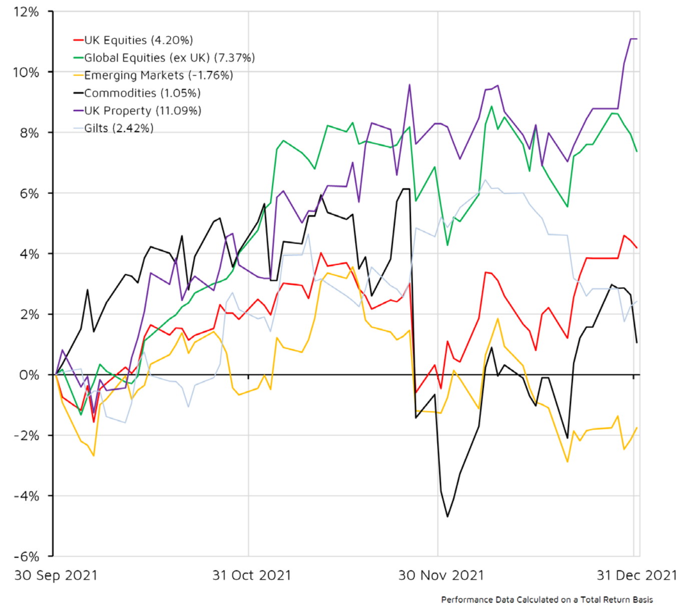
WINTER OUTLOOK

REVIEW OF THE PAST QUARTER:

Rising inflation, ongoing supply chain problems, speculation about central bank interest rates and the emergence of the Omicron variant has driven markets this quarter. Most developed equity markets produced positive returns; however, there were periods of considerable volatility. The emergence of the more infectious Omicron variant sparked a particularly short and sharp sell-off when it was detected in late November.

US equities benefited from positive sentiment for most of the quarter, helped by Jerome Powell's nomination for a second term as US Federal Reserve chair. However, the Fed's indication that it will raise interest rates faster than expected in 2022 caused high-performing tech stocks to fall towards the end of the quarter. European equities fared well but UK equities lagged for most of the period and most equity markets faded in early December due to concerns about further Covid-19 disruption.

Gilts produced strong returns as they were boosted by the Bank of England's decision to leave interest rates unchanged in November and then received further support from the flight to safety caused by the spread of the Omicron variant. Property had a very robust quarter as the post-lockdown property boom continues to drive prices up. Oil prices fell as uncertainties around Omicron, and its impact on global growth, eased demand.



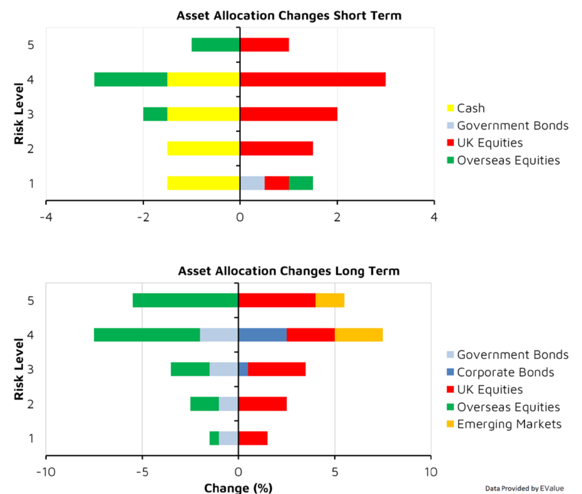
ASSET CLASS RETURNS

Cash	Government Bonds	Index Linked Bonds	Corporate Bonds	UK Equities	Overseas Equities	Emerging Markets	Property
-0.01%	+2.42%	+4.94%	+0.40%	+4.20%	+7.37%	-1.76%	+11.09%

THE ACTUARIAL VIEW:

Financial markets are indicating that interest rates will increase in the near future, and higher interest rates mean higher expected returns in general. For bonds in the short term that offsets the higher starting yields. By the same token, increasing rates bring the possibility of earning some interest on cash so short-term rate rises are likely. Relatively weak demand for bonds with relatively healthy prospects for issuers is a benign environment for corporate credit investors, and the prospects for corporate bonds have improved a little more than for government bonds.

Further signs that UK financials successfully weathered the pandemic, a positive outlook for the energy sector and a strong US dollar all give UK equities an edge over other markets. US valuations remain elevated and prospects fell behind a little, as did European equities. A rocky period for China hangs over Asian and emerging market equities but the outlook for energy-producing emerging economies like Russia and Brazil means emerging markets seem to have more legs. Some confidence is returning to property markets but the full impact of Covid-19 disruption is still not clear, and issues like rent arrears remain unresolved.



WHAT TO LOOK FOR:

- **UK**: The Bank of England Monetary Policy Committee announcements and minutes are set to be released on 3 February and 17 March. Preliminary GDP growth for Q4 2021 will be released on 11 February. Labour market overview to be published on 26 January.
- **US**: There will be interest rate decisions from the Federal Open Market Committee (FOMC) on 26 January. Minutes from the FOMC meeting will be published on 16 February. GDP growth for Q4 2021 will be released on 27 January. Core inflation for December 2021 will be released on 12 January.
- **Eurozone**: Flash data for GDP growth for Q4 2021 will be published on 31 January. European Central Bank monetary policy meetings will be held on 3 February and 10 March. Unemployment for December is to be published on 1 February.
- **Other data**: Opec meeting is to be held on 4 January. Caixin China General Manufacturing PMI is due on 4 January and the JPMorgan Global Composite PMI on 6 January.

