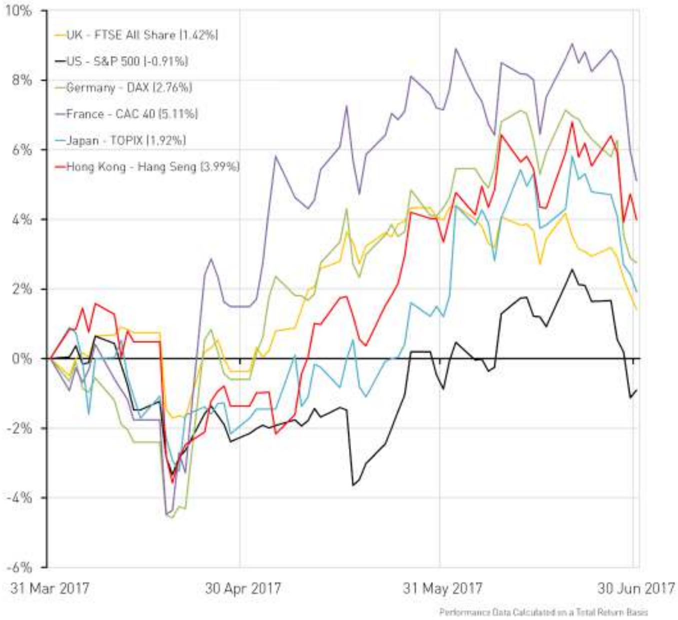
SUMMER OUTLOOK

REVIEW OF THE PAST QUARTER:

The second quarter of the year included the UK general election and the French presidential election – and while the outcome of the latter, a win for Emmanuel Macron and La République En Marche party, was widely anticipated, the outcome in the UK's election wasn't. The UK was left with a hung parliament following the general election, with incumbent Prime Minister Theresa May scrambling for a majority. Meanwhile, the Bank of England continued to hold rates at a record low level at its latest meeting; however, the bank took a more hawkish tone as three of the eight members of the Monetary Policy Committee (MPC) voted for a hike, citing high inflation as their reason. Bank of England Governor Mark Carney insisted now was not the time, listing weak wage growth, and mixed signals on consumer spending and business investment as reasons to wait.

Across the Atlantic, the US Federal Reserve hiked interest rates in June for the second time this year. It also set out plans for reducing its US$4.5 billion balance sheet and analysts expect this to begin in September. Meanwhile problems in the Middle East left Qatar isolated when several nations cut diplomatic ties in June. Qatar has since been given a list of demands that will require compliance for the blockade to be lifted.



ASSET CLASS RETURNS

UK	US	Japan	Europe	Emerging Markets	Commodities	Property	Corporate Bond	Gilts	Cash
+1.42%	-0.91%	+1.92%	+3.94%	+2.30%	-8.99%	+0.72%	+0.65%	-1.23%	+0.02%

THE ACTUARIAL VIEW:

Markets have continued to rise steadily, if unspectacularly – this is somewhat surprising as there have been plenty of news stories that we would have expected markets to react to. The UK general election results, disappointing growth figures and rising inflation were all largely shrugged off. Strong equity markets mean that the prospects for the asset class are marginally lower in general. UK market growth has been weak compared to broader international markets, but this has not been matched by any real changes in fundamentals, meaning prospects have held up better as the UK market looks better on a relative value basis. Emerging markets are the other stand-out market in equities as optimism increases in line with fundamentals.

Changes are therefore muted, as would be expected given the quiet state of markets. The biggest change has been the reintroduction of emerging markets at the higher risk levels. The model also sees a shift away from international markets and back to the UK. Finally, we see a slight movement out of gilts and into cash.

WHAT TO LOOK FOR IN Q3:

- **Bank of England Monetary Policy Committee (MPC) meetings:** The next meetings are scheduled for August 3 and September 14. Inflation reached 2.9 per cent in May, encouraging some members to vote for a hike at the June meeting.
- **Federal Reserve meetings:** The Fed's next meetings are scheduled for July 25-26 and September 19-20. Analysts expect the September meeting to host another interest rate increase.
- **European Central Bank (ECB) meetings:** The next monetary policy meetings for the ECB are due to take place July 20 and the September 7. President of the European Central Bank Mario Draghi seems to be taking a more bullish tone lately and analysts expect an announcement at the September meeting that tapering will begin in 2018.
- **German election:** Germany's election is set to take place September 24. Chancellor Angela Merkel's Christian Democratic Union party is in a close contest with the Social Democratic Party.

ASSET CLASS SCENARIOS:

UK EQUITY

Most Likely: Markets continue to revert between growth and value stocks as economic data and negotiation soundbites flow between positive and negative. The FTSE 100 may reduce performance divergence from FTSE 250 as income compounders thrive. We remain constructive on inflationary stocks as the Bank of England holds off rising rates. Mining stocks look positive as the weak US dollar is supportive.

