

MARKET INSIGHT

IRRATIONAL EXUBERANCE VERSUS RATIONAL OPTIMISM



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Key takeaways

- Equity markets have forged ahead, but left behind some great businesses
- AI story showing signs of getting overheated in a few areas, and watch out for private credit wobbles
- There are still plenty of opportunities for long-term investors, as the world's leading businesses innovate, grow and prosper

Global equity markets forged ahead in the third quarter, with the shock of April's Liberation Day tariff announcement mostly forgotten and investors in 'risk on' mode. All the major regions finished in positive territory, although there was a notable disparity between the strong performance of the US and Japan and the relatively more muted returns from Europe.

In the US, there wasn't any sign of the traditional early autumn pall in equity markets, with both the S&P 500 and Nasdaq enjoying their best September in 15 years. Several members of the Magnificent Seven were prominent in the quarter, and the gang collectively accounted for just under half of the MSCI World Index return.

It was a good quarter for information technology stocks, with the AI theme again to the fore. One sub-plot of the AI narrative is the discrimination between perceived AI winners and losers, which is resulting in marked performance divergence in the sector. The threat of AI disruption on established tech businesses has been a focus of investors.

Leaders for a reason

The new AI kid-on-the-block-versus-incumbent story often ignores the fact that many companies are leaders precisely because they are innovators, with a track record of adapting to new trends. This is true of companies such as enterprise software company SAP and Adobe, whose products are deeply embedded in complex workflows. Their value lies in understanding their customers' needs, having built up years of data and client feedback, and offering integrated solutions which their own AI technology is enhancing.

As time goes on, investors will increasingly want to see what returns are being achieved relative to the vast sums of money being invested in AI. A recent Massachusetts Institute of Technology paper has sparked some controversy. The report, which covered the first six months of 2025, found that “despite US\$30–40bn in enterprise investment into generative AI, 95% of organizations are getting zero return.” AI is an epochal, evolving technology. Our approach towards evaluating its impact is selective and long term, focusing on high-quality, financially stable companies, that are able to monetise AI or are benefiting from its development.

Credit cockroaches

To paraphrase the former CEO of Citicorp, Charles Prince, there has been a fair amount of ‘dancing’ in certain areas of the credit market. Private credit, i.e. non-bank direct lending, has grown substantially in the US and Europe since the Global Financial Crisis, catering to demand which traditional bank lending can’t or doesn’t want to meet. Without besmirching the entire asset class, it can be a lending model marked by opacity, highly leveraged borrowers and vulnerable businesses with convoluted loan structures. Now-defunct auto parts company First Brands and auto-lender Tricolor being cases in point.

The appeal of private credit to investors is higher yields and low correlation with public equities, but the flip side is higher risk, and a lack of true price discovery in terms of the value of sometimes covenant-lite loans.

The endemic lack of clarity and rising scale of the industry raise a few cautionary signals for financial systems, and represent a potential source of financial sector and equity market volatility. JP Morgan CEO Jamie Dimon’s quip about cockroaches (where you see one, there will be others), is recognition of the existence of further potential credit accidents. In the meantime, a few banks have been remarking on the impact of private credit worries on their funding costs.

It's all fun and games until someone gets hurt

What the growth of private credit highlights is the interconnectivity of the financial industry, with banks involved as funders and facilitators. It has broader implications too. All maybe fine in benign economic conditions, but a downturn might test the robustness of the weaker parts of the private credit model. A significant portion of capital expenditure on AI investment, a notable driver of economic growth, is being financed by private credit. This lending stream could play a part in turbocharging an AI capex blowout, ultimately feeding a bubble with an eventual economic and financial fallout.

A resilient America

Such nascent concerns have so far done little to erode the buoyant picture of the US economy. Second-quarter GDP growth was revised up to an annualised 3.8%, testament to the resilience of the American consumer and growth in business-related investment. Despite a few cautious consumer confidence and manufacturing activity surveys, the Federal Reserve is maintaining a benign view of the outlook. In a recent speech, Chairman Powell stated that “economic activity may be on a somewhat firmer trajectory than expected”. Granted that the US government shutdown will throw up near-term distortions in some data.

In the industrials sector, the tepid backdrop continues to present a few hurdles, but a number of companies have seen an improvement in their business despite the challenges. For instance, industrial supplies and fasteners company Fastenal has enjoyed a period of accelerating organic sales growth due to the success of the company’s efforts to target larger national accounts.