ASSET CLASS SCENARIOS:

UK EQUITY

Most Likely: Even if Covid-19 is contained, consumer confidence could be affected by inflation. The Bank of England's interest rate increase reflects a tight labour market and rising inflationary pressures, which will affect UK-focused small and mid-sized businesses. Global recovery will be slower as central banks start winding down monetary stimulus. Large companies with globally diversified income should fare better but we expect a highly volatile market in the coming months.

Worst Case: The fast-spreading Omicron variant could hit demand and supply and additional restrictions would harm many sectors. This could add to supply-chain strains and push up costs. Small and mid-sized companies would struggle the most. Large companies in the travel sector or those with international supply chains will also feel the effect.

Best Case: Milder effects from the Omicron variant could mean any extra restrictions are short-lived. The normalisation of international supply chains and a reduction of monetary stimulus that eases the pressure on labour markets should support profits. Higher inflation and higher rates would support sectors such as banks, mining and energy.

GLOBAL EQUITY

Most Likely: The impact of the new Covid-19 strain could put pressure on economic recovery, especially in Europe, even though prolonged lockdowns appear unlikely. Inflation should remain elevated in the short term but the US Federal Reserve has decided to accelerate its wind-down of stimulus. The European Central Bank has remained more accommodative and it likely to be flexible within its mandate as Omicron stirs uncertainty about economic recovery.

Worst Case: Persistent inflation, tied to supply disruptions and soaring energy prices, could trigger wage inflation and push central banks to hike rates sooner and faster, potentially hampering global equities. Moreover, a vaccine-resistant strain leading to renewed lockdown measures could result in a negative impact on developed equities, with cyclical companies and small- and mid-caps hampered the most.

Best Case: Global equities should benefit from global recovery, and the easing of supply chain strains should help stabilise inflation. Japan's record US$490 billion stimulus package and positive earnings revisions should support Japanese equities. The European Central Bank's flexible monetary policy should provide some relief for European equities.

EMERGING MARKET EQUITY

Most Likely: The global recovery should shift assets from 'safe havens' to riskier assets such as emerging markets, putting downward pressure on the US dollar and strengthening emerging market currencies, exports and future growth expectations. The 'green revolution' will benefit emerging markets via strong commodity demand and pricing.

Worst Case: Further Covid-19 mutations could force localised shutdowns, stalling recovery and forcing central banks to keep quantitative easing in play. Premature increases in US interest rates could provide support for the US dollar, but as a majority of emerging market debt is in US dollars this could weaken company balance sheets. Any further escalation in Chinese regulatory scrutiny or US-China tensions could materially weigh on investor sentiment.

Best Case: Successful vaccination programmes coupled with limited future mutations and waves of Covid-19, will prove supportive. The 'green revolution', backed by many stimulus programmes, will provide a tailwind to many emerging market economies. When the regulatory tone in China changes, we could see a strong rally.

CASH

Most Likely: Yields available for money market instruments remain low despite the Bank of England becoming the first major central bank to increase rates. Inflation remains far higher than the official target but the chance of further hikes in the first quarter is low due to the rapid spread of the new Covid-19 variant. If December's rate hike is not a one-off, the price of money market instruments could drop significantly and more than offset the increase in yields. However, cash remains compelling for investors concerned about equity and bond valuations.

Worst Case: Although there is almost zero probability of the Bank of England exploring negative interest rates, the delay in lifting all restrictions means yields for money markets are anchored to very low levels. Any increase in Covid-19 infection rates might force investors to reassess yields, lowering the returns expected

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Best Case: If inflation rises above expectations, the Bank of England may further rate hikes. If so, it is likely that the interest rate curve will steepen, which would slightly improve the return from money market funds, as managers can lock higher rates at longer maturity dates.

FIXED INCOME

Most Likely: The Bank of England increases interest rates further in February due to rising inflation but the move is anticipated and has limited impact on bond prices. Some corporate bonds fall due to persistently high Covid-19 infections but the wider market is largely unaffected. Investors speculate about the Bank of England's bond purchases but no formal announcement means gilt yields are stable.

Worst Case: Inflation continues to rise and this prompts the Bank of England to increase rates and indicate plans to accelerate the unwinding of its bond purchase programme. This puts upward pressure on longer dated gilt yields. A lack of fiscal support means borrowing costs for businesses in a number of sectors spike, resulting in declining corporate bond valuations.

Best Case: Rising Covid-19 cases do not result in significant pressures on health services and restrictions are eased. Corporate bond valuations in coronavirus affected sectors rebound. Distressed borrowers are limited to small sections of Emerging Markets but Chinese bonds rally due to loosening monetary policy support. The Bank of England maintains its bond buying programme which supports gilt prices.

PROPERTY

Most likely: The spread of the Omicron variant and a slowdown in economic growth present headwinds. Sectors like residential and healthcare should continue to perform well. The outlook is also positive for companies that have greater pricing power, which should outperform if inflationary pressures remain high. A reintroduction of lockdown could hit occupancies and rents, limiting the potential upside.

Worst case: Omicron disruption and a reintroduction of restrictions would hit some sectors, particularly those operating within economically sensitive areas such as retail, offices and leisure. While property should perform well on a relative basis in a higher inflation environment, a sharp rise in bond yields in response to high inflation could cause the sector to tumble in the short term.

Best case: Omicron disruption is less than first feared and the global economic recovery from the pandemic continues. The sector's high-dividend and defensive characteristics means it should perform relatively well in an uncertain environment as cautious investor positioning should see defensive and inflation hedge assets strengthen.

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