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Market Update

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SQUARE MILE

The Macro

In summary, the final quarter of 2025 saw central banks pivoting toward rate cuts despite stubborn inflation, particularly from tariff pressures in the United States. Growth has softened markedly across developed markets, with unemployment rising and labour markets cooling. The Bank of England and the US Federal Reserve both eased policy, while the European Central Bank held rates steady and signalled a more cautious path ahead. Against this backdrop, volatility remained subdued, although beneath the surface lay significant uncertainties around trade policy, geopolitical tensions, and the sustainability of recent market rallies.

- On 2 April, President Trump announced sweeping tariffs on imports, triggering one of the sharpest equity selloffs in recent years as investors grappled with the potential economic fallout. Fears of supply chain disruption, margin compression, and reignited inflation sent risk appetite crashing, but the shock proved short-lived. Within weeks, signals of a more flexible approach calmed nerves and equities rebounded sharply through the spring and early summer.
- By June, markets had fully reversed their April losses, driven by renewed enthusiasm for artificial intelligence and reshaped expectations for monetary policy. The narrative shifted from stagflation risk to "soft landing" hope, as central banks began cutting rates in the latter half of the year.
- In October and November, data painted a picture of a cooling but resilient economy. The US labour market weakened notably, with job creation slowing to a trickle and the unemployment rate edging higher. The UK economy grew barely in Q3, expanding just a minimal amount quarter-on-quarter, while output stalled in October before edging forward in November. Consumer confidence in both the US and UK deteriorated sharply, yet spending held up better than feared, suggesting American households benefited from government spending and stock market gains earlier in the year.
- Inflation, however, refused to fall as cleanly as hoped. US headline consumer price inflation stood at a moderate level in November, down from a higher level in September but still above the Federal Reserve's target. Core inflation, excluding food and energy, reached its slowest pace since March 2021. In the UK, inflation cooled in November, down from a slightly higher level in October, but services price growth remained sticky and above target. The eurozone held core inflation at a moderate level in line with the European Central Bank's medium-term expectations.
- The Federal Reserve, meeting on 10 December, cut the federal funds rate again but notably, the committee split three ways: the majority backed the cut, but two members preferred no change, and one pushed for a larger reduction. This division hinted at underlying tensions over whether the central bank should be easing into a slowing economy or holding firm against lingering inflation risks. The Fed's own projections suggested only one further marginal cut in 2026, a marked shift from earlier expectations of a more accommodative path.
- In the United Kingdom, the Bank of England cut Bank Rate by a further 0.25% to 3.75% on 18 December, marking its sixth cut since August 2024 (1). The vote was tighter than expected, just over half in favour, reflecting concern amongst some members about sticky wage growth and the risk of premature easing. Officials guided that further cuts would likely come but cautioned that the pace would depend on whether pay growth and services inflation continued to ease.
- The European Central Bank held its deposit facility rate steady on 18 December, having paused after several cuts earlier in the year. Policymakers reinforced their data-dependent stance, ruling out a pre-committed rate path and signalling that inflation should stabilise at the target over the medium term.
- By late November and early December, tariff uncertainty loomed large again. Trade negotiations between the US and China remained fractious, with modest agreement on a one-year truce but deeper frictions unresolved. Separately, tensions between the US and Venezuela over oil shipments escalated in mid-December, adding geopolitical edge to energy markets. Meanwhile, the war in Ukraine showed no signs of abating, and risks of broader Middle East escalation persisted despite relative quiet in recent months.

Bond Markets

In Q4 2025, global bond markets swung between safe-haven rallies and intermittent sell offs as central banks adjusted course and growth fears waxed and waned.

- US government bond yields fell sharply from late September through November as recession fears mounted and bets on aggressive Federal Reserve cuts gained traction. The 10-year Treasury yield dipped toward a moderate level in early November before rising modestly and so yields and bond prices were broadly flat over the quarter. Short dated bond yields compressed even more steeply than the longer dated issues, reflecting expectations of further interest rate cuts. The yield curve, which shows the interest rates (or yields) of bonds with the same credit quality but different maturities, steepened markedly, with longer-dated yields proving more resilient than shorter ones, a pattern which usually signals both expected growth and rising inflation.

