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MARKETS ARE LOOKING FOR A NEW UPSWING, TORN BETWEEN THE ECONOMY'S RESILIENCE AND RISING INTEREST RATES

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Reflecting seasonality (MSCI World -1.17% on historical average), equity markets mostly fell in September. The majority of MSCI World sectors delivered a negative performance, affected by the further rise in energy prices and the sharp rise in sovereign yields. However, this decline remains rather moderate compared to the movements observed on the bond markets. Equity markets remain supported by high corporate profitability, particularly in the technology sector, and by a global economy that remains resilient.

Rising sovereign yields do not affect all markets in the same way

The exceptionally large and broad-based rise in sovereign yields, fueled by the inflation premium but above all by economic growth momentum and governments' growing financing needs, has impacted all bond markets. This movement has moderated the upward trend in equity markets, particularly the most rate-sensitive sectors.

Indeed, the German 10-year yield rose above 3.56% while France's 10-year yield approached 5%, its highest level since 2002. The yield spread between France and Germany has widened to levels not seen since the financial crisis across the curve, with a peak of 140 basis points on the 10-year maturity. The US 10-year yield rose by more than 0.5% in September, the largest monthly increase in 4 years. It has since hovered around 5.3% while the 2-year yield remains close to its year-to-date highs at 4.80%.

High rates are undoubtedly a headwind for equity markets, although they alone are not enough to predict the end of the cycle. The key determinant remains the ability of companies to maintain solid earnings growth, sufficient to offset the rise in the cost of capital and the decline in valuations. In an environment of high rates, a further rise in equities is not a utopia, especially for the US market where the growth premium is the main determinant of the rise in bond yields.

This rise in rates is occurring in a context of significant financing needs, particularly in the technology sector, which creates new competition to capture global savings, putting pressure on the cost of capital, at a time when governments also need to borrow more. Investment demand related to artificial intelligence (AI) is expected to be at an unprecedented level, reaching 1,000 billion in 2027, compared with 800 billion this year.

Regardless of their credit rating, companies are facing tighter credit conditions after years of broad and direct access to global capital markets. This is reflected in the implied volatility of sovereign bonds and credit spreads on high-yield bonds, both of which have risen sharply since the end of June. Companies with the lowest ratings may display characteristics typical of a late-cycle environment, with rising rates, increasingly selective financing and stress indicators that remain persistently above their averages. However, at this stage, none of these measures has reached the panic thresholds observed in 2008, 2016 and 2020, although there is a deterioration in credit conditions, particularly in the high-yield



segment. The market seems reassured by the fact that the “refinancing wall” (a high volume of debt maturities that requires new mass issuance) is not expected until 2028.

Despite the magnitude of this change in interest rates, equity indices managed to hold their own against the bond market, although the dispersion of returns remains very high and the participation of index members remains very low, particularly in US equities. This slight decline in the market in September hides another reality: nearly 80% of S&P 500 stocks ended in the red. Nearly 60% fell by at least 5% and more than a quarter by more than 10%! This was also illustrated by the decline in the equally-weighted S&P 500 index, which fell by 5% over the month.

The Russell 2000 index of small-cap companies, for example, fell by 5.4% in September while the semiconductor index rebounded by more than 9.5%. This dispersion also affected the Magnificent Seven with Meta rising by 26.7%, while Amazon declined by -4.1%.

Apart from the technology and communication sectors, all the others posted negative performance, especially the sectors most sensitive to the rise in financing costs. This was the case particularly in the real estate sector (-6.7%), utilities (-6.1%), as well as consumer discretionary (-5.9%).

As a result, investors are turning away from most sectors, with the exception of technology. Faced with the inexhaustible demand for computing capacity for AI, rising rates are not a factor. It is therefore not surprising that the high exposure of US markets to the technology sector has allowed them to outperform their European counterparts, who have also suffered from the European Central Bank’s tougher rhetoric in the face of inflation resilience.

Latest economic data underscore the strength of the economy

In the face of rising rates, several interesting indicators have been published recently, offering a welcome respite to the equity markets, as well as some arguments for the US Federal Reserve (Fed) to temper the pace of its rate-hiking cycle. Among these elements is the Personal Consumption Expenditures Price Index for August, which rose by 3.4% compared with the expected 3.7%. Its underlying component, excluding food and energy, rose by 3%, confirming the stabilisation of inflation. This is in line with an environment of solid consumer spending, while US growth has been revised upwards to 2.2% for 2026.

This robustness of consumption with no major effect on inflation suggests that inflation is the result of higher volumes and not higher prices, and that it is benefiting from moderate wage increases, as demonstrated by the ADP employment report. At the same time, the increase in private sector job creation and the number of hours worked testify to the resilience of the US labour market. At this stage, the fear of higher producer prices (PPI) being passed on to consumer prices does not seem to be materialising.

More recently, the weakness of non-farm payrolls has lowered current expectations of a Fed rate hike at its October meeting to below 15% and has led to a slight steepening of the yield curve. This has also allowed equity markets to regain momentum and some indices to reach new valuation records. This dynamic has also been supported by the fall in oil prices and the likely mobilisation of strategic reserves in Europe, where economic indicators, such as PMIs, show an increase in activity, while inflation is rising as a result of higher energy prices. The risk associated with peripheral and especially French yields has also led to expectations of lower ECB policy tightening.

Persistently high interest rates: not necessarily an unfavourable outlook for equity markets

The Fed will most likely need to raise interest rates several times to bring inflation back to its 2% target. Investors will therefore have to deal with an environment of elevated long-term interest rates in the



coming months, while the drift in fiscal policies and the resilience of economic growth continue to fuel upward pressure.

However, in the medium term, high rates are not necessarily unfavourable to equity markets. The absolute level of interest rates is in itself less important than the pace at which they rise and, above all, the fundamental reasons for these movements. When robust growth and strong corporate results trigger higher rates, equity markets can withstand them. Historically, US equities have often continued to rise after the start of a monetary tightening cycle. On the other hand, persistent inflation can be negative, as it puts pressure on wages and corporate margins, which, combined with higher financing costs, can in turn impact equity valuations.

In conclusion, in the face of the continued rise in interest rates, equity markets do not seem to be at the end of the cycle, but in a phase of breathing space that is not very noticeable in the indices, as technology is supporting their performance. Ongoing monetary tightening, combined with economic growth that has so far refused to contract, is forcing investors to adapt their expectations: support will come less from the expansion of multiples than from the careful selection of sectors and companies, in favour of business models capable of creating value in an environment where the cost of capital will be higher.

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