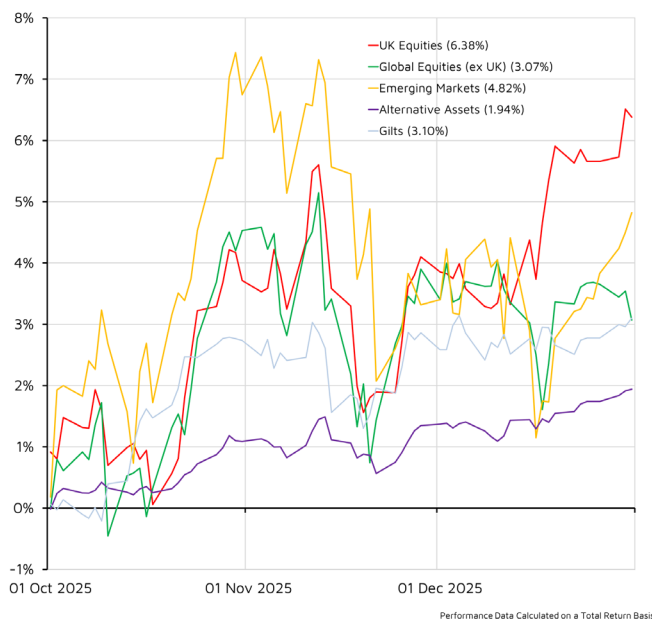


## REVIEW OF THE PAST QUARTER:

Stocks have gained further ground in the fourth quarter. Doubts about the monetisation of record AI investment led to declines in mid-October and all throughout November. Even so, US indices posted modest gains as market leadership rotated, with mega-cap tech underperforming small-cap companies. Japanese equities led developed-market gains, benefiting from the yen's depreciation, while South Korean shares also advanced following a trade deal with the US.

UK stocks were supported by an increase in commodity prices, particularly industrial metals, with banks also contributing positively. However, smaller UK companies retreated as weak consumer confidence delayed spending. Large European companies made modest gains, but German and Dutch shares underperformed significantly amid slow growth.

The US Federal Reserve delivered two successive quarter-point cuts as inflation plateaued and the labour market showed signs of weakening. In the UK, the Bank of England held rates as inflation continued to run hotter than peers. A more balanced Budget and a pledge of future tax rises allayed gilt-market concerns, and gilts performed well as sterling strengthened. Sterling's strength materially detracted from returns on foreign sovereign bonds. Corporate bonds also advanced, but higher-yielding bonds underperformed.



## ASSET CLASS RETURNS

Cash	Government Bonds	Index Linked Bonds	Corporate Bonds	UK Equities	Overseas Equities	Emerging Markets	Alternative Assets
+0.90%	+3.10%	+3.29%	+2.53%	+6.38%	+3.07%	+4.82%	+1.94%

## THE ACTUARIAL VIEW:

We previously expected growth to slip below its long-term trend while inflation stayed at moderate to high levels. As US interest rates fall and companies adapt to higher tariffs, the risk of a growth slowdown has fallen. The risk of persistently high inflation has risen as the US Federal Reserve continues to cut interest rates, amid public pressure from the White House for faster, larger cuts. We therefore expect inflation to remain elevated even as growth cools only slightly. This backdrop is more pronounced in the UK, where unemployment is rising, inflation is higher and growth is weakening.

With deficits elevated and debt burdens already high across developed markets, investors increasingly view government borrowing as unsustainable. That perception is likely to keep pressure on sovereign bonds. Corporate bonds are better positioned to outperform, particularly in emerging markets where a weakening US dollar provides an additional tailwind. We expect equities to continue to do well, led by Japan, Europe and emerging markets. In Europe, recent underperformance and earnings misses are offset by a stabilising macro backdrop and lower exposure to the now overvalued tech sector, reducing risk. By contrast, US equities face a higher risk of a pullback given lofty expectations for the impact of AI. In the UK, small- and mid-caps are likely to struggle amid weak consumer confidence and anaemic growth, while large caps are less tied to domestic conditions. After strong gains, equity drawdown risk is elevated – so maintaining broad diversification across asset classes, regions and styles is essential.

## WHAT TO LOOK FOR:

- UK:** Bank of England Monetary Policy Committee decisions on 5 February and 19 March. December inflation update on 21 January; January data on 18 February; and February data on 25 March. Initial GDP estimate for Q4 2025 is due on 12 February. Unemployment data due on 20 January.
- US:** Federal Reserve rate decisions on 27-28 January and 17-18 March. Inflation figures for December are due on 13 January, January and February. The Bureau of Economic Analysis's advance estimate of Q4 2025 GDP is rescheduled from the original 29 January slot (the exact new date to be announced following post-shutdown calendar updates).
- Eurozone:** European Central Bank interest rate meetings on 4-5 February and 18-19 March. Preliminary Eurozone Q4 GDP on 30 January and final figures on 6 March. ZEW economic sentiment index is published on 20 January.
- Other data:** Bank of Japan monetary policy decisions on 22-23 January and 18-19 March. Spring wage negotiations (Shuntō) in mid March. Chinese GDP growth, industrial production and retail sales due on 19 January.

## ASSET CLASS SCENARIOS:



### UK EQUITY

**Most Likely:** Inflation slows but remains sticky so the Bank of England has less room to cut rates. Growth is modest as higher taxes keep business investment and hiring subdued. Companies with overseas revenue are resilient, but any decline in the dollar will dilute earnings. UK equities grind higher, and companies with balance-sheet strength, defensive stocks and cyclical companies that benefit from easing financial conditions do best.

