



Investment Views

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Navigating Market Volatility Through Discipline

After a very strong run over the last few years, global markets are facing some important tests. A disciplined, thematic approach is the best antidote to the potential volatility ahead. Below we explain what the market's challenges are and how they shape portfolio construction.

The potential for conflict in Iran has materialised. Achieving regime change by only using air power and not putting boots on the ground would be unprecedented. The hope is that the Iranian people will do the job themselves, but killing the supreme leader and his top military advisers does not mean the regime will inevitably collapse. The Syrian and Libyan states were built around ruling families, whereas Iran's regime is a system engineered over 50 years to survive wars and assassinations. This will surely be its sternest test but once attacked, the military immediately split into independent splinter groups operating country-wide, designed to make an uprising and coup far more difficult.

The immediate impact on energy prices has drawn headlines. Maritime activity in the Strait of Hormuz, the world's most sensitive chokepoint and one responsible for about 20% of the world's seaborne oil and gas, is being severely disrupted. If energy-driven inflation remains sticky, the West's ability to cut interest rates any further will be hampered at the same time as growth slows. Modern conflicts are also extraordinarily expensive. US-made Patriot air-defence missiles costing \$4 million apiece are being used to destroy Iran's \$20,000 drones. At a time when sovereign debt levels are already under scrutiny, the cost of a prolonged Middle Eastern conflict would inflate both the global debt bubble and the cost of servicing it, raising fresh questions about fiscal sustainability and potential tipping points.

War and its impact are not the market's only challenges. Long-term valuations remain elevated and earnings expectations high. A vivid illustration is Nvidia - despite a significant beat on both top and bottom lines, the stock recently suffered its steepest one-day drop since the "Tariff Tantrums" of April last year. When perfection is priced in, even an exceptional performance that falls short of miraculous risks being treated as a failure. We may be moving past the Goldilocks era of Artificial Intelligence, where every mention of a Large Language Model (LLM) added billions to market caps, and into the era of execution risk.

AI also continues to cause heavy churning across and within stock market sectors. Software has been particularly bruised. Much of the recent sell-off was attributed to a report from the Citrini group, which suggested that AI would cannibalize the previously stable and high margin Software as a Service (SaaS) business model ("the revolution devours its own children"). While the report merely represents one hypothetical 2028 scenario, its impact was real because it spoke to a deep-seated investor and employee fear: obsolescence. Such fear is no longer confined to code-heavy industries. It has metastasized across areas such as Logistics (autonomous efficiency vs. legacy infrastructure), white collar Professional Services (law and accountancy, for example, face a fundamental questioning of billable-hour models), and commercial real estate (if AI reduces headcount for mid-level administrative tasks, what happens to demand for the office towers that house them?).

These fears have also weighed on Private Credit, an asset class we do not own and one which is starting to show signs of real strain. Blue Owl has lost \$24 billion in market value in the last year amid concerns about its technology lending. And the rise in rates over recent years may finally be catching up with borrowers. When the cost of servicing debt exceeds the cash flow generated by the underlying business, the "private" nature of these deals only serves to delay the recognition of pain, not prevent it.

Finally, the US regulatory landscape remains in a state of flux. The Supreme Court's recent ruling that last year's tariff changes were illegal—followed by immediate, aggressive amendments by the administration—has added to the "policy fog". For global corporations, this uncertainty makes long-term capital expenditure planning very difficult indeed, impacting growth and making earnings delivery even more challenging. What to do? First, remember that "time in the market" will always be a far better strategy than "timing the market".

More often than not, the impact of geopolitical events on the economy turns out to be relatively muted. As the chart below shows, it is vital to maintain a long-term perspective. Since 1940, the S&P 500 has been higher one year after a major geopolitical crisis 85% of the time. And where the S&P goes, the world will follow.

However, within the context of remaining invested, proactive positioning does make sense. Our thematic equity and alternatives allocations aim to provide sufficient ballast to portfolios whilst positioning them well for the opportunities that may emerge. China, for example, trades at a significant valuation discount to global markets and represents a contrarian play on domestic Chinese stimulus and manufacturing dominance. Our recently initiated India theme is the "demographic dividend" powerhouse with a digitally native burgeoning middle class and structural infrastructure growth. US Healthcare is a defensive value play where aging demographics provides a permanent tailwind that is largely immune to energy prices and international turmoil. Our Quality Equity theme prioritises companies with stellar operating metrics and fortress balance sheets that can self-fund growth without relying on stressed credit markets.

Since we expect volatility to resurface and perhaps persist, we have integrated specific assets with lower correlations to equities into client portfolios (where permitted). Our Trend Following managers implement systematic strategies across a plethora of asset classes (such as commodities and currencies as well as stocks and bonds) that can profit from sustained market moves in either direction. Gold remains the ultimate currency of last resort and despite its meteoric price rise the rationale for a strategic allocation remains firmly intact. Equity Dispersion is a strategy designed to profit from the market's "churn", capturing the widening gap between the winners and losers of the AI revolution as dispersion hits levels not seen in decades. Finally, Cat Bond funds are linked to natural disaster events rather than economic cycles, providing a source of non-correlated yield that is indifferent to whether Nvidia hits its quarterly targets.

Of course, no portfolio is immune to the vagaries and gyrations of the market. "Time in the market" may sound simple but that does not mean adhering to it is easy. That is why we are here. So forgive us if we reiterate that for the genuine investor, volatility is not the enemy; it is there to serve you by providing you with opportunities, not master you by forcing your hand.

Chart: during conflict, it is important to maintain a long-term perspective. Since 1940 the S&P 500 has been higher 12 months after a major geopolitical crisis 85% of the time



Source: Pinnacle Investment

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