an apparent misunderstanding of OpenAI's revenue figures (more on that below), but tech stocks mostly recovered. The recovery shows how optimistic investors are about the AI theme, but the whole episode shows that this optimism partly relies on some poorly understood figures about AI growth.

The nervous mood is partly because equity investors are looking over their shoulders at bond markets. Long-term government yields keep creeping higher – or jumping, in France's case. How high can they go before investors are lured out of their equity holdings?

Getting over the hurdle?

Higher 'risk-free' government bond yields should, theoretically, make stocks less attractive by comparison. Over the last few months, however, global stocks have been virtually flat – despite yields soaring. Equity holders are not selling their stocks to buy bonds, making each asset class's base of investors look entrenched. We have argued before that yields will probably have to cross a high hurdle rate before that changes.

There are whispers that yields might now be close to, or even above, that hurdle rate. Long-term inflation-linked UK bonds, for example, now offer a quite attractive return above inflation (around 2.6% for 20-year maturity inflation-linked bonds) and, unlike equities, those returns are

government-guaranteed. We have heard anecdotal evidence that short-term credit instruments are struggling to attract capital, as 10-year US inflation-linked yields of 3.2% plus inflation look too good to pass up.

To be clear, this is not hitting share prices yet – and it might never, given that AI growth is expected to drive tech stock gains much higher than 3% above inflation over the long term. The AI investment thesis is supposed to be separate from the usual economic cycle of growth, yields and interest rates. But even if AI optimism does not depend on it, the cycle can certainly complicate the story.

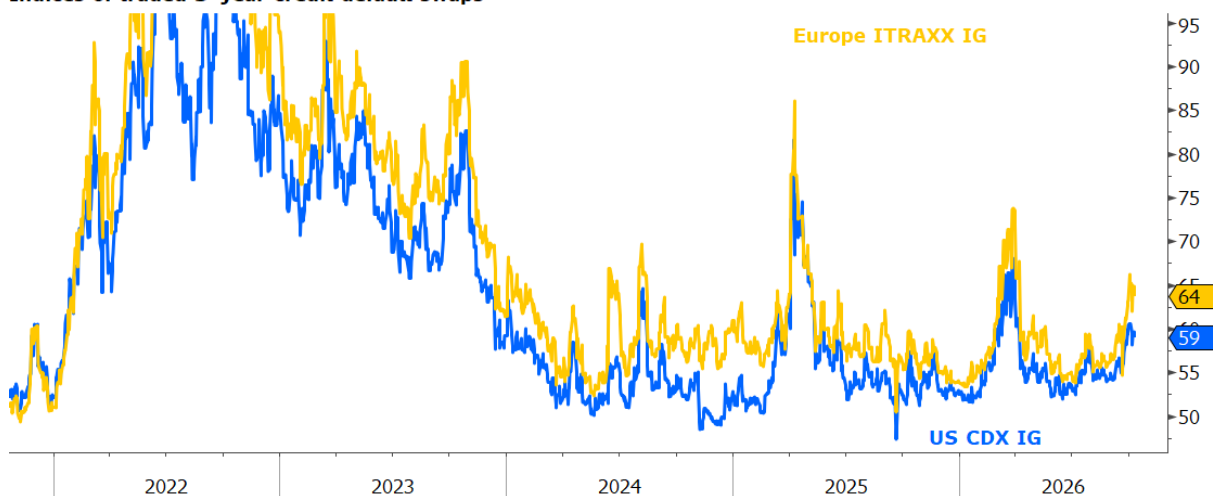
Yields hurt stocks through credit stress

On Thursday, the Financial Times reported that ChatGPT maker OpenAI’s annualised revenue is running at \$50bn, below “expectations” of \$70bn. Investors took that as a sign of slowing demand for computing power, so chip manufacturer stocks sold off. The story’s source then quickly said that the FT had essentially misunderstood the technicalities of OpenAI’s metrics, leading to a revenue miscalculation. Tech stocks then regained almost all of their losses. Still, the fact that so much of markets’ AI optimism depends on industry-specific metrics of ‘compute’ revenue growth is slightly disconcerting.

