Quarterly Investment Bulletin

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Headlines

- Global equity markets pushed ahead in the second quarter despite the threat of supply chain disruptions and challenging inflation numbers.

- Developed markets continue to be resilient despite the conflict in the Middle East not being fully resolved.

- Bond markets have struggled more in this environment and yields continue to fluctuate as rates have looked likely to increase.

- AI has caused higher levels of uncertainty as capital expenditure reaches significant levels and company valuations move to stretched levels.

- The UK economy was flat in the quarter as global political conditions influenced future projections of growth.

- The Bank of England maintained interest rates at 3.75% in May. Pressure for a rate hike has increased as a result of energy inflation caused by the Iran conflict, but overall inflation has started to fall in the UK.

- UK inflation was 2.8% in May.

- The US economy continues to drive ahead, and the stock market has again reached all-time highs as AI capex and high levels of employment support growth.

- The Federal Reserve installed a new Chair, but his tone was more hawkish than anticipated and interest rates stayed the same at the May meeting.

- Equity markets were robust as a resolution to the Iran conflict became more likely.

- Emerging markets continue to offer good returns but concentration in some markets is higher than in the US, especially in technology (chip) stocks.

General Economic Overview – Quarter 2 2026

Halfway through the year and the turbulence caused by the conflict in Iran continues to disrupt the global economy and markets. The uncertainty created by the various statements from the US government and the Iranian leadership have added fuel to the fire, causing large swings in sentiment in both the bond and equity markets. At the end of the second quarter there is significant belief that a settlement is near but, as at other points in the quarter, both sides seem to be offering different interpretations of the same set of solutions. A final agreement and an end to hostilities will be a relief for the global economy and should spark a new confidence in the minds of investors. GDP data across the globe is mixed and there is significant divergence in economic performance across regions. The US remains the strongest economy in the developed world, but emerging markets have posted a strong recovery over the last 18 months. Conversely European markets continue to struggle to raise the tempo of growth despite large infrastructure spending, although signs of recovery are starting to emerge outside of manufacturing. China is still growing at a reasonable pace but the unresolved issues around the property market continue to restrict consumer confidence and therefore the short-term growth prospects of the economy.

Without doubt the movement in the oil price has impacted the outlook for the global economy in recent months, influencing inflation and growth across both oil-producing and oil-consuming nations. The recent memorandum of understanding (MoU) between the US and Iran has eased concerns over escalating tensions, sending oil prices sharply lower during June. Fears of a major supply disruption, including warnings from the International Energy Agency, have not materialised which reflects several factors, including reduced dependence on energy in developed economies. Oil also plays a less dominant role within the broader energy mix, which limits the market impact of geopolitical tensions. The higher oil price is expected to have only a modest impact on US growth (-0.3% GDP), compared with a larger impact on Europe (-0.8%) and perhaps slightly more for Japan (source: FT). Inflation has been a persistent issue for central banks since Covid and whilst it had been heading downwards, the Iranian conflict put this on hold. Elevated inflation is expected in such circumstances and equity markets have wobbled as speculation on central bank action caused uncertainty. A new more dovish Fed chair has eased concerns, but his opening position was to offer a more hawkish tone, whilst maintaining rates at current levels after an unusual unanimous vote in the most recent Open Market Committee meeting.

The AI factor continues to drive sentiment across the globe, and valuations in certain sectors are as stretched as ever, causing volatility as investors worry about bubbles, but so far earnings have lived up to expectations. The amount of capex and concentration of value in these sectors will continue to be a major factor in how investors react to news each quarter as results emerge and will certainly influence stock market performance. Recent and future IPOs in the US will indicate confidence levels in the sector and its valuations.

The global macroeconomic environment in mid-2026 is characterised by persistent inflation, divergent growth trajectories, ongoing geopolitical risks, and significant sectoral shifts driven by AI and energy markets. Policymakers are balancing inflation control with growth support, and investors must remain vigilant to evolving risks and opportunities.

Equity Markets

Global equity markets have remained resilient through the first half of 2026, supported by robust corporate earnings, AI-driven investment, and improving business capital expenditure. US equities continue to lead, fuelled by technology and semiconductor stocks, and parts of Asia have benefited from stronger manufacturing and AI demand. European markets have lagged amid weaker growth and energy concerns. Investors remain alert to geopolitical tensions, inflation risks and policy uncertainty, which have increased market volatility. Despite these headwinds, the outlook for equities remains constructive, although elevated valuations and the concentration of gains in a handful of large-cap technology companies leave markets vulnerable to setbacks.