- UK gilt yields tracked a similar arc. The 10-year gilt sold off sharply in April alongside equities on tariff jitters, then recovered through the summer. By December, after the Bank of England's rate cut, longer-dated gilts held their ground, yield curves remained steep, as investors balanced interest rate cuts against the headwinds of poor government finances and weak growth. Demand for longer-dated bonds remained solid, supported by pension funds.
- In the eurozone, German bund yields moved higher through Q4 despite the European Central Bank pausing rate cuts. A combination of fiscal expansion signals from the German government and sticky services inflation kept longer-dated yields supported. Italian and Greek government bonds did well in the last few months as growth improved and the eurozone avoided a sharp downturn. French bond spreads widened somewhat amid fiscal unease and political instability after the country has experienced repeated government collapses and difficulties passing budgets, which increased investor nervousness about the country's ability to control its debt.
- The spreads in corporate bonds, which is the extra yield investors earn for holding these bonds over holding a safer government bond remained compressed, trading near their tightest levels in over a decade, despite economic softness. Investors demand for yield was insatiable, as central bank rate cuts and weak starting yields elsewhere funnelled capital toward corporate bonds, and issuers responded with heavy supply in September and sustained issuance into Q4. Fundamentals held up reasonably well as corporate earnings beat expectations in the third quarter and defaults remained rare. High-yield credit lagged investment-grade bonds in the fourth quarter after a very strong first 9 months of 2025.
- Emerging market debt saw renewed inflows after years of outflows, buoyed by Latin American and Central European central banks cutting rates in line with disinflation and attractive local currency yields at moderate levels. The US dollar, after posting gains in early 2025 amid higher-for-longer interest rate expectations, reversed sharply from May onwards. By December, the dollar had weakened materially against most major peers, a shift that boosted returns for unhedged EM debt investors. Argentina and Egypt, which had seen credit rating upgrades earlier in the year, continued to attract allocations, though political and fiscal risks remained.

Equity Markets

Q4 2025 equity markets inherited momentum from an extraordinary Q3. The broad US market had risen sharply through the summer on the back of solid earnings, Fed rate cuts beginning in September, and tariff negotiations moving into calmer territory. The tech-heavy sector had led, but as autumn progressed, signs of "AI fatigue" emerged: massive capital spending, steep valuations, and uncertain paths to revenue raised investor concerns.

- By October and November, a subtle but telling shift in investor preferences took hold. Money began to rotate from mega-capitalisation technology stocks towards smaller-cap and cyclical names. Financials stocks did well over the quarter, and some more defensive stocks, such as Utilities began to look appealing on a valuation basis. Healthcare and consumer staples, many of which are on lowly valuations, began to attract renewed investor interest.
- Geographic rotation proved equally striking. US equities had dominated for years, but by Q4 2025, UK equities had outperformed Wall Street on a year-to-date basis, driven by strength in commodity and banking stocks. European equities, trading at a substantial discount to US valuations and expected to deliver solid earnings growth in 2026, found new buyers. Emerging market equities had already rallied for several consecutive months through November, with Asia leading the charge. A weaker US dollar helped, as did easing US monetary policy, which reduced the opportunity cost of investing abroad.
- Earnings proved resilient. Companies across sectors beat consensus forecasts in Q3, though earnings guidance for Q4 and 2026 remained measured. The concentration of gains in a handful of large technology and growth names masked a broader market where dispersion was high and stock-picking, rather than sector bets, mattered.
- Valuations across all major regions and styles sat well above historical averages. Forward price-to-earnings multiples in the US remained stretched, leaving little room for surprises. Yet earnings growth expectations for 2026 remained upbeat, hinging on continued monetary easing and tariff resolution.
- Currency markets saw a pronounced shift. The US dollar, having rallied hard through mid-November, retreated sharply as Fed rate-cut expectations crystallised. Against the pound, the dollar weakened from early-November highs. Emerging market currencies rallied steadily, benefiting from both dollar weakness and improving economic outlooks for Asia in particular.

Outlook

Entering 2026, the key question is not whether central banks will cut, but how fast and how far. The Federal Reserve faces a delicate balancing act: labour markets have softened materially, yet inflation remains above target. Consensus points to a pause in the cutting cycle in early 2026, with further reductions dependent on economic data. A Fed rate at a moderate level by mid-2026 is plausible if growth holds and inflation drifts down but is far from certain.

- The Bank of England is expected to continue a gradual easing path, with rates likely reaching a moderate level by mid-2026 depending on wage and services inflation dynamics.

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- The ECB, by contrast, looks unlikely to cut rates further in the near term, having signalled it is comfortable with the current stance. Only a sharp growth deterioration or inflation undershoot would likely trigger additional easing in 2026.
- Trade policy remains the elephant in the room. Tariff negotiations will set the tone for global growth, inflation, and investment. A resolution or further pause could unlock further capital spending by companies; whilst escalation would likely crimp growth. Energy prices, geopolitical tensions in Eastern Europe and the Middle East, and China's ability to stabilise its property market via policy all carry material downside risk to the base case.
- Earnings momentum for 2026 is forecast to accelerate, particularly in Europe and among cyclical names, but this hinges on tariffs not materially escalating and central banks continuing to ease even modestly. Credit markets face a fork in the road: if policy easing sticks and growth remains steady, spreads could tighten further. If growth disappoints or policy surprises to the hawkish side, repricing could be sharp.
- But total returns for bonds are expected to be attractive compared with recent years, particularly for high-quality securities.
- US equities are broadly expected to continue generating positive returns, though some forecasts suggest that gains may be more modest given high valuations and political uncertainty.
- International equities outside of the USA and emerging market equities could benefit from lower interest rates, valuation support and currency dynamics.
- For long-term investors, the combination of stretched valuations, policy uncertainty, and geopolitical risk argues for disciplined diversification. Quality, income-generating assets, a tilt towards broad international exposure, appears more prudent than chasing concentrated growth bets.

SOURCES

(1) Bank of England <https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2025/december-2025>

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