Worst Case: Brexit hostilities continue to escalate as investment stagnates and earnings disappoint. This scenario is favourable to compounding income exporters and quality defensive stocks. Inflationary pressures are set to continue from rising costs other than demand-pull as importers pass on costs. Following dangers of stagflation, we expect the yield curve to steepen as the Bank of England raises rates and financials rally.

Best Case: We think small and mid cap companies still represent good value and expect them to outperform larger cap stocks. A hung parliament ensures a softer Brexit policy, and encourages negotiations to further stimulate investment and reduce uncertainty. Supportive monetary policy could add to drivers with cyclicals benefiting the most. Expect UK sterling to strengthen and exporters to re-rate unfavourably.

GLOBAL EQUITY

Most Likely: Europe continues to see solid growth and falling unemployment while we are yet to see stronger wage growth and inflation, which is likely to lead the ECB to continue to maintain an accommodative monetary stance. As the political and policy risks have dissipated for now, global equity markets are increasingly likely to focus on earnings.

Worst Case: The US Treasury yield curve, which is gauged to be the leading indicator of economic distress, appears to be flattening. When the yield curve flattens, there is potential for inversion, pointing towards a potential recession, which could weigh negatively on US equities. While most of the political risk in Europe has faded, there is potential for contagion stemming from the Italian banking sector. While a large proportion of the Japanese equity gains in 2017 have emerged from the weaker currency, a stronger Japanese yen could be a headwind for Japanese equities.

Best Case: Expectations of pro-growth policies have faded, allowing strong earnings growth to potentially lead US equity markets higher. Europe, meanwhile, continues to grow – growth that is less reliant on Germany, which has primarily driven the expansion so far, and more driven from several eurozone countries.

EMERGING MARKET EQUITY

Most Likely: Emerging markets are most likely to continue to benefit from a stable US economy and positive domestic environments in key countries. This, along with relatively attractive valuations and investors being underweight the region by historic standards, should lead to decent market gains.

Worst Case: Significant slowdowns in either China or the US could lead to troubles for the emerging market region. In the case of China, this could be due to a reduction in credit creation, which has already been noted. This could lead to a slowdown in economic activity in countries with significant trading relationships with China.

Best Case: The emerging markets region is exiting an earnings recession. If corporate earnings numbers are strong when released, then it could lead to significant inflows into the region and a re-rating of valuations, which could amplify the positive effects of the international environment on local markets.

CASH

Most Likely: It is most likely that the Bank of England keeps interest rates at 0.25 per cent, with the end result that the returns on cash accounts remain paltry, particularly with inflation at an annualised pace of around 3 per cent. The Bank of England will likely decide that it needs the stimulative effect of low rates to offset concerns about the Brexit negotiations, and to encourage consumer spending as it comes under pressure from inflation caused by sterling's depreciation.

Worst Case: Any deterioration of economic news could bring pressure on the Bank of England to raise rates even further. Although they are probably more likely to use other measures in this case – such as quantitative easing – it is possible that a rate cut could slash the returns available on cash. If inflation rises faster than expected this would reduce real returns further.

Best Case: Some members of the MPC believe the UK should raise rates, as the underlying data is still positive in their view. This could become a majority opinion in which case a rate hike to 0.5 per cent is possible, which would slightly increase the returns to cash accounts but only return us to where rates were before last June's EU referendum Brexit vote.

FIXED INCOME

Most Likely: It is most likely that gilts sell off slightly as the market adjusts to more political stability in the UK after the election. If this happens, then we would also expect UK corporate bond spreads to tighten more in line with their EU and US peers.

Worst Case: Gilts could sell off if UK economic data is strong. If the Bank of England decides to raise rates in response, this could strengthen this trend.

Best Case: There are some signs of economic weakness in the UK, specifically in consumer spending, which has been key to the country's post-EU referendum Brexit vote economic stability. Should there be further evidence for this then risk aversion could dominate in the UK gilt market, pushing yields back towards the 0.5 per cent they reached in the immediate aftermath of the 2016 referendum.

PROPERTY

Most Likely: Fundamental views have not changed since the previous quarter as nothing has moved the property market in the past three months. Rental growth remains modest in developed countries and property prices are still under pressure. Hence income will continue to drive returns. In the UK, the lack of clarity around the type of Brexit wanted by the government translates into a volatile market.

Worst Case: Rapidly rising rates are a threat to property markets as they reduce the yield gap between bonds and property and make the asset class less attractive. Any economy overheating would come close to this and present a risk to property markets.

Best Case: In the UK the government could potentially lower corporate tax to incentivise foreign businesses to set up office in the country. This would boost the office sector and push both rents and buildings prices higher. News about Brexit negotiations are likely to impact property prices too, just like positive macro data would support gains in the asset class.