UK

The UK economy enters the second half of 2026 in a broadly stable, though still challenging, position. Economic growth has proved more resilient than many expected as GDP expanded by 0.6% in the first quarter of the year (source: Bloomberg), driven primarily by strength in the services sector. Inflation has fallen significantly from the double-digit levels experienced in 2022 and 2023 and is currently running at around 2.8% (source: FE Analytics), although it remains above the Bank of England's 2% target. Interest rates have been held at 3.75% as policymakers balance easing inflation against continuing wage pressures and uncertainty surrounding global energy markets.

Despite this improvement, the underlying picture remains mixed. Household finances are still under pressure as real disposable income declined in early 2026, while productivity growth and business investment remained subdued. Economists continue to forecast modest annual growth of around 1%, (source: IMF) reflecting longer-term structural challenges including weak productivity, skills shortages and the continuing economic effects of Brexit.

The UK stock market has been a brighter story. The FTSE 100 has benefited from attractive valuations, strong earnings from globally diversified companies, and expectations that interest rates may gradually decline over time. International investors have increasingly viewed UK equities as relatively inexpensive compared with US markets, helping to support both large-cap and mid-cap shares, particularly in sectors such as financials, energy, defence and mining.

Politically, the UK is entering a period of renewed uncertainty. The Labour government is focused on delivering economic growth through infrastructure investment, planning reform, and measures aimed at boosting productivity, but falling public approval ratings and increasing political pressure are creating questions about future fiscal policy and the government's ability to deliver its growth agenda. Investors will be watching closely to see whether political developments lead to policy changes that affect taxation, public spending and business confidence. Overall, while the economic backdrop is improving, both political and global risks remain key determinants of the UK's outlook.

US

Much of the noise surrounding the US has been focused on activity outside of the country, especially in the Middle East, and on AI, which is not just a US phenomenon. In the meantime, the US economy is proving to be consistently robust, and companies are meeting or exceeding earnings expectations, not just in the technology sectors. The main US indices have been volatile due to external events and changing sentiment about the level of capex being spent on AI and its potential to be the next bubble in markets. Market levels have been supported by corporate earnings which have been very strong, partly because many companies have benefited from a strong consumer and productivity gains. This isn't restricted to AI, for example in the healthcare sector, Eli Lilly's first-quarter sales rose 56% to US$19.8 billion, fuelled by surging demand for weight loss and diabetes drugs. In the energy sector, profits for companies such as ExxonMobil, Shell and TotalEnergies have increased as the Iran conflict sent oil prices sharply higher. Meanwhile, Apple reported blockbuster earnings in April, not due to any AI-related news, but because iPhone 17 sales skyrocketed.

Inflation in the US has been higher because of the Middle East conflict, but the US has been more insulated from the global supply issues as it is broadly self-sufficient in oil. The White House is very keen to resolve the conflict as the expectation of a resolution is one of the reasons the market keeps hitting all-time highs. There were some concerns that a new Fed chair would result in more uncertainty, but Kevin Warsh has calmed markets by offering a hawkish tone in his first days. Warsh had already stated he would look to improve the conduct of monetary policy, and the statement issued in June was both shorter and dispensed with forward guidance. The most important policy announcement was the creation of a taskforce in each of the five areas the Federal Open Market Committee (FOMC) view as central to the broad conduct of monetary policy – communications, the Fed's balance sheet policy, the use and reliance on existing data sources, productivity and jobs in an era of transformation, and finally the Fed's inflation frameworks.

Overall, the US economy remains in good shape, and employment data and consumer spending support this. The stock market continues to perform well but with more volatility as macro events dictate sentiment ahead of fundamentals. Certain sectors still look stretched in valuation terms but are supported by earnings at the moment.

Europe

European equity markets delivered a volatile but ultimately positive second quarter, with performance largely shaped by geopolitical developments in the Middle East and significant swings in oil prices. Early in the period, the escalating conflict triggered a sharp sell-off as Brent crude surged above $126 per barrel, intensifying concerns for Europe as a major energy importer. As expectations for a de-escalation improved and oil prices fell back towards pre-conflict levels, sentiment recovered strongly. The Euro Stoxx 50 rose more than 3% in June alone, reflecting this rebound in confidence.