Higher bond yields heighten these tensions. Not only do they make equity price-to-earnings valuations less attractive, but they also dampen future growth prospects and raise debt costs. We can see this now in sharply higher credit spreads – the premium corporate borrowers have to pay above the government. There were similar, though larger, spikes after Donald Trump’s “Liberation Day” tariffs in 2025, and after the US-Iran war started (see chart below). But those were sudden geopolitical shocks, whereas this has been a gradual rise in government bond yields that has hit spreads all at once.

Investment Grade Credit Spreads

Indices of traded 5-year credit default swaps



Source: Tatton IM, Bloomberg, CDX, ITRAXX; G2536

ITRXAGE Curncy (MARKIT ITRX ASIAXJ IG 12/31) CDS CDX ITRAXX IG + HY Daily 09OCT2021-09OCT2026

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Credit spreads were also hurt by SpaceX's announcement of another \$40bn in corporate bond issuance. Investors have started to dislike that big tech firms keep borrowing, even as borrowing costs rise. Those concerns raise the risk premium (the amount investors demand for a given level of risk) on additional lending, which can feed other worries in a vicious cycle.

We should point out that the underlying signals of credit look okay. Default rates have risen somewhat but there is no sign of widespread stress. Markets recovered well the last two times credit spreads spiked, so we do not want to overstate the problem.

Bloomberg US bankruptcy rate index



As the inherently pessimistic media point out, however, it could worsen. High credit spreads put pressure on price-to-earnings valuations as the cost of finance rises and business activity slows. We write in a separate article about how AI's strength might be coming at the expense of everyone else. If AI stocks themselves come under pressure (they still pay much lower-than-average credit spread premiums), that could make investors extremely nervous. The bearish risk is that this creates a reverse wealth effect: consumers (especially Americans) are so heavily invested in stocks that share price falls might slow consumer spending.

Hope for good news to fix fragile sentiment

Whether or not such deterioration happens largely depends also on market liquidity conditions. Liquidity dried up somewhat over the summer, as central banks have signalled higher interest rates. Higher credit spreads are another sign of tight liquidity, as is Bitcoin's recent drop. Liquidity both influences and is influenced by investor sentiment – so we should hope nothing else spooks investors.

Enter, geopolitics. Aside from the usual flashpoints (US-Iran, Russia-Ukraine and potentially China-Taiwan), there are potentially impactful elections coming in Spain, France, Israel and Brazil – not to mention the US midterm elections. There were some suggestions this week that Trump's

Republican party might resort to election denialism if it suffers defeat next month. As we wrote last week, any attempt to overturn US election results would not be good for US bonds, or the dollar.

Thankfully, the upcoming third-quarter corporate earnings season should counter those worries and fuel share prices – given surprisingly strong economic growth in recent months. The vast sums tech firms have raised, but not yet spent, should support liquidity too. There are some signs that businesses' demand for AI tokens might be plateauing, but we doubt this will affect Q3 earnings reports. That demand might increase anyway, as new AI assistants like Meta's Muse use up computing capacity and add to revenues.

In any case, you could argue that markets are already pricing in slower growth: earnings growth has been faster than share price gains this year, so valuations have fallen. And if growth weakens, that suggests yields should fall back to less worrying levels. In recent weeks, this tug-of-war between growth and yields has put stock markets on notice, to either keep delivering earnings growth or stop rising. Investors will watch the coming earnings season even more closely, to see if growth slows any more than is already priced in.

AI crowds out investment

The AI trade is dominating markets. Global stocks are roughly flat in aggregate from a month ago, and bonds have taken a big hit – but AI stocks continue to power ahead. The growth of the AI sector is, in large part, being sustained by tech companies' significant demand for capital. That demand is also pushing up borrowing costs for everyone else. With bonds and non-tech companies struggling, investors are starting to wonder if AI is crowding out the rest of the economy.

When the government does it, it's crowding out, but when AI does it...

The 'crowding out effect' is primarily a theory about how government spending affects the private sector. Governments naturally increase their share of GDP when they increase their spending – since GDP is just public plus private spending – but the hope is that public investment in the short term increases private sector growth in the long term. The crowding out effect is a counter to that logic: it says that government spending raises interest rates in the short term, making it more difficult for businesses to borrow and invest in their own long-term growth.

