
Investment review

Hope of a quick resolution to the Iran conflict has helped drive a very good recovery in global stockmarkets in the second quarter. The conflict has dominated news headlines and clearly been a significant influence on economic activity and investor sentiment in recent months, but markets have been encouraged by the recent news surrounding a ceasefire and progress towards reaching a deal. Continued confidence and momentum in AI and broader technology-related stocks, backed up by strong earnings growth and future revenue optimism, has also been a big contributor, extending beyond the US into Asian markets – these two regions have helped drive some very encouraging returns for investors in the year to date. European markets have also recovered in the second quarter after being hit quite hard by the energy-related uncertainty, yet gains have also been contained somewhat by the under-representation of technology-related companies in Europe's key benchmark indices. Even bond markets have seen some recovery more recently as concerns over a prolonged US/Iran conflict – with its negative connotations for both inflation and interest rates – have eased.

The signing of the so-called 'Islamabad Memorandum of Understanding' does not mean we have a signed agreement yet, but it does scope out a framework that should provide for an end to military strikes, a durable reopening of the Strait of Hormuz to commercial shipping, an end to the US naval blockade of Iranian ports and a 60-day extension to the ceasefire. It is not yet full steam ahead in the Strait of Hormuz, but the tentative reopening of this vital energy trade artery to shipping traffic has sent the oil price sharply lower, currently close to \$70 per barrel of Brent crude oil, having been above \$110 at times during the month of May.

Some caution is still appropriate



Whilst there is more encouraging news on the Middle East front, we do retain some caution as there will undoubtedly be some difficult negotiations in the weeks ahead before a formal deal is signed. We also acknowledge that, if and when a firm agreement is reached (and assuming it holds), there will be question marks over how quickly the current backlog of energy-related and broader trade will take to clear: this will be a logistical challenge in itself, but could be complicated further by a lack of clarity on tolls and insurance costs, and perhaps a reluctance by some shipping operators to weigh anchor until there is greater certainty of a safe passage through the Persian Gulf's waters.

Recession or stagflation avoided

Nevertheless, these developments are undoubtedly positive and push expectations more firmly towards our 'base case' scenario, which is that the impact of the Iran conflict will not be sufficient to lead us into recession or a 2022-type 'stagflationary' environment – which was triggered by the war in Ukraine – of weakened growth and high energy-linked inflation, or derail the investment case for risk assets.

So far, actual data and forecasts point to a relatively modest retrenchment in global economic growth this year followed by a recovery in 2027 – back to pre-conflict estimates of around 3% – with the more direct impact of the Iran conflict being felt mainly in Europe, an area where we have moderate exposure.

US, Asia and AI driving the global economy

Strength in the world economy has continued to emanate from the US and Asia, with the former showing particularly good economic resilience to the Iran conflict, much due to its energy independence and technological world dominance, especially where AI is concerned.



Some Asian economies, including South Korea and Taiwan, have also been able to use the booming demand for AI and technology hardware as a powerful economic cushion, helping them counteract some of the conflict-related challenges of higher imported energy costs. Furthermore, many Asian economies, notably China, have benefitted from reduced trade policy uncertainty in recent months after the US Supreme Court's ruling in late February: this has led to the effective toning down of some of the harshest 'Liberation Day' tariffs announced last year.

One could argue that trade tariffs have evolved into a permanent structural reality for the global economy, making their impact – and the unpredictable policymaking behind them – a constant fixture of modern supply chain management and cross-border trade. With the Iran situation seemingly de-escalated and US mid-term elections looming fast, hopefully one can also assume that the US president is unlikely to want to up the ante again on global tariffs. The US and Asia remain key components of our asset allocation, and we see these regions as being important drivers of future long-term economic and stockmarket growth from which investors can benefit.

