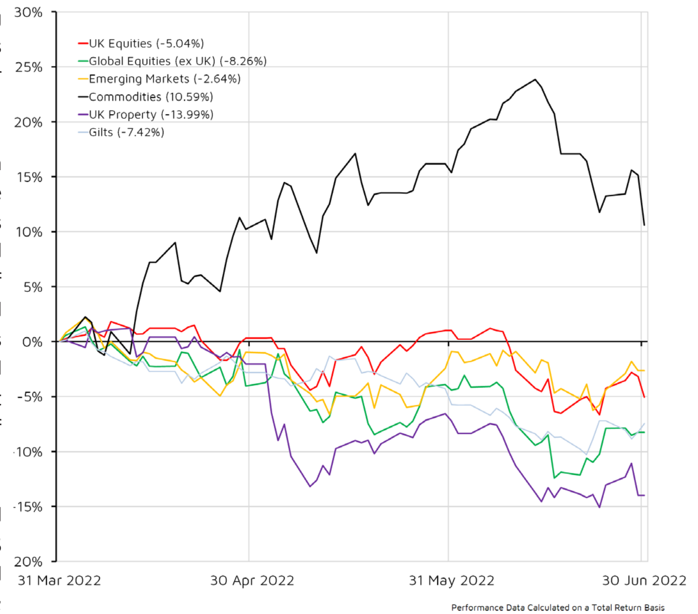
SUMMER OUTLOOK

REVIEW OF THE PAST QUARTER:

The performance of financial markets continued to be driven by rising inflation and rising central bank interest rates, but the rate of both has added the fear of recession to the mix. The result of this has been for almost all financial assets to fall in value over the last three months.

The Consumer Prices Index (CPI) has reached 9.1% in the UK and 8.6% in the US. Energy prices have been the biggest driver of inflation, and these have been kept high by Russia's invasion of Ukraine, but there are signs that inflation is starting to broaden out and central banks have doubled down on their commitment to bring inflation under control. The Bank of England raised rates for the fifth consecutive month when it announced a 0.25% hike in June, while in the US the Federal Reserve increased rates by 0.75%. The European Central Bank ended its programme of bond purchases and has cleared the way for a rate hike in July. Government bond yields have risen sharply as a result as government bonds sold off and corporate bonds have also fallen.

Financial markets have seen very high levels of volatility but US and global equities have underperformed fixed-income markets, with US growth companies leading the fall. Japanese equities have performed comparatively well as the falling value of the yen has helped exporters; however, the relative weakness of sterling weighed on returns for UK-based investors. UK equities fell but outperformed other developed markets due to the contribution of energy and mining companies, as well as utilities and banks.



ASSET CLASS RETURNS

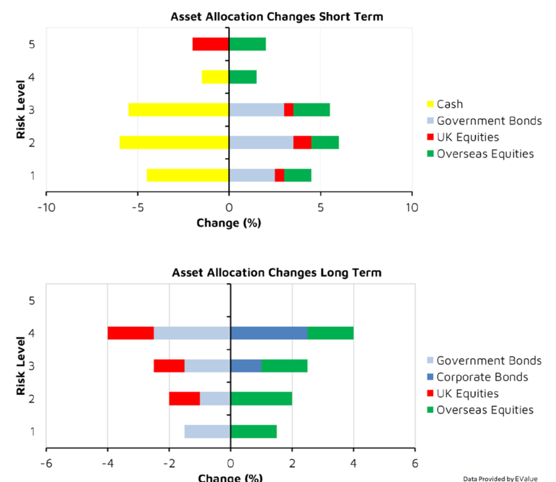
Cash	Government Bonds	Index Linked Bonds	Corporate Bonds	UK Equities	Overseas Equities	Emerging Markets	Property
+0.22%	-7.42%	-17.54%	-7.16%	-5.04%	-8.26%	-2.61%	-13.99%

THE ACTUARIAL VIEW:

Higher inflation means interest rates rising rates faster, and higher expectations for financial returns in general. Bonds and shares were cheaper at the end of the quarter than at the beginning, and prospects for growth are correspondingly raised.