Economists debate how common or strong this effect is. You could argue that there was a form of crowding out after the 2008 global financial crisis (GFC), when governments massively increased their debts, while overall debt levels stayed virtually level. The fact governments took on a larger share of global debt suggests they were competing for capital that might have otherwise gone to the private sector – resulting in the era of low growth.

However, the odd thing about the post-GFC period is that it was characterised by *low* borrowing costs (due to sluggish growth and necessarily loose monetary policy), not prohibitively high ones. This counters the crowding out story somewhat: if governments had not stepped in to fill the void of private sector investment, there may have been a lasting recession, rather than just sluggish growth.

Some commentators now suggest that a crowding out effect is being caused by private tech giants, rather than governments. AI-related companies have issued very substantial amounts of new bonds and equity in the last two years. Investors have been happy to give AI firms that money but, without the easy central bank money we had post-GFC, that inevitably means less investment capital for everyone else.

We have argued before that AI's ravenous appetite for capital has sapped demand from even government bond markets, resulting in the highest yields we have seen in decades. The AI engine has also powered aggregate growth – forcing central banks to raise rates to keep the growth from causing inflation. AI firms may seem impervious to higher rates, but consumers and non-tech companies are not.

Does resilient growth disprove crowding out?

Others dispute the AI crowding out narrative. Goldman Sachs' researchers acknowledge that higher rates are hurting large parts of the US economy, for example, but they estimate only a small effect on overall borrowing rates from AI demand. They argue that AI spending is crowding out some construction and non-AI tech services, but they think these effects are exaggerated.

Absolute Strategy Research (ASR) is even more dismissive of crowding out: they say there is no clear sign that yields are being driven higher by increased tech bond supply. If it was, you might expect higher yields to be more heavily concentrated on areas with higher issuance. But the yield rise has been virtually uniform across regions and sectors.

Instead of AI capital demand, ASR put the rise in yields down to the strength of the global economy, in the face of high energy prices. You would expect an oil price shock to destroy demand and dampen growth, but demand has actually kept up the pace this year. That is why market-based inflation expectations have increased recently, forcing central banks to turn hawkish.

Thanks to that resilience, aggregate growth – and aggregate stock prices – keep ticking up.

It depends who's being crowded out

We think that ASR's argument that yields are high because of growth, not AI borrowing, slightly misses the point. Yes, resilient growth is pushing up yields, but growth has been strong largely *because* of the AI investment boom – as ASR themselves recognise. Recent economic indicators have been much weaker outside of the US, for example, where AI investment is lower.

Even in the US itself, the non-AI companies are struggling. McDonald's has seen its share price drop more than 30% from a peak in February, partly thanks to weak demand from consumers, who are feeling the pinch from higher energy prices and housing costs. The fast-food giant is also having to pay for equipment upgrades just as financing costs are surging. McDonald's consumers are struggling, but the firm still has to pay steep rates because unrelated AI companies are doing so well.

This inequality between tech and the rest has been going on for a while. Last year, everyone called it the 'K-shaped economy'; this year, it's called crowding out. Without AI powering aggregate growth, yields and interest rates would almost certainly be lower, and the rate-sensitive parts of the world economy would have an easier ride.

That is the awkward thing about crowding out: it is only a problem if you are the one being crowded out. AI companies – and the investors making money from them – are doing fine, but that is little comfort for McDonald's.

For investors, the risk is that disparity comes back to hurt the winners too. Big tech's borrowing costs rose sharply last week, suggesting that AI firms might not be as insensitive to tightening capital supply as everyone thought. With borrowing costs rising and AI firms having already borrowed vast sums, we can reasonably expect to see new bond issuance slow in the coming months. That is a natural process and not something to be scared of, but the fact markets are so concentrated on a handful of AI companies makes any potential slowdown much more daunting. Tech firms should be careful who they crowd out.

High French bond yields force fiscal discipline

Protests across France have brought the nation's social spending problems into focus. Students and teachers are demanding a better education system, but bond investors worry about where the money will come from. Fiscal instability is one of the key reasons that French bonds (OATs) have fared worse than others in recent months. That risk now seems to be hurting the euro too.

