

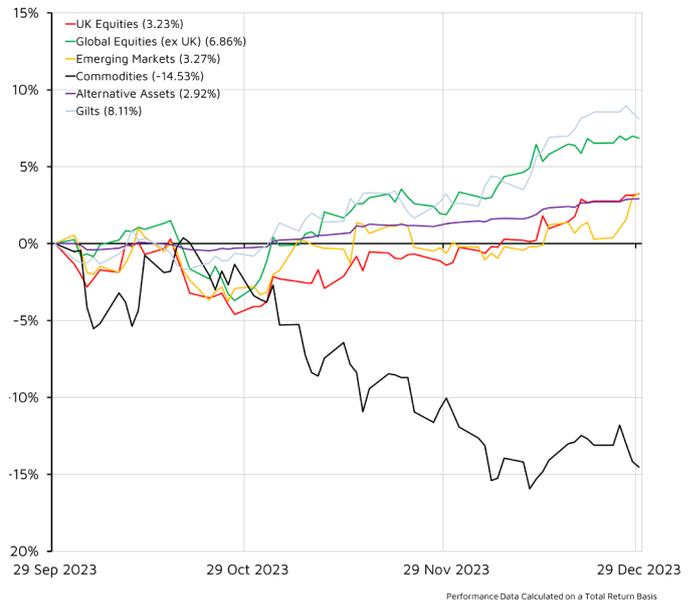
REVIEW OF THE PAST QUARTER:

The rapid decline of inflation caused a big shift in investors' expectations about central bank interest rates. Until recently central bankers have insisted rates would rise further and then remain higher than markets were anticipating. As inflation has fallen further back towards its target, bond markets' acceptance of this narrative has given way to expectations of significant rate cuts beginning in the first half of 2024.

This change in sentiment helped lift financial markets as government bonds experienced an aggressive rally. Rising bond prices pushed yields down from recent highs and the yield on benchmark ten-year US treasury bonds fell from almost 5% to 3.9%. UK government bonds also recorded significant gains as the 10-year gilt yield dropped to around 3.5%.

The potential for rate cuts spurred global equities to further gains. The US market outperformed led by large, high-growth technology. European equities also produced strong gains, despite economic activity declining. Japanese equities continued their recent rally, although at a slower pace. Emerging market equities received some respite as a weaker US dollar helped offset concerns about sluggish economic growth in China.

The price of oil fell, despite the outbreak of war between Israel and Hamas in Gaza, as the outlook for economic growth in 2024 deteriorated.



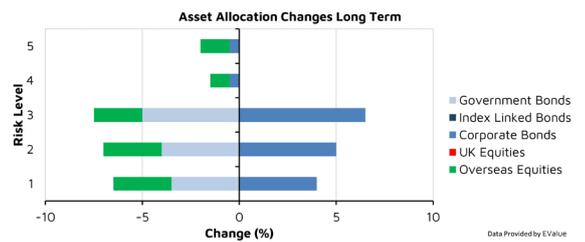
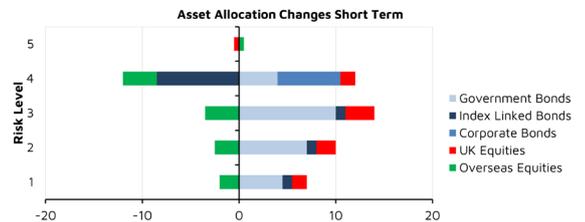
ASSET CLASS RETURNS

Cash	Government Bonds	Index Linked Bonds	Corporate Bonds	UK Equities	Overseas Equities	Emerging Markets	Property
+0.90%	+8.11%	+8.72%	+7.37%	+3.23%	+6.86%	+3.27%	+2.92%

THE ACTUARIAL VIEW:

Markets are positioned for a positive start to 2024. The soft-landing scenario – where inflation is brought gradually back to target without any further rate hikes and no significant decline in economic activity or uptick in unemployment – is seen as supportive of equity values. Global economic growth is predicted to slow, but the outlook is seen as positive for equities – although weak earnings growth is likely to limit any gains. Expected central bank rate cuts would be supportive of government bonds, and yields are expected to drift lower.

This positive view is not the only plausible outcome. Interest rates remain far higher than the recent average and there are growing signs of economic slowdown. The time lag between rate hikes and their full impact means the effect of the hikes already in place is still to be seen. Any sign that inflation is rising could see central banks take further action. This means that recession cannot be ruled out, despite the positive mood among markets. If recession does arrive this would be negative for equity markets that are priced for a gentle slowdown. Japan remains the region with the most positive outlook as markets prepare for the Bank of Japan to end the country's negative interest rates, if it can see steady wage growth and mild inflation.



WHAT TO LOOK FOR:

- UK:** Monetary Policy Committee (MPC) announcements and minutes are set to be released on 1 February and 21 March. Employment data is released on 16 January. Inflation data will be available on 17 January. Consumer confidence and retail sales data to be published on 19 January.
- US:** Interest rate decisions from the Federal Open Market Committee (FOMC) are due on 31 January and 20 March; minutes will be published three weeks after each decision. Monthly inflation data is released on 11 January. December retail sales data is due out on 17 January. Nonfarm payrolls employment data is released on 5 January.
- Eurozone:** December inflation data is set to be published on 17 January. The European Central Bank monetary policy meetings are on 25 January and 7 March. The unemployment rate is set to be published on 9 January.
- Other data:** Chinese December inflation data is due on 12 January and balance of trade data is due on 13 January. Chinese quarterly GDP growth is due on 17 January.