Lagging inflation keeping central banks on their toes

In the near term, however, inflation and its impact on interest rate policy remain two key factors currently influencing market sentiment. These are likely to keep both central bankers and investors on their toes over the coming months. There is an understandable, slightly hawkish, tone in central bank rhetoric at present as they warn about the risks of complacency with regards to the inflation outlook, particularly if energy production and supply remain disrupted for an extended period and the second-round inflationary impacts last longer than expected. It is still quite early to assess what these effects will be and how long any lagged effects will last. In the UK, for example, CPI inflation may have steadied at 2.8% recently but is still expected to climb as the rest of the year unfolds: Ofgem's 13.5% increase in the energy price cap from July will undoubtedly contribute to the expected inflationary hump.

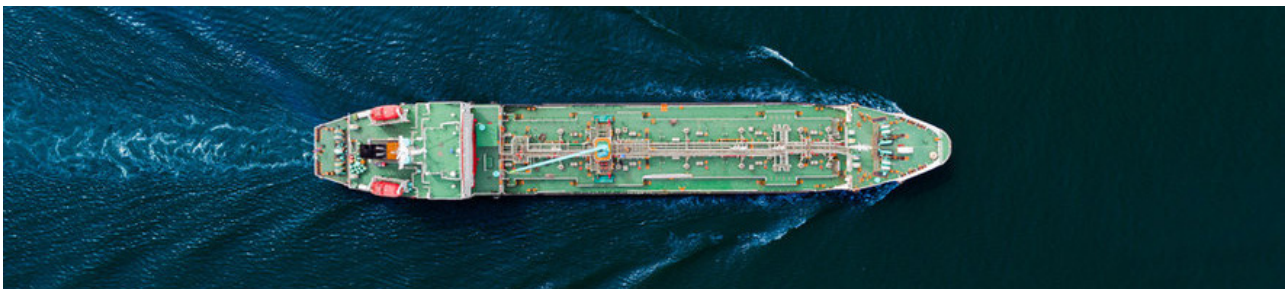
But the good news is that monetary authorities will be aware this is not a demand-led inflation shock but a supply-led one. So, with a US/Iran deal in the offing they will know this is more likely to be a temporary situation than one requiring immediate action. Of the world's major policymakers, only the European Central Bank has so far found it necessary to hike rates, albeit from a lower base, as a direct consequence of the energy crisis (Japan is also raising interest rates, but in response to broader inflation trends within its economy).

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An oil glut to come?

Whilst we are hopeful that the inflationary consequences will pass relatively quickly, the situation does still mean central banks face some tough policy decisions in the short term. For instance, will they focus more on the (upward) inflationary impact or (negative) economic growth impact of the energy supply shock in their rate decisions? Their work is not just complicated by lag effects within the wider economy, but also by some longer-term factors within energy markets which are a key component of the inflation statistic. For example, there is an argument that once we are through this supply-side energy shock, there may well be a period of oil oversupply as the United Arab Emirates, having freed itself from OPEC's tight supply guidelines, delivers more oil to the market and we also see more production originating from countries such as Brazil, the US and potentially Iran itself if sanctions are lifted.

Estimates for this extra production could be up to four million barrels per day, approximately 3-4% more than the world actually needs on an annual basis. Whilst some countries will likely initially look to restock their own depleted reserves, thereby keeping oil demand and prices quite high, in due course this extra supply could suppress the oil price significantly and, in turn, ease inflationary pressures. Additionally, some further moderation in longer-term inflation could come if, on the back of the Iran crisis, countries look to reinforce their energy independence, causing demand for traditional oil-related energy to wane in favour of alternative energy sources. The impact of the oil price on inflation may therefore reverse in the future.