Sector performance was uneven. Defence stocks underperformed despite the geopolitical backdrop, as investors focused on potential cost overruns and delivery constraints whilst luxury and consumer discretionary names, including LVMH, Hermès and Inditex, rallied as lower energy costs supported consumer sentiment. ASML remained a standout performer, benefiting from continued AI-related demand optimism and supportive commentary from the semiconductor sector. Banks also performed strongly across many markets, supported by expectations that higher interest rates would sustain net interest margins – Italy and Spain outperformed due to their higher financial sector exposure.

Macroeconomic conditions remained challenging, Eurozone growth was positive but below 1%, and Germany experienced a significant downward revision to growth expectations. Importantly, equity gains were driven more by improved sentiment and lower geopolitical risk than by earnings upgrades, which contrasts with the US where AI-driven earnings momentum played a larger role.

Europe had outperformed earlier in the year, but it lagged the US in Q2, particularly in constant currency terms given dollar strength. Fiscal spending and relatively low nominal rates near 2.25% remain supportive – Europe continues to trade at a valuation discount versus the US, but valuations are near the upper end of historical ranges and so earnings growth of at least 10% may be required to justify current levels. Key risks are renewed geopolitical escalation and a more hawkish global rate environment, both of which would disproportionately impact European assets.

Asia & Emerging Markets

The Chinese economy is facing growing pressure as efforts to shift growth towards domestic demand continue to struggle. Retail sales contracted in May for the first time in more than three years, and fixed asset investment fell 4.1% over the first five months of 2026. The prolonged property sector downturn remains the biggest challenge, undermining household wealth, consumer confidence and local government finances. Falling house prices and a weak labour market continue to constrain spending, suggesting that a meaningful recovery in domestic demand is still some way off, despite targeted policy support.

There are signs of resilience elsewhere in the economy. Strong export growth, rising industrial production and steady expansion in services activity helped support GDP growth of around 5% year-on-year in the first quarter. China also continues to prioritise strategic investment in technology and AI, with significant spending on research, semiconductors, computing infrastructure and digital self-reliance. While policymakers remain cautious about deploying large-scale stimulus, technology development and export strength are likely to be key drivers of growth in the near term.

Indian equities have underperformed so far in 2026 as concerns over slowing economic growth and earnings downgrades, particularly in the IT and financial sectors, have weighed on sentiment. Significant foreign investor outflows have added further pressure, although strong domestic inflows have helped provide some support. Having entered the year on relatively elevated valuations compared with regional peers, market performance is now increasingly dependent on earnings growth rather than valuation expansion.

India also remains sensitive to oil price movements due to its reliance on energy imports. Higher oil prices during the Iran conflict initially pressured consumer-related sectors, including autos, property and banks, although the subsequent decline in oil prices has helped a partial recovery. Concentrated foreign ownership in large-cap stocks has amplified market volatility, and domestic investors have increasingly favoured mid-cap companies.

Indonesia has been one of Asia's weakest markets in 2026, as equities fell sharply amid concerns over a potential MSCI downgrade to frontier market status and ongoing governance issues. Despite solid GDP growth of 5.6%, investor sentiment has been weighed down by uncertainty surrounding President Prabowo's expansionary fiscal policies and concerns over fiscal discipline.

Brazil and Mexico have delivered mixed performance in 2026. Brazilian equities have outperformed many emerging markets despite a sharp pullback from April highs, but high interest rates, rising inflation and political uncertainty remain key headwinds. Valuations appear attractive but weak earnings momentum and elevated real yields continue to limit investor appetite, with meaningful rate cuts unlikely before 2027. Mexican equities have generated modest gains, supported by strong foreign direct investment, nearshoring trends and a resilient economy. Inflation remains under control and monetary policy has stabilised following a period of rate cuts. Although markets may be range-bound in the near term, strong structural growth drivers, World Cup-related spending, and a credible policy framework support the longer-term outlook.

Emerging markets have performed well in the last six months but much like the US this has been built on the momentum created by technology stocks which makes the sector vulnerable to a reset if investors become fearful of a bubble. South Korea provides an example of this as the market is dominated by semiconductor giants Samsung Electronics and SK Hynix. Both companies have delivered strong profits and helped drive the Kospi index to almost double over the year, but the market is heavily reliant on the enthusiasm of domestic retail investors, raising questions about the sustainability of recent gains. As investors we need to be wary of this level of vulnerability when considering emerging markets as an alternative to the US.