ASSET CLASS SCENARIOS:



UK EQUITY

Most Likely: Inflation falls as the Bank of England hold rates steady, though the path is not completely smooth. The outlook stays gloomy as recession is a possibility. Large companies continue to do better than small and mid-sized companies. Companies closely tied to consumers will suffer more acutely than less-exposed peers. Global markets are volatile and growth is suppressed as geopolitical tensions remain high as markets wait to see if a soft landing will materialise.

Worst Case: War in Ukraine and the Israel/Gaza conflict cause energy bills to rise – pushing up inflation. Aggressive interest rate rises and rapid reduction in central bank balance sheets sends markets into a deep recession as stocks and bond sink. This culminates in the collapse of an unexpected area and a run on the wider market. The UK should be more defensive than other regions due to lower relative valuations.

Best Case: Recent rate hikes bring inflation back to target without a significant rise in unemployment or drop in GDP. UK equities rebound strongly from relatively low valuations as the economy returns to growth. An end to war helps cool energy, food and commodity prices, further reducing inflation. Flows into UK equities turn positive as sentiment improves and smaller companies benefit the most.



GLOBAL EQUITY

Most Likely: As inflation continues to drop and economic activity slows attention turns to rate cuts. Monetary tightening continues to affect the real economy as US consumers burn off pandemic-era savings. Sectors like technology and communications benefit from significant rate cuts. In Europe, a weak economy and falling inflation bring expectations that the European Central Bank will be the first to cut rates.

Worst Case: War in Gaza spreads pushing up energy and food prices. Central banks raise rates again as they fight stagflation. Energy and defensive sectors are the best place to hide. European markets suffer due to their reliance on food and energy imports. A big drop in global trade would drag on the export-oriented Japanese market.

Best Case: An end to war in Ukraine and a ceasefire in Gaza creates optimism that commodity supplies will begin to flow more freely. Increased energy supply from North America and Brazil brings down the oil price significantly, easing inflationary pressures. The Chinese economy rebounds as issues in its real-estate market are resolved. Inflation declines rapidly, allowing central banks to cut interest rates. A global bull market ensues and all corners of the market are lifted.



EMERGING MARKET EQUITY

Most Likely: China's decision to prioritise industrial policy over boosting domestic demand disappoints investors hoping to see more forceful stimulus. Problems in the property market drag on economic growth, given it is one of the economy's central growth drivers, potentially reducing wage and spending growth. Investors continue to resist investment in Chinese markets if geopolitical tensions rise.

Worst Case: Chinese monetary easing and stimulus measures are unable to restore consumer confidence. China's property market deteriorates which further diminishes investor sentiment. Inflation in developed markets remains sticky, reducing global demand for Chinese exports and posing a negative effect on various emerging-market currencies. Heightened geopolitical tensions may escalate in a Chinese invasion of Taiwan; however, the probability of this is relatively low.

Best Case: China uses more forceful stimulus to boost domestic demand and shore up the property market. A pause or cut in rates by the US Federal Reserve would be favourable for emerging markets. Indian growth continues, fuelled by increased foreign investment, and the 'nearshoring' drive by the US is positive for Latin America.

Data Sourced from FE Analytics, and FactSet

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CASH

Most Likely: Money market instruments continue to provide high yields with minimal risk as the Bank of England leaves rates unchanged. However, returns may be less attractive relative to government bonds due to their sensitivity to interest rates as the market begins to price in rate cuts for 2024 amid falling inflation.

Worst Case: The Bank of England may be expected to start cutting rates if signs of recession appear, reducing the interest paid by money market funds and increasing the attractiveness of government bonds. Cash instruments will therefore be a less compelling option for investors.

Best Case: Money market instruments continue to provide high yields with minimal risk as the Bank of England leaves rates unchanged in the face of a resilient economy. Returns adjusted for inflation are likely to improve as inflation falls.



FIXED INCOME

Most Likely: Central banks have finished raising rates and although inflation appears under control they must carefully time their actions to avoid driving up unemployment. If inflation continues to towards its target confidence grows that central banks do not need to engineer a hard recession and government and corporate bonds rise.

Worst Case: Inflation stays persistently high. Higher-for-longer rates mean bonds start to struggle again in a stagflation situation. The premium paid by corporate borrowers spikes, as the ability to pass on inflationary price rises diminishes in the face of sagging consumer demand. Defaults and repossessions rise in US real estate, and investors suffer capital losses across other risky credit markets.

Best Case: Central banks begin to cut rates at the end of the first quarter as inflation falls towards target. Even if a recession does occur it is merely a short, technical event. Returns are strongly positive for the likes of UK gilts and US treasuries. Global investment grade corporate bonds and more speculative high yield bonds also benefit from confidence in a stabilising business environment. Profit margins are stable, and defaults remain low.



ALTERNATIVES

Most Likely: The outlook for traditional asset classes is mixed as the market continues to focus on central bank policy and economic conditions. Listed real assets such as REITs and gold miners have been fallen in value since 2022 due to the rapid rise in interest rates, but they should benefit if inflationary pressures ease and the market sees a visible path to rate cuts. However, stubbornly strong US growth and a hawkish stance by the Federal Reserve could mean share prices continue to be challenged. Investment strategies that are more dynamic and can benefit from moves in asset prices in either direction, such as global macro and long-short equity, should benefit.

Worst Case: More benign conditions where equity markets rally, led by large US technology stocks, would likely lead to relative underperformance of listed real assets and most alpha strategies.

Best Case: Rising market volatility and dispersion would allow alternative assets with low correlations to major asset classes and well-positioned active managers to deliver strong relative performance.