New broom at the Fed

In the meantime, most of the financial market attention is still focused on the likely response from the US central bank in the second half of the year. Kevin Warsh's inaugural meeting as US Federal Reserve ('Fed') Chair has given a clear signal that the rate-setting committee is in no mood to bow to any persuasive influence from the White House. It has also shown solidarity in removing the previous bias under former Chair Jay Powell, which had indicated most committee members were in support of easing monetary policy. This subtle shift towards a more hawkish stance on interest rates highlights the Fed's lingering concerns over the inflationary impact of the Iran conflict, which has seen headline Personal Consumption Expenditures ('PCE') inflation, the Fed's preferred measure, drift up to 4.1% in May, well ahead of its 2% target.

With the ink still drying on a sketchy outline plan to end the Iran conflict, the Fed is understandably exercising some caution, having sight also of a recovering jobs market, strength in consumer spending and an economy that is expanding at a solid pace. Market expectations for US interest rates have now shifted from two potential cuts to at least one increase in the second half of this year, but the timing of any move is very uncertain and will be heavily data dependent: on the one hand, evidence of softening inflation on the back of lower energy and food prices may push any rate hike into the final quarter; yet on the other hand, loose financial conditions and a strong stockmarket could sustain the current economic momentum, slowing down the decline of inflation.

Cash reductions – alternatives now more attractive than bonds

This juxtaposition not only makes the new Fed chair's role quite tricky, but it also complicates the backdrop for bond markets, giving investors little, if any, certainty over the things they rely on most, i.e. inflation and interest rate clarity. For this reason, and taking all the aforementioned factors into account, we are not yet minded to re-commit the cash we raised from fixed interest investments at the beginning of the Iran conflict back into this asset class. Instead, we prefer to reallocate to alternative investments where we believe we can find better, and less volatile, sources of return which show lower correlation with fixed interest (and equity market) behaviour, whatever the paths taken by inflation and interest rates are from here.

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We are therefore reducing cash levels for those mandates where it is currently elevated and increasing the commitment to alternatives, introducing a fund that will diversify the present mix and has the tools to deliver, hopefully, a competitive real return marginally ahead of that expected from both bonds and cash in the coming year.

Goldilocks fending off the bears

Whilst all the talk of potential interest rate rises does act as a possible dampener on sentiment near term, particularly (as noted) on fixed interest markets, it is worth noting that at this stage we are neither staring down the barrel of big shifts in monetary policy nor a prolonged rise in inflation, unless of course the current Middle East peace plan unravels spectacularly. Assuming central banks remain disciplined and both interest rates and inflation, after a brief hiatus, do resume their pre-conflict downward paths, then the risks of stagflation or recession should dissipate quite quickly.

This should shift the rhetoric more towards a 'Goldilocks' scenario where both equity and bond markets respond well to balanced, or 'just right', economic conditions that foster the ideal conditions for sustainable economic growth, without resulting in significant inflationary pressures or leading to an economic slowdown.

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Valuation vindication

One could argue that stockmarkets are already anticipating this more benign outlook, having rebounded strongly from the lows in March and being supported by a healthy corporate backdrop. At first sight, it may seem that markets are defying gravity, but a closer inspection shows that in most areas markets are actually cheaper on a fundamental price-versus-profits basis than they were before the Iran conflict began, principally thanks to some very strong corporate performance and an expectation that the future inflation and monetary backdrop (i.e. into 2027) will be conducive to a continuation of this trend.

It is understandable that some investors and media outlets are scratching their heads at some extraordinary moves in share prices in certain corners of global stockmarkets, notably in broad technology-related sectors, but in the main corporate earnings are in rude health and justifying both current and future valuations. In the US, for example, we have seen profits for S&P 500 Index constituent companies grow by more than 20% in the first half of 2026 and there are similar forecasts for the next two quarters, driven by AI infrastructure and technology sectors, but also aided by recoveries in energy and materials companies.

Aside from our commitment to a global AI fund, which continues to perform very well, we have altered the balance within our US market allocations in the past year to capture more of the positive momentum in technology and AI-related sectors, specifically introducing more exposure to those larger companies at the forefront of innovation and which we believe can generate further superior returns for shareholders. We are currently making some further minor adjustments in this regard to ensure we have good exposure to the heart of this secular, transformative technological change.



