



WATTERSON
FINANCIAL PLANNING

Market Update

October 2026



Quarterly Market Commentary: Q3 2026

The third quarter of 2026 was dominated by a renewed energy shock. The relief seen at the end of June proved short-lived: fighting between the US and Iran resumed in July, shipping through the Strait of Hormuz was disrupted again, and oil prices climbed through the summer. As a result, the key question for investors shifted from how long interest rates would stay high to whether central banks would need to raise them further.

In the UK, inflation turned higher again. Headline CPI eased to 2.6% in June but then rose to 2.9% in July and 3.1% in August[1]. Motor fuel was the main driver, with petrol and diesel prices rising sharply in August[1]. More encouragingly, services inflation, the measure the Bank of England watches most closely for domestic pressures, held steady at 3.4%, well below the levels seen earlier in the year[1,2].

The Bank of England kept interest rates unchanged at 3.75% in both July and September, but on each occasion three of the nine policymakers voted for an increase to 4%[2]. In September, the Bank said inflation is likely to rise further, reaching slightly above 4% in early 2027, and warned that the longer energy prices remain volatile, the more likely it is that rates will need to rise[2].

Energy prices were again the central market driver. Brent crude averaged \$91 per barrel in August, up from \$84 in July[3], and by mid-September had reached around \$106, while UK wholesale gas prices rose even more sharply[2]. This added directly to inflation pressures and weighed on consumer confidence.

Despite this, UK economic growth has proved more resilient than expected. GDP rose by 0.4% in July, following growth of 0.3% in June, and the economy has now grown for eight consecutive rolling three-month periods[4]. Growth was led by services, while production and construction remained weak[4].

In Europe, inflation also rose, reaching 3.2% in August as energy prices climbed to more than 14% above their level a year earlier, although services and core inflation eased[5]. Growth was firmer than expected, with euro area GDP rising 0.6% in the second quarter[5]. The European Central Bank raised interest rates again in September, taking its deposit rate to 2.50%, and now expects inflation to average 3.0% this year[6].

In the US, the Federal Reserve raised interest rates for the first time since 2023, lifting its target range by 0.25 percentage points to 3.75–4.00% in a unanimous decision[7]. It described economic activity as expanding at a solid pace but inflation as still elevated[7], and its latest projections point to at least one further increase before the end of the year[8].

Towards the end of September, sentiment swung with headlines on US–Iran negotiations. Reports of progress towards reopening the Strait of Hormuz briefly eased oil prices and bond yields, but hopes faded again in the final days of the quarter[3].

Bond Markets

Bond markets had a difficult quarter. Rising energy prices revived inflation concerns and pushed expectations for interest rates higher, leading to a broad sell-off in government bonds. Yields rose across all major markets, in some cases to multi-decade highs[9].

UK gilts were among the most affected. In early September, 10-year gilt yields rose above 5.2%, the highest since the global financial crisis, while 30-year yields reached levels last seen in the late 1990s[9]. Given that bond prices fall when yields rise, this weighed on returns over the quarter. Higher borrowing costs have also reduced the Government's room for manoeuvre ahead of the Budget on 28 October[9]. For new investors, however, gilts now offer some of the highest starting yields in a generation.

Corporate bonds were again more resilient. Credit spreads, the extra yield investors receive over government bonds, stayed close to historically tight levels, at around 0.8 percentage points for US investment grade bonds, while overall yields rose to around 5.9%[10]. Issuance remained very strong, with US corporate bond issuance up almost 30% on the previous year to the end of August, supported by refinancing needs and heavy borrowing to fund AI investment[10].

Emerging market debt came under pressure as the global sell-off spread, with government bond yields rising from South Africa to South Korea and Poland as markets priced in a US rate rise[11]. Dollar-denominated emerging market bonds held up relatively well, but spreads are now near their tightest levels since 2007, leading some managers to reduce risk[11].

Equity Markets

Equity markets were notably resilient given the pressure in bond markets. Strong corporate earnings, particularly from technology companies linked to artificial intelligence, offset much of the drag from higher yields and energy costs[12].

US large-cap equities stayed close to record highs through September, supported by expectations that third-quarter earnings will be more than 20% higher than a year ago[12]. Leadership rotated during the quarter: energy was the best-performing sector over the summer as oil prices rose, before technology and semiconductor stocks took the lead again in September[12].

This supported returns but further increased concentration risk, with technology now making up well over a third of the US market[12].

UK equities held up well. UK large-cap equities traded close to record levels, helped by their large weighting in energy and mining companies, which benefited from higher commodity prices, and by the strength of banks[13]. More domestically focused mid-sized companies were more volatile, reflecting their greater sensitivity to UK borrowing costs.

Europe reached record highs in early August, led by semiconductor-related companies and banks[14], before giving back some ground in September as bond yields rose. Sectors such as autos remained under pressure from higher energy costs and weaker demand[14].

Emerging markets and Asia continued to be driven by the AI theme. Chip-heavy markets such as Taiwan and South Korea led gains, and Taiwan has become one of the largest country exposures within broad emerging market equities[15]. This has increased concentration across emerging markets, while other markets, including China, lagged[15].

Outlook

Looking ahead, three key questions will shape markets in Q4:

- Will energy prices ease, or will disruption in the Strait of Hormuz persist?
- Will higher energy costs feed through into wider prices?
- How much further will central banks need to raise rates?

The Bank of England has said that, so far, higher energy costs have had only a limited effect on UK wages and prices, but that a rate rise becomes more likely the longer the volatility continues[2]. Its next decision is on 5 November, shortly after the Budget[9].

In Europe, the ECB will take a meeting-by-meeting approach, with risks to inflation tilted to the upside and risks to growth to the downside[6].

In the US, the Federal Reserve has signalled a firm commitment to returning inflation to target, and its projections point to at least one further increase this year[7,8].

Energy and geopolitics remain the key swing factor. The US Energy Information Administration expects flows through the Strait of Hormuz to recover only gradually, with some constraints persisting to the end of the year[3]. A lasting agreement could bring oil prices and inflation expectations down quickly; a prolonged disruption would keep pressure on bond markets and household budgets.

What This Means for Portfolios

The investment environment has become more challenging, but it is also creating opportunities.

- Bonds now offer the highest starting yields in many years, which improves their long-term return prospects, but volatility has increased and inflation risk remains.
- Equities continue to be supported by strong earnings, but leadership is narrow and valuations leave limited room for disappointment.
- Diversification across regions, sectors and asset classes remains essential.

A balanced approach, focusing on quality investments, maintaining liquidity, and avoiding over-reliance on any single market or theme, remains the most effective way to navigate current markets.

Sources

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