The impact of tariff-induced price increases is evident in Fastenal’s results, and while tariffs have added complexity to its business, the company can use its global sourcing expertise and strong balance sheet to its advantage. Inflation is a distributor’s friend and that should continue to show through as the year progresses, in our view. Quality industrial businesses may not be immune from cyclicalities, but they often operate in highly fragmented, long-term growth markets that are ripe for consolidation by financially strong, leading companies.

Short-term pain, long-term gain in healthcare

White House moves to reduce the cost of healthcare have continued to cast a shadow over the sector globally. However, negotiations between the healthcare industry and the government are ongoing. The US is replete with policy noise, but we have been here before with Obamacare and Hillary Clinton’s campaign trail of 2016. The likely outcome is for small

concessions/wins that the administration can hail as a policy success. However, genuine innovation, which is a strong suit of leading healthcare companies, will continue to be rewarded over the long term.

We are confident that the clouds currently gathered over healthcare will clear, encouraging investors to fully re-engage with one of the most compelling opportunities in global equities. Unmet needs and underdiagnosis in developed countries, growth in developing markets, aging societies, and the personalisation of medical treatment are formidable structural forces that will drive long-term growth and innovation.

Savoir faire

Across the pond, the French equity market largely ignored the country's political merry-go-round, which has seen the country lose its fourth prime minister in two years. Although the bond market signalled its disapproval of the political turbulence by sending French yields higher, equity investors were more sanguine, perhaps reflecting the strong global profiles of many of the country's leading companies. The fortunes of many high-profile French companies are far more dependent on overseas consumers than those in their country of domicile.

There are signs of renewed vigour in the luxury sector, as indicated by LVMH's recent positive sales update which saw improving trends across all business groups and regions outside of Europe. The desire for luxury is innate, although the industry has been churning through post-Covid indigestion. However, to create sustainable long-term demand for such goods requires an organisation imbued with a sense of culture and savoir faire, able to combine adaptability and innovation with craftsmanship and tradition. Investors should continue to appreciate this differentiation.

The slightly less robust performance of Europe in the third quarter can be partly laid at Germany's door, with a weaker market reflecting concerns about economic growth and industrial competitiveness. The once-unassailable automakers are struggling in the face of US tariffs, a troubled electric vehicle transition, and both weak demand and strong competition from China.

Japan's new deal?

While similar travails might vex parts of the Japanese industrial landscape, they did not inhibit a new high in the country's TOPIX index. Some good-ish news came in the confirmation of a trade deal which will see US tariffs on Japan reduced from 25% to a still-elevated 15%. Following the resignation of Shigeru Ishiba, the elevation to the premiership of the country's first female leader, Sanae Takaichi, an admirer of former UK prime minister Margaret Thatcher, offers up a prospect of fiscal stimulus and more reform.

Our view on Japanese opportunities is less founded on hopes of macroeconomic reinvigoration, although governance moves to enhance shareholder return have been a welcome, if slow, development. We have seen Japan as home to many globally competitive businesses, but its economic and demographic challenges also present investment opportunities. An ageing population, a shrinking labour market, and a corporate sector that has chronically underinvested in technology and digitisation, offer long runways of growth in companies related to addressing these issues. For instance, businesses such as enterprise software company OBIC, or management consultant and IT services provider Nomura Research Institute.

Reasons for caution

Federal Reserve chairman Jerome Powell was perhaps channelling former chairman Greenspan's 1996 "irrational exuberance" speech when he commented that US "equity prices are fairly highly valued". According to Bank of America's September fund manager survey, investors are now as bullish on global equities as they have been at any point this year. This is despite a record number believing that the asset class is overvalued. Perhaps this is a tribute to 'FOMO'. There are some reasons for caution. The tail effect of tariffs may have a further impact on economies, while valuations in pockets of the market suggest uninterrupted growth. Eventually, equity markets may focus more on the trajectory of government debt.

However, it would be wrong to imply that investor optimism is without foundation. Economies have been broadly resilient, and monetary policy is broadly accommodative. Despite forecasts of a difficult year, companies have continued to return solid earnings, displaying an admirable resilience and adaptability. Faced with numerous hurdles, including an abrupt rewiring of the global trading system, many leading companies have shown resilience and adaptability.

The near-term direction of equity markets will likely be determined by how investors weigh up these various competing undercurrents. Over the long term, however, it will be the enduring ability of the world's leading companies to innovate, grow and prosper that will drive investor returns, and in that regard, we are resoundingly bullish.

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