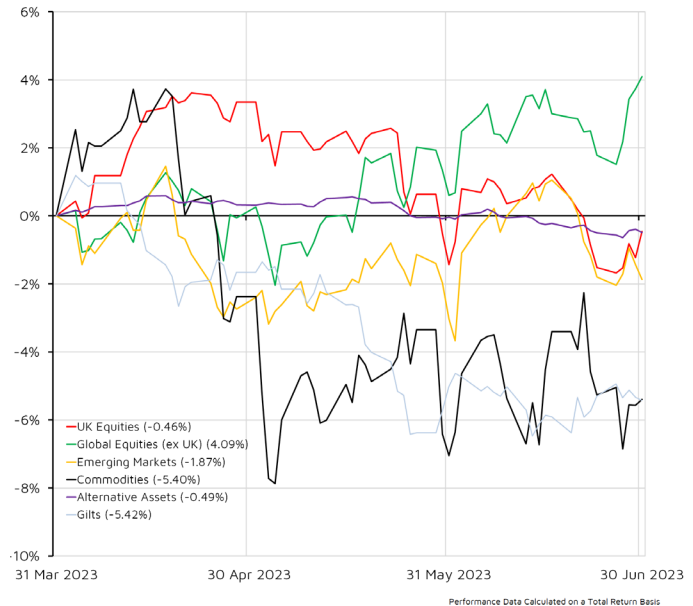


### REVIEW OF THE PAST QUARTER:

Positive equity markets have been offset by declines in bond markets as persistently high inflation has pushed central banks towards further rate hikes. US inflation continued to drop, but the pace was slower than hoped and employment remained resilient as consumer spending was robust. The US Federal Reserve indicated that further hikes in 2023 are likely and chair Jerome Powell has repeatedly said that rates will remain high for longer than markets expect. Inflation in the UK proved to be particularly sticky and markets are now positioned for rates to rise from 4.75% to 6% or higher by the end of the year.

Changing expectations for interest rates have weighed on bonds and UK government bonds declined steeply. Equity markets generally fared well. US equities have risen strongly, driven by a small number of technology stocks and relatively good economic growth has driven one of the strongest rallies in Japanese equities in recent years. UK equities lagged other developed markets as economic growth has been weak and consumer confidence remained low as inflation erodes spending power.

The expectation that the Bank of England will keep raising rates has caused sterling to rise in value against many global currencies and this has significantly reduced the gains from global equities for UK investors. Meanwhile, weaker global economic growth, particularly from China – as well as an easing of the disruption caused by Russia's invasion of Ukraine – means oil, natural gas and many industrial metals have fallen significantly this year.



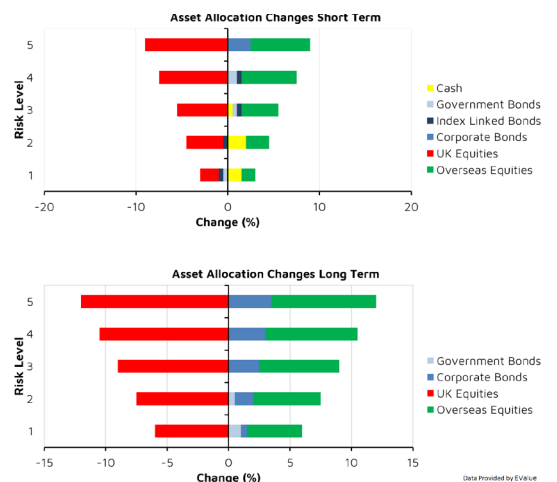
### ASSET CLASS RETURNS

Cash	Government Bonds	Index Linked Bonds	Corporate Bonds	UK Equities	Overseas Equities	Emerging Markets	Alternative Assets
+1.13%	-5.42%	-6.61%	-3.35%	-0.46%	+4.09%	-1.87%	-7.50%

### THE ACTUARIAL VIEW:

Relatively strong economic growth and employment is leading markets towards a higher-for-longer scenario for US interest rates, although not sufficiently enough to lift the risk of another down-leg in equities and risk appetite. Indeed, the focus has been on the better-than-expected earnings backdrop. However, if earnings are being held up due to corporate pricing power (higher inflation), this is unlikely to be acceptable to the US Federal Reserve, even if the US moves into a mild recession. This means the risks are still tilted to the downside on equities. Meanwhile, longer dated bonds are in the midst of a reassessment of the outlook for US interest rates and may have some more upside for yields in the short term but, ultimately, are likely to provide ballast to portfolios.

The outlook remains negative on global developed equities and neutral for emerging markets. Another observation is the emerging divergence between growth versus value stocks and the expectation that growth should underperform value near term.



### WHAT TO LOOK FOR IN THE NEXT QUARTER:

- UK:** The Monetary Policy Committee interest rate decision and minutes are set to be released on 3 August. Preliminary GDP growth for Q2 is available on 11 August. Unemployment data for May to be published on 11 July.
- US:** There will be interest rate decisions from the Federal Open Market Committee (FOMC) on 25-26 July and 19-20 September. Minutes will be published three weeks after each decision. GDP growth for Q2 to be released on 27 July. Core inflation data for June is released on 28 July. Change in Nonfarm Payrolls expected to be available on 7 July.
- Eurozone:** Initial GDP data for Q2 and inflation data for June is set to be published on 31 July. A European Central Bank monetary policy decision is due on 27 July. Unemployment rate set to be published on 1 August.
- Other Data:** Chinese GDP growth for Q2 is due to be published on 17 July. Caixin China Manufacturing PMI and the JPMorgan Global Manufacturing are set to be published on 3 July.