At the same time, however, there is growing political appetite for fiscal discipline. We think this says less about French politicians' preferences, and more about the harsh conditions that high bond yields impose. Those conditions affect all of Europe.

Protests and fiscal risks

The demonstrations started with anger at underfunded French schools, but have spiralled into broader anger at the perceived lack of funding from the French state. The protests came after the government published its plan of both spending cuts and tax rises, to reduce France's unsustainable budget deficit.

As we wrote recently, France's underlying fiscal position is perilous. Its debt-to-GDP is nearly at 120%, and the gap between spending and revenue is currently 5.4% of GDP. The shortfall has to be made up with extra borrowing, and the cost of that borrowing is going up. Government bond yields have soared everywhere since the US launched its war against Iran, but OAT yields have climbed faster than most others. The gap between French government bond yields and equivalent maturity central bank swaps – a form of lending rate which we use to measure fiscal risk – is wider for OATs than for any other G7 nation.

The problem is not as simple as politicians being fiscally irresponsible; it is that bond investors want fundamentally different things to the French electorate. The public is clearly unhappy with the current mix of tax and spending, but bond vigilantes think it is already too generous. As the Financial Times put it, France is “between the bond markets and the barricades”, heading into next April's presidential election.

Previous attempts to balance the books have either been defeated or severely watered down. Pension commitments are the single biggest area of spending, but President Macron has struggled to reduce them in his nearly 10 years in office. Marine Le Pen and Jean-Luc Mélenchon, the two frontrunners for the presidency, have both opposed Macron's pension reforms.

Le Pen pushes for cuts

We argued last month that it was difficult to see any French leader pushing for fiscal discipline – but, this week, Le Pen came out in favour of exactly that. The polls' leading candidate published her own budget proposal to bring the deficit down to 3% by 2030, promising €140bn in savings. She also wants a referendum on a “golden rule” that caps France's debt at 60% of GDP, similar to the constitutional debt brake Germany had until last year.

It is hard to see how Le Pen might achieve those savings. She has been reluctant to touch pensions, but there is not much else to substantially cut. She wants to drastically reduce France's payments towards the EU, but many of those payments come back to France itself. It is the single biggest recipient of subsidies from the EU's Common Agricultural Policy (CAP), for example. If CAP payments fell, French farmers – a crucial electoral group – would feel the pain.

The realism of those promises is not the point, however. For bond investors, the more important thing is that Le Pen is making them. It suggests that she is moving away from the particular brand of right-wing populism that has been popular across the West for the last decade, combining social conservatism with high fiscal expenditures. Even if it proves unpopular with voters, Le Pen is pitching to the bond markets.

High yields themselves force discipline

The tightening belt narrative might not be so unpopular anyway. Three quarters of French voters are worried about national debt, according to recent polls. Wanting a balanced budget is not the same thing as accepting the cuts or tax rises needed to balance it, of course, but the rhetoric still

has an impact on policy. For example, of the presidential candidates, only Mélenchon has avoided promising to reduce the deficit and, after the backlash to his debt cancellation plans, we would not be surprised if he too errs towards fiscal discipline.

That discipline does not necessarily mean spending cuts; it could also mean tax rises. What matters for bond investors is the balance of bond supply and demand – the gap between spending and revenue. Whether that gap is closed by raising revenues or cutting spending is a matter of political priorities.

Across countries and political parties – from Britain's Reform party to Spain's Pedro Sánchez – the needle is moving towards fiscal discipline. This is not because politicians have suddenly had a change of heart, but because debt costs have risen so high. Rising yields mean higher repayments which, as we have seen in the UK, limits the effectiveness of extra borrowing. When governments signal looser fiscal policy, the primary impact now is immediately higher yields – meaning most of the money just pays for the higher debt costs anyway.

Bond investors have struggled to be positive about anything lately. The effectiveness of the bond vigilantes themselves should at least stop them worrying as much about fiscal risk.