Higher interest rates generally mean higher fixed-income returns. Equity returns have more moving parts and their fundamentals face challenges from inflation, the war in Ukraine, policy interventions and an economy that was weak even before the pandemic. However, fundamentals are relatively sold due to continued momentum from the recovery and some major industries are benefiting from higher prices.

In the resource-heavy UK market fundamentals are solid, while the outlook for European and Japanese equities has significantly improved. Despite the relative strength of the US economy, US fundamentals are relatively weak and prospects lag the other markets as high growth tech stocks are sensitive to interest rates. Emerging markets are suffering from a strong US dollar, offsetting many of the wins of the, up to now, relatively limited impact of the pandemic.



WHAT TO LOOK FOR IN THE NEXT QUARTER:

- **UK:** CPI data is out on 20 July, 17 August and 14 September. The Bank of England's interest rate decision meetings are set to be held on 4 August and 15 September. UK GDP growth for Q2 2022 is available on 12 August. Employment data is to be published on 19 July.
- **US:** There will be interest rate decisions from the US Federal Reserve on 27 July and 21 September. CPI data is out on 13 July, 10 August and 13 September. Monthly unemployment and Non Farm Payrolls data is out on 8 July and 5 August. GDP growth for Q2 2022 will be released on 28 July.
- **Eurozone:** Initial CPI data is out on 1 July, 29 July, 31 August and 30 September. The labour market overview to be published on 1 August. Initial data for GDP growth for Q2 2022 will be published on 29 July. European Central Bank monetary policy meetings will be held on 21 July and 8 September.
- **Other Data:** China's Q2 GDP is due on 15 July. Caixin China General Manufacturing PMI is due on 1 July and the JPMorgan Global Composite PMI on 6 July.

ASSET CLASS SCENARIOS:

UK EQUITY

Most Likely: High inflation and rising unemployment clouds the economic outlook. Geopolitics keeps commodity prices elevated so inflation remains high and this erodes consumer spending. Small and mid-sized companies will continue to struggle. These headwinds affect consumer-focused businesses most while large stocks in defensive sectors, such as healthcare, consumer staples and utilities, should prove resilient. Banks would benefit as rising rates support profits.

Worst Case: Tensions with Russia and China get worse, causing commodity prices to go even higher. Aggressive rate rises and rapid reduction in central bank balance sheets push markets, including the UK, into a recession and send stocks and bonds plummeting. This culminates in the collapse of an unexpected area of the market, as US housing did in 2008, leading to a run on the wider market. The UK should prove defensive, given lower relative valuation levels.

Best Case: Interest rate hikes work and inflation begins to fall without causing increasing unemployment and affecting GDP. A resolution to the invasion of Ukraine helps to cool energy, food and commodity prices, further helping to reduce inflation. As more catalysts for a bull market materialise, smaller companies will stand to benefit the most from equity markets reversing their recent underperformance.

GLOBAL EQUITY

Most Likely: Aggressive central bank action to curb inflation and persistent disruption of supply chains will likely induce a global economic slowdown. Defensive sectors and, generally, quality investments should outperform, along with energy, given the continued supply shortages driven by the ongoing war in Ukraine.

Worst Case: Russia cuts energy supplies to Europe, leading to record energy-prices. Global supply shortages intensify and inflation continues to rise, meaning consumers face a cost of living crisis and cut back dramatically on discretionary spending. Central banks are forced to increase interest rates faster, which depresses economic activity and causes a global recession. Defensive areas of the market shoudl protect much better than cyclical areas in a renewed sell-off for global equities.

Best Case: An end to the war in Ukraine creates optimism that commodity prices will ease. Inflation is expected to peak, and central banks reduce the speed and size of their interest rate hikes. The reopening of Japan to foreign tourists should provide a boost for the service sector, thus supporting the recovery of the country's economic activity. Global economic growth is preserved, leading to the outperformance of cyclical sectors.