**Worst Case:** Tariff-driven inflation proves persistent, and the global slowdown intensifies. A renewed energy shock adds to inflation and squeezes real incomes, while tighter financial conditions and weaker trade hit UK company earnings. Rate cuts get delayed and equity markets fall, with the most economically sensitive areas (domestic cyclical and smaller companies) underperform meaningfully.

**Best Case:** Inflation slows to give the BoE room to cut rates. Global growth and less trade uncertainty support a broad equity rally. In the UK, lower rates, improving confidence and low valuations allows performance to broaden beyond the large-cap defensives and global companies, and domestically exposed small/mid caps benefit.



### GLOBAL EQUITY

**Most likely:** The US Fed cuts rates to protect jobs, but tariffs keep inflation risks alive. AI spending supports some sectors, but investors are sensitive to potential for returns. Modest growth and policy stability help European markets as government spending helps offset trade friction and a firmer euro. Rising wages and inflation help Japanese stocks, but the central bank is likely to hike if the outlook holds.

**Worst case:** Tariffs spread and push inflation back up as growth slows and the Fed pauses, or even reverses, rate cuts. Tech stocks fall as investors question whether huge capital spending will pay off. Europe is hit by weaker external demand and renewed energy sensitivity. Japan struggles as global demand weakens and the yen strengthens.

**Best case:** Trade tensions ease without a fresh inflation shock. Disinflation continues, allowing the Fed to keep easing while growth holds up, and AI investment begins to pay off. Europe benefits from improving confidence and steady fiscal spending. Japan performs well as wage gains support consumption and corporate reforms continue, while the yen stays broadly competitive.



### EMERGING MARKET EQUITY

**Most Likely:** US inflation eases, allowing the Federal Reserve room for rate cuts in 2026. Targeted sector support in China helps curb deflation. Taiwan and South Korea gain from stable semiconductor demand. Lower inflation and supportive central banks in Latin America create a positive environment for equities.

**Worst Case:** High inflation keeps Fed rates elevated, reducing global liquidity and causing capital outflows from emerging markets. Chinese growth slows and deflation intensifies. Taiwan and South Korea confront soft semiconductor demand. Rising inflation and funding costs dampen investor sentiment in India, while Latin America grapples with declining commodities, currency swings, and increased borrowing expenses.

**Best Case:** US inflation slows, allowing the Fed to lower rates and ease global financial conditions, boosting capital flows to emerging markets. China addresses deflation, improving confidence. Taiwan and South Korea see higher semiconductor demand, while Latin America benefits from steady commodity prices and easing inflation.



### CASH

**Most likely:** Money market yields have remained broadly stable. The Bank of England cut in November as inflation eased toward target, though wage growth has kept policymakers cautious. The US Fed also cuts rates, suggesting a coordinated but gradual global easing cycle. Against this backdrop, money market instruments continue to offer steady returns and resilience amid shifting rate expectations.

**Worst case:** Inflation declines faster than anticipated, prompting the Bank of England to accelerate rate cuts. In this scenario, cash yields would compress more quickly, reducing the appeal of money market funds relative to short-duration gilts or bond funds that could benefit from capital gains. A sharper global downturn or renewed financial stress could amplify volatility even in highly liquid markets.

**Best case:** The UK achieves a soft landing with inflation near target and resilient growth. The Bank of England steadily cuts rates, but signals that rates may remain above pre pandemic norms. Money market instruments continue to deliver attractive real yields and preserve capital stability, with investor demand supported by caution around duration risk.



### FIXED INCOME

**Most Likely:** The Fed cuts rates in early 2026, reflecting concerns around labour market, but the Bank of England leaves rates unchanged due to persistent inflation. Government bonds are very sentiment-driven, with elevated volatility. Higher-quality credit with limited rate sensitivity sees limited volatility and offers a slightly higher return.

**Worst Case:** Global reflationary surprises emerge in early 2026 driven by the Fed cutting rates too aggressively forcing other central banks to hold rates or even use corrective rate hikes. Refinancing risks rise for weaker issuers, leading to increased defaults and capital losses in riskier credit markets. US fiscal uncertainty and geopolitical tensions exacerbate volatility across global corporate bond markets.

**Best Case:** The Fed cuts twice more, stabilising growth expectations and reducing labour market concerns. Inflation is contained across major developed markets. The Bank of England makes at least one additional cut. Short-dated government bond yields decline, while longer-term yields stabilise as confidence in policy credibility improves. Investment grade and high-yield bond defaults stay low.



### ALTERNATIVES

**Most likely:** Artificial intelligence, electrification, and infrastructure investment drive growth. Energy transition commodities and critical minerals are likely to gain and power infrastructure benefits from increased AI demand. Gold stays valuable amid persistent inflation and uncertainty over Fed independence.

**Worst Case:** Persistent inflation prevents central banks from lowering rates, worsening recession fears. Weak demand hits commodities and energy, while rising correlations challenge real asset strategies. Investors shift to fixed income and cash, leading to outflows from less liquid alternatives.

**Best Case:** Inflation eases, yet demand stays strong, driven by AI, electrification, and infrastructure growth. Commodities and gold perform well thanks to supply limitations and robust long-term demand. Shares in energy and natural resources climb due to rising electricity needs from data centres. Meanwhile, global macro and event-driven strategies benefit as increased market volatility creates new opportunities.

Data Sourced from FE Analytics and MSCI Barra

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