Global Equity Markets			09-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	10563	+0.8	+0.8	→ →	3.2	13.7	13.3	12.6	
UK FTSE 250	24247	-0.1	-0.1	→ ↗	3.4	8.2	14.1	13.0	
UK FTSE All-Share	5700	+0.7	+0.7	→ →	3.3	13.1	13.3	12.5	
FTSE Small x Inv_Tsts	6790	+0.4	+0.4	→ ↗	4.0	15.1	10.2	9.8	
EU STOXX ex UK	803	-0.3	-0.7	→ →	3.0	16.8	17.0	15.1	
France CAC 40	7816	-1.1	-1.5	↘ →	3.3	15.2	14.9	14.1	
Germany DAX 40	25124	-0.5	-0.9	→ ↗	2.6	17.2	17.1	13.4	
US S&P 500	7785	+0.5	+0.7	↗ ↗	1.1	23.7	21.7	19.1	
US NASDAQ comp	27288	-0.1	+0.0	↗ ↗	0.5	31.9	28.1	26.2	
Japan Nikkei 225	69031	+1.1	+0.9	↗ ↗	1.4	22.4	25.5	18.8	
World Bloomberg	2650	+0.3	+0.4	→ ↗	1.5	20.5	18.9	16.7	
China Bloomberg	1224	+0.2	+0.3	↘ →	2.4	13.4	13.9	12.5	
Emerging Bloomberg	1803	-0.2	-0.1	↗ ↗	2.1	15.1	11.6	12.4	
FTSE100 Top 6		S&P Global Top 6		(GBP terms)	Global Sectors		(GBP terms)		
Company	%	Company		%	Sector	%	Sector	%	
Sage	+8.9	Localiza Rent a Car		+36.2	Tech	-0.6	Staples	+3.2	
Imperial Brands	+8.7	PTC		+34.9	Financials	+0.3	Energy	+3.9	
Experian	+8.3	B3 - Brasil Bolsa Balcao		+28.9	Health	+2.1	Materials	+0.8	
Tesco	+7.3	Cia de Saneamento Basico do Est		+24.8	Discretionary	+2.4	Utilities	+2.4	
RELX	+7.2	Rede D'Or Sao Luiz		+20.2	Industrials	-1.3	Real_Estate	+1.0	
London Stock Exchange	+7.1	Nan Ya Plastics		+18.7	Communicati	+1.2			
FTSE 100 Bottom 6		S&P Global Bottom 6		(GBP terms)	Fixed Income				
Company	%	Company (GBP terms)		%	Govt bond		%Yield	1 wk chg	
Barratt Redrow	-8.6	Hanwha Aerospace		-16.7	UK 5yr Gilt		4.99	+0.08	
Rolls-Royce	-7.2	Schneider Electric		-13.0	UK 10yr Gilt		5.44	+0.07	
Lion Finance	-6.7	BE Semiconductor Industries		-12.7	UK 15yr Gilt		5.74	+0.07	
Balfour Beatty	-6.3	Argenx		-11.3	US 10yr Treasury		5.27	+0.01	
Melrose Industries	-6.0	Intel		-11.1	France 10yr OAT		4.86	-0.01	
Vodafone	-5.6	Skyworks Solutions		-10.6	Germany 10yr Bund		3.48	+0.02	
					Japan 10yr JGB		3.02	-0.06	
Currencies			Commodities			UK Mortgage Rate Estimates			
Pair	last	%1W	Cmdty	last	%1W	Rates (LTV c.75%, no fee)		09-Oct	09-Sep
USD per GBP	1.323	-0.1	Oil Brent \$:bl	104.10	+5.5	UK BoE base rate		3.75	3.75
GBP per EUR	0.846	-0.7	Gold \$:oz	4188	-0.0	2yr fixed		5.27	4.92
USD per EUR	1.119	-0.8	Silver \$:oz	60.95	-0.9	3yr fixed		5.29	4.77
JPY per USD	158.35	+0.5	Copper \$:lb	669.6	+1.4	5yr fixed		5.20	4.78
CNY per USD	6.693	-0.1	Alumnm \$:mt	3037	-2.3	10yr fixed		5.45	5.25
USD per Bitcoin	82,790	-4.1	Agriculture BBG	62.36	+1.0	Standard variable		6.58	6.58

Where possible, prices taken levels at 09 October 3:00 PM and 02 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.

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Lothar Mentel

