

Why inflation fights on, but markets tell a different story

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1. Why are markets staying resilient despite hawkish central banks?

2. Is inflation still the dominant investment issue?

3. Is AI driving growth despite higher rates?

Why inflation fights on, but markets tell a different story

by Christian Gattiker, David Kohl, and Sophie Altermatt

Central banks around the world have delivered a consistent message: inflation remains the primary concern. The Fed, ECB, and BOJ have all tightened monetary policy. Yet this is not what financial conditions reflect, as they remain exceptionally loose for now. Adding to the oddity, investor sentiment has weakened sharply, with fear gauges hovering near panic levels and more than half of US retail investors turning bearish. So, what questions do investors need to be asking?

Most of the world's major central banks have now spoken. Their message has been remarkably consistent, but markets have responded less predictably. Here are the five questions investors should be asking.

1. Why are markets staying resilient despite hawkish central banks?

The recent policy backdrop would normally be expected to weigh more heavily on risk assets.

The Federal Reserve has adopted a more hawkish tone, the Bank of Japan continues its gradual policy normalisation, and Europe is offering little in the way of an accommodative counterbalance. Yet financial conditions continue to look relatively loose despite the more hawkish policy backdrop.

One explanation may be the continued dominance of AI-related investment spending, which remains a powerful driver of growth and market leadership. Economic activity has remained resilient, while AI-related capital expenditure continues to support broader investment activity.

As a result, markets have remained remarkably resilient despite the increasingly restrictive tone from policymakers.

2. Is inflation still the dominant investment issue?

Yes, but the answer increasingly depends on geography.

In the United States, underlying inflation remains elevated. Strong consumer spending, a positive wealth effect, and significant AI-related capital expenditure continue to support demand, making it difficult for inflation to return fully to the Federal Reserve's 2% target.

The picture is different in Europe. While headline inflation has been influenced by energy prices, underlying trend inflation has moved much closer to the ECB's goal. Importantly, policymakers have

seen little evidence of broader second-round inflation effects.

Japan presents a third story altogether. Inflation around 2% suggests the country's long battle with deflation has largely come to an end, giving policymakers room to continue normalising interest rates over time.

For investors, this means monetary policy is becoming increasingly differentiated rather than moving in lockstep across regions.

3. Is AI driving growth despite higher rates?

Investment linked to AI remains the dominant force in the current cycle. It is increasingly affecting the broader economy through second-round effects: demand for data centres, power infrastructure, construction activity, and financing.

Our Technical Analysts see the same narrowing in price action: AI, and the rest. Performance continues to be concentrated among companies and sectors exposed to AI-related investment.

Until another meaningful growth engine emerges, investors may find it difficult to look beyond this theme.

Investor sentiment appears significantly weaker than market performance would suggest.

Fear-and-greed measures have moved close to panic territory, while more than half of US retail investors now describe themselves as bearish. Such pessimism seems inconsistent with financial conditions that remain broadly supportive and economic activity that continues to show resilience.

September may have already done some of the market's seasonal adjustment work, making October appear less threatening than usual.

Geopolitics could prove to be the next major catalyst.

The Trump-Xi summit is being closely watched for signs of progress on trade, tariffs, and cooperation around emerging technologies such as AI. Any meaningful developments could encourage broader market participation beyond the current leaders.

Investors will also monitor global flash PMIs, Germany's ifo survey, the UN General Assembly, the G7 foreign ministers' meeting, and rate decisions across several economies, including Switzerland.

In Switzerland, attention will focus less on immediate policy changes and more on the Swiss National Bank's assessment of future inflation risks. While underlying inflation remains contained, investors will be watching the SNB's updated inflation forecasts closely for clues on when policy normalisation may eventually come into view.

Investors face an unusual combination of hawkish central banks, loose financial conditions, washed-out sentiment, and a narrow growth engine led by AI-related investment. For now, the trend remains intact.

Until the evidence changes, investors may be best served by recognising the current leadership while continuing to look for the next source of market breadth.

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