Japan

Japan was a standout performer among developed equity markets during the second quarter, and the market rose by more than 20% in local currency terms (source: FE Analytics). Significantly, this strong performance has come despite continued weakness in the Japanese bond market, suggesting the rally is being driven by improving corporate earnings rather than abundant liquidity or accommodative monetary policy. Structural reforms are a key pillar of the investment case and years of corporate governance improvements have encouraged companies to focus on profitability, capital efficiency and shareholder returns, attracting renewed foreign investment and supporting a sustained re-rating of Japanese equities. AI and semiconductor-related companies have been among the strongest contributors to market gains, and Japan has also benefited from its status as a major energy importer, as falling oil prices have boosted corporate profitability and investor sentiment. The recent depreciation of the yen against the US dollar provided an additional tailwind for exporters, enhancing overseas earnings and reinforcing Japan's appeal as a market where company-specific improvements, rather than favourable global macroeconomic conditions alone, are driving earnings growth.

The earnings outlook continues to support this positive narrative. Consensus forecasts for TOPIX earnings per share growth (excluding SoftBank) are expected to accelerate from around 4% in 2025 to 14% in 2026, followed by a further 10% in 2027. Following a relatively subdued earnings year, Japanese companies have consistently exceeded expectations, underpinning the market's outperformance during the first half of 2026. The Tokyo Stock Exchange continues to encourage listed companies to improve returns on equity and capital efficiency while deploying substantial cash reserves through investment, mergers and acquisitions, share buybacks and higher dividends. Some domestically focused businesses have faced pressure from higher import costs caused by yen weakness, and real wage growth has lagged inflation (particularly in food and energy), but the broader earnings backdrop remains favourable. One notable exception has been the factory automation and robotics sector, where several companies have underperformed as Chinese competitors have steadily gained market share despite robust long-term demand for automation.

Fixed Interest

Recently, fixed income has become more closely tied to equity market movements and investor sentiment, rather than fulfilling its traditional role as a defensive offset to higher-risk assets. This may be a temporary trend, but it has meant that investors have needed to look elsewhere to offset risk in portfolios, especially when trying to deliver to a balanced risk profile.

The recent increase in bond / equity correlation reflects the shift to a higher inflation and interest rate environment that we have seen since 2020. Rising inflation has led to higher interest rates, which have generally been a headwind for both bonds and equities, making the two asset classes move more closely together. This contrasts with the 2000 - 2020 period, when low and stable inflation supported the traditional negative correlation between bonds and equities. Recent market behaviour therefore reflects a change in the macroeconomic regime rather than a permanent structural shift and if inflation and interest rates fall, the historical diversification benefits of bonds could re-emerge.

Understanding this relationship is important in the current environment. Rising interest rates have created a more challenging backdrop for bonds, and while inflation had been easing, the Iran conflict has delayed expectations of further rate cuts. Recent hawkish signals from the Federal Reserve have reinforced the view that rates may remain higher for longer, marking a significant change from the start of the year when markets anticipated a more accommodative policy outlook.

After a very challenging period for government bonds the medium-term outlook is more positive as long as we get a permanent resolution to the Middle East conflict. In the UK the move to a new Prime Minister is causing some concern as no new policy details will be set out until the new PM is in place. That said recent inflation numbers are heading downwards, and oil prices are falling so the direction for interest rates seems to be downwards, although we do not expect any BoE movement in the short term. The US is similar, although inflation has been on an upward trend in recent months which suggests that a move to longer duration assets is being seen more positively than for some time. Debt levels in both the UK and US are very high which creates vulnerability in market perceptions and so the new UK Prime Minister will need to carefully craft their words and policies to instil confidence in their regime. Elsewhere, Japan is on a different path as the Bank of Japan is gradually normalising monetary policy after years of ultra-low rates, which creates some upward pressure on Japanese government bond yields.

Corporate debt is in a strong position globally as companies have continued to reach profit expectations, especially in the US. The only overhang relates to the increased amount of debt issuance in the US linked to capital expenditure on AI and AI infrastructure. The demand for expansion in these areas is currently insatiable and has exceeded free cash flow, so has moved into the debt markets. The corporate debt market remains healthy with supply being met by demand, and the only obvious downside is that spreads are tight which suggests that risk is not being fully rewarded and so any gains made from interest rates coming down may be offset by a widening of spreads. In high yield, a lack of defaults and good corporate earnings bode well, alongside delivering high and sustainable yields.