Greenback in vogue again

In the near term at least, the combination of an increased chance of a second-half hike in US interest rates and more resilient economic landscape does suggest the US dollar will retain some strength. For sterling-based investors, a resultant stronger dollar and the positive impact on US investment valuations, ought to help cushion any negative influences brought about by higher policy, should it arise. In the UK, however, we envisage the pound coming under further pressure against a challenged economic, fiscal and political backdrop.

As a result, and despite inflationary concerns still circling, the Bank of England ('BoE') is quite understandably continuing to exercise monetary policy restraint by holding interest rates at 3.75%, with the likely divergent policy trajectory to the one expected in the US also creating relative weakness in sterling versus the dollar. As seems increasingly likely, if the BoE is forced to cut, rather than hike, rates to focus more on reviving the economy than on addressing near-term inflation, then this currency divergence could grow.

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UK stockmarket detached from political and economic woes

As noted, the UK's fiscal position appears increasingly strained: rising borrowing, which surged to more than £23bn in May (a 30% increase on the Office for Budget Responsibility's own forecasts made only a few months ago), together with record debt interest payments and persistent inflationary pressures have left the public finances vulnerable, with higher gilt yields further constraining the government's options. Whether it is Andy Burnham or someone else leading the government going forwards, they will be faced with an economy with very limited room for manoeuvre and difficult choices between fiscal prudence and demands for increased spending. As a result, steering the country onto a more sustainable path is likely to require some tough decisions and patience, with little prospect of an easy or quick turnaround.

As we have noted before, that pessimism surrounding the state of the UK's finances, combined with an anaemic backdrop for economic activity generally, does not necessarily translate into a negative outlook for the UK stockmarket. Around three quarters of the mainstream UK stockmarket index is exposed to revenues generated outside the UK, not from within it, essentially through multinational companies that just happen to be listed on London's stock exchanges. Exposure to our domestic market can also plug some gaping holes in industry sectors underrepresented or absent in other global stockmarkets, such as those giving exposure to financial, energy, commodity and healthcare stocks. Despite all the rather negative political and economic headwinds, we are not therefore inclined to reduce our commitment to the UK stockmarket in sterling-based portfolios.

Balancing diversification with opportunity

Overall, we are maintaining stockmarket exposure at the upper end of strategic ranges and believe we have the appropriate balance between diversification and focused areas of opportunity that can help portfolios through this near-term, hopefully short-lived, period of inflation and interest rate uncertainty. It is worth noting that allocations to global listed infrastructure assets, which we increased at the start of the Iran conflict, still have a valid role to play, giving access to generally more defensive stockmarket sectors.

They also have attractive income and inflation-protected revenue characteristics which could remain valuable as conflict-induced price pressures persist. As noted, we do not yet feel comfortable with redeploying any cash currently held back into fixed income markets, but instead feel there is a good opportunity to extend our range of alternative investments to seek improved returns and reduce overall portfolio risks.

Hot conditions, but well prepared and sleeping comfortably

Some solid gains have been recorded for investors this year, despite markets being tested quite significantly in the spring. Like the summer so far, some corners of equity markets are seemingly running quite hot and fixed interest markets could continue to wilt if inflationary pressures linger. But we believe our diversified approach to portfolio construction, whether it is for portfolios exclusively invested in stockmarkets or for those with greater cross-asset diversification, means that investors should be well positioned to not only withstand any further bouts of volatility but also participate in further market momentum.

If the stars begin to align on the inflation and interest rate front – aided by a durable de-escalation of conflict in the Middle East – and we head more towards the aforementioned ‘Goldilocks’ scenario, then there may be merit in making further tactical moves within – or between – equities, bonds and alternatives. We cannot control the weather, but as economic and market conditions change we can, and will, evolve our positioning to create the appropriate balance so that investors continue to sleep comfortably at night.

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