## ASSET CLASS SCENARIOS:



### UK EQUITY

**Most Likely:** Inflation grinds downwards as the UK teeters on the edge of recession amid persistently low consumer sentiment. Food inflation remains high, but energy costs fall. Large companies continue to protect share prices and earnings better than small and mid-sized companies, and consumer-facing businesses struggle. Persistent inflation and higher interest rates slow global growth and lead to further volatility.

**Worst Case:** The war in Ukraine drags on and food and grain prices remain elevated. Aggressive interest rate rises help cause a deep recession. Stocks and bonds plummet as unemployment rises. This ends in the collapse of an unexpected area of the market leading to a run on the wider market. The UK is more defensive than other developed markets, but investors will struggle to find anywhere to hide.

**Best Case:** Central banks' interest rate hikes prove successful and inflation begins to fall without pushing up unemployment or slowing GDP growth. The UK recovers faster than other markets, as it comes from a lower valuation. A reasonable agreement for an end to fighting in Ukraine cools food and commodity inflation. Smaller companies will stand to benefit the most from equity markets returning to sustained positive performance.



### GLOBAL EQUITY

**Most Likely:** US rates increase once more but cooling inflation convinces the Fed to stop there. In the US, interest rate sensitive sectors like technology benefit from the peak in interest rates. Slowing European economies lead to outperformance in the less economically sensitive sectors like consumer staples, healthcare and technology.

**Worst Case:** The war in Ukraine escalates significantly and western governments scramble to respond without an escalation. Markets panic and global supply disruption pushes energy and food prices to new highs. Central banks are forced to hike interest rates further as they fight stagflation. Energy and defensive sectors are the best place to hide. European markets suffer most due to their proximity to the crisis.

**Best Case:** An end to war in Ukraine eases commodity supplies. China's recovery and the scale of government stimulus exceed expectations and boost global markets. Inflation falls rapidly and central banks are able to adjust down the trajectories for the path of interest rates. Economic growth regains momentum, giving a boost to all corners of the market.



### EMERGING MARKET EQUITY

**Most Likely:** Recent Chinese stimulus will be ineffective but further action is unlikely due to concerns over financial risks. Weakness in China's property market may drag on activity, given it is a central driver of economic growth. Investors will continue to shun Chinese markets if current geopolitical issues heighten and will likely build Indian exposure until there are signs of Chinese economic recovery.

**Worst Case:** Chinese consumer spending is further reduced while sticky inflation in developed markets reduces demand for Chinese exports. The potential for further US rate hikes poses a negative effect for emerging market currencies. A Chinese invasion of Taiwan would be catastrophic, however, the probability of such an event is relatively low.

**Best Case:** Chinese monetary and fiscal stimulus revives economic growth. Tensions between the US and China ease and investor sentiment to Chinese equities improves. A cut in rates by the US Fed would be favourable for emerging markets if it leads to US dollar depreciation. Indian growth continues and the 'nearshoring' drive by the US remains a positive catalyst for the Latin American market.

Data Sourced from FE Analytics, and FactSet

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### CASH

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

**Worst Case:** If further signs of recession appear, the Bank of England is likely to raise rates less aggressively, so limiting the upside for money market funds. This also means 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:** The Bank of England surprises by continuing to raise rates higher than currently expected because inflation proves even more resilient. This 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 any downside.



### FIXED INCOME

**Most Likely:** At least one more rate hike is possible. Falling inflation in the US and Eurozone is a cause for optimism but UK inflation remains elevated. If rates stay high a moderate recession looks likely. This would increase calls for rate cuts and would be supportive of government and high quality corporate bonds. An end to US rate hikes could see a weaker dollar benefiting sterling and emerging market currency bonds.

**Worst Case:** Central banks' attempt at a 'hawkish pause' fails, and high inflation forces further rate hikes. The premium paid by corporate borrowers spikes due to high costs and sagging consumer demand. In the mortgage market, rising defaults and repossession cause significant pain for many consumers. The greatest risk is in junk bonds, as recession predictions move towards a harder landing.

**Best Case:** Central banks opt for a 'pause and hold' approach as inflation continues to fall. Rate cuts are priced in for late this year, as optimism grows for a soft landing and short recession. Government bond yields stabilise and start to fall, while global corporate bonds remain steady thanks to good creditor fundamentals. Defaults are largely avoided.



### ALTERNATIVES ASSETS

**Most Likely:** The outlook for traditional assets is mixed as markets continue to focus on central bank policy and economic conditions. Given the potential for a hard landing, liquid real assets such as gold may benefit, while more cyclical areas such as commodities and natural resource equities are likely to struggle. Actively managed funds which are able to react quickly and benefit from moves in asset prices in either direction may benefit, such as global macro. However, market reversals and volatility remain a risk.

**Worst Case:** A continuation of the equity market rally driven by growth and technology sectors would likely lead to relative underperformance of most alternative strategies. While some managers can benefit from these moves, they are likely to wrong-foot many, particularly those who are currently positioned for more bearish conditions.

**Best Case:** Elevated market dispersion, volatility and macro uncertainty continues, allowing well-positioned managers to benefit from idiosyncratic trading opportunities and to deliver strong relative performance.