Alternatives

Infrastructure was one of the more resilient asset classes during the quarter, benefiting from its defensive qualities amid economic uncertainty and geopolitical tensions. Returns were supported by inflation-linked revenues and the essential nature of infrastructure assets, including utilities, energy networks, transport and digital infrastructure. Investor demand remained strong for structural growth areas such as renewable energy, battery storage, electricity transmission and data centres, driven by electrification and AI-related power demand. Listed infrastructure performance was mixed, although airports, toll roads and digital assets generally performed well. Stable cash flows, reliable income streams and expectations of lower interest rates continued to make the sector attractive for diversification and long-term investors.

The commodities market experienced a volatile but generally positive quarter, driven largely by geopolitical tensions and supply-chain disruptions. Energy markets were the standout performers as oil prices surging during the quarter following disruptions to Middle East supply routes, although prices eased towards quarter-end as fears of a prolonged supply shock moderated. Although gold has retreated from recent highs, precious metals remained relatively stable and continued to benefit from demand for safe-haven assets amid geopolitical and inflation-related risks. Industrial metals such as copper were supported by structural demand linked to electrification, infrastructure investment and artificial intelligence-related power requirements, despite concerns about slower global economic growth. Agricultural commodities experienced pockets of strength as fertiliser and transportation disruptions raised concerns about future supply. Overall, commodities outperformed many traditional asset classes during the quarter, although performance varied significantly between sectors, but investors should remain mindful that easing geopolitical tensions and a slowing global economy could lead to greater price volatility in the second half of the year.

Commercial property delivered modest but positive returns over the quarter, supported by resilient rental growth despite a slowdown in transaction activity. According to the MSCI UK Property Index, all-property total returns were 1.3% in quarter one 2026, taking 12-month returns to 5.6%. Retail was the standout sector, returning 1.8%, while offices also performed strongly at 1.6%, benefiting from continued demand for high quality, energy efficient space. Industrial and logistics assets were supported by tight supply, although rental growth has moderated from the exceptionally strong levels seen in recent years. Investment volumes were weaker as higher gilt yields, geopolitical uncertainty and tighter credit conditions meant some investors remained cautious. Nevertheless, UK REITs generally performed better than direct property valuations would suggest, helped by expectations that interest rates may gradually decline and by the narrowing discounts to net asset value seen across the sector. Short-term volatility remains possible but improving income yields and stabilising property values have contributed to a more constructive outlook for both commercial property and listed REITs.

Alternative assets are becoming a significant holding in many multi asset portfolios as managers look for diversification from traditional assets, to reduce the risk when bonds and equities become more closely correlated.

Summary

At the start of 2026 investors expected US interest rates to fall and Fed expectations published in March showed one cut was likely over the calendar year. The war in Iran and appointment of the new Chair of the Fed have transformed market expectations and one rate rise is now being pencilled in. A more sustained rise in US interest rates or longer-term bond yields would put market valuations under pressure, and 10-year US Treasury yields above 5% would cause a problem for the market, although this is a long way off.

The strong outperformance of mega caps has meant market indices have become more concentrated across most regions. In the US, the top 10 stocks account for 40% of the S&P 500 Index, TSMC alone accounts for close to 15% of the MSCI Emerging Markets Index, and the Korean memory chip makers SK Hynix and Samsung Electronics are over 50% of that benchmark. Part of the reason these stocks have become such large index constituents is their strong levels of profit growth, both in the past 12-months and on forecasted earnings over the next couple of years. Whilst many valuation indicators for the US look stretched, on 2-year forward multiples the US is not particularly expensive versus its recent history. Investors might focus on headline comments about market concentration, but company earnings and fundamentals will determine the relative performance of these stocks rather than their starting weight in any particular index.

For the remainder of 2026 economic outcomes based on fundamentals will hopefully dominate the investment landscape. Whilst growth and inflation numbers have both worsened, the bleakest outcomes appear to have been avoided and if oil prices hold at lower levels, then fundamentals could be more positive in 2027. As long as future earnings numbers are delivered, current valuation levels can be justified. In regional markets, Asia and emerging markets look well placed to deliver further gains as long as there isn't an aggressive US tightening cycle, and the profits outlook in Japan remains positive over the next few years aided by continued self-help and improved governance. Europe needs to demonstrate higher fiscal spending which can then translate to stronger levels of profitability.

Now that the conflict threats have reduced, fundamentals are more positive and valuations, although not cheap, can be justified if corporate earnings come through as expected. Market sentiment indicators are elevated but not excessively so and equities look well-positioned to deliver further gains over the year although at a slower rate than occurred in quarter two. Overall, investors should retain their exposure to equities as long as they can tolerate periods of volatility which will continue to be a theme in markets given the geopolitical backdrop.

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