EMERGING MARKET EQUITY

Most Likely: A stronger US dollar will increase the burden on companies with debt issued in dollars. Rising inflation can be a relative advantage for commodity-producing markets but others, such as India, are heavily exposed to food imports and will be pressured to continue to increase interest rates, crippling economic activity. Many segments of emerging markets are now trading at pronounced discounts to developed markets and this could represent an attractive entry point into the asset class.

Worst Case: Further waves of Covid-19 in China and further extreme lockdowns could lead to more supply shocks. This would have a negative impact on many emerging markets, which have strong links to China via export demand. Faster US interest rate rises have a negative impact on many emerging markets due to the US dollar appreciating further.

Best Case: Vladimir Putin ends Russia's invasion of Ukraine; this leads to an improvement to the current commodity crisis and this would dampen a lot of the global inflationary pressures. China continues to ease regulatory scrutiny of industry while also avoiding another wave of Covid-19, meaning the Chinese market's recent rally could continue as foreign-investor sentiment shifts to a more positive place.

CASH

Most Likely: Yields available for money market instruments should improve over the next quarter as the Bank of England continues its interest rate hikes. Nevertheless, the pace of interest rates increases is likely to remain behind inflation and so returns adjusted for inflation for these instruments is likely to stay negative. These instruments will also suffer from negative capital returns as their price moves inversely to yields.

Worst Case: If more signs of recessions appear, the Bank of England is likely to raise rates less aggressively, hence limiting the upside for money market funds. It will also mean that investors might revisit the case for UK government bonds as safe-haven assets, due to their sensitivity to interest rates. Cash instruments will therefore be a less compelling option for investors.

Best Case: **I**f inflation keeps surprising to the upside the Bank of England may further rate hikes. If so, it is likely that the interest rate curve will steepen, which would improve the expected return from money market funds, as managers can lock higher rates at longer maturity dates which may offset the loss from capital return. It would also mean cash will further help investors to protect from downside.

FIXED INCOME

Most Likely: Inflation continues to rise and the Bank of England tightens monetary policy further by a combined 0.75% over the next two meetings, but increasingly tight monetary conditions contribute to further economic slowdown. Investors are convinced by the bank's commitment to controlling inflation, and government bonds trade flat, but corporate bond valuations decline on the weakened growth outlook.

Worst Case: Inflation exceeds expectations, with signs of an upward wage spiral in the UK and US. The Bank of England increases interest rates by 0.5% at two separate monetary policy meetings and announces plans to quicken the pace of balance sheet reduction. Investors react in a similar manner to recent periods of interest rate shocks and government bonds and corporate bond valuations are dented further.

Best Case: Chinese lockdowns ease, and the US and Opec increase oil supply. Oil and natural gas prices decline, supply chain issues ease a little more and inflation decelerates quicker than forecast. This gives policy makers room to prioritise economic growth and slow the pace of monetary tightening. The improved economic outlook supports corporate bonds and improving outlook for inflation supports government bond prices.

PROPERTY

Most Likely: Recent performance of property companies has been disappointing amid the rapidly changing economic environment, but the sector has historically performed well in inflationary periods and landlords generally have pricing power. Going forward, favourable fundamentals could help the shares of property companies, but macro issues are likely to continue to be a challenge.

Worst Case: Expectations for a weaker economic outlook negatively impact cyclical plays such as property stocks, particularly those operating within economically sensitive sectors such as retail, offices and leisure. Rising bond yields continue to have a negative impact on company valuations.

Best Case: Property companies act as a strong inflation hedge, helped by their strong pricing power and attractive dividend yields. Fundamentals remain strong in sub-sectors such as industrials, storage, and healthcare, where supply and demand dynamics are favourable. Government bond yields stabilise or edge down, making shares in property companies more attractive on a relative basis.

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