Spring
2026

market outlook.

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contents.

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2 UK

3 Europe

4 US

5 Japan

6 Asia & Emerging

7 Fixed Interest

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The UK Economy

UK equities maintained positive momentum into early 2026. Markets pulled back in March amid escalating Middle East tensions, but sentiment remained resilient and prices recovered quickly. However, performance across the UK market has remained uneven. The FTSE 100, with its greater exposure to global earnings, has continued to outperform smaller, more domestically focused indices. This divergence is now at extreme levels and highlights a clear investor preference for internationally diversified businesses over those tied more closely to the UK economic cycle.

The UK market houses many high-quality, globally competitive companies, whose valuations continue to trade at discounts relative to international peers. Over the long term, this creates scope for valuation recovery, provided assets are not acquired opportunistically at depressed prices before a re-rating can occur.

The domestic economic backdrop is challenging due to labour market weakness, falling vacancies, lower participation and slowing wage growth. Elevated inflation is pressurising real wages, creating a headwind for consumer spending. Core inflation has come in slightly below expectations and services inflation - previously a key pressure point - has stabilised. Persistently high oil prices and ongoing geopolitical risks also continue to pose upside risks to inflation.

Higher energy costs and elevated mortgage rates are expected to weigh further on growth as the year progresses. This slowdown is beginning to feed into public finances: recent improvements in borrowing reflect higher tax receipts rather than stronger underlying activity, while rising spending leaves deficits vulnerable if unemployment increases.

Despite these conditions, markets continue to price in the possibility of further interest rate tightening, which appears inconsistent with a weakening economy and labour market. The Bank of England is unlikely to tighten aggressively as growth slows and spare capacity rises, suggesting rate expectations remain elevated. Political uncertainty also adds another layer of risk. Leadership tensions and the upcoming local elections could prompt policy changes, particularly if results undermine the current government.

The UK market offers attractive valuations and improving non-energy inflation, but this is offset by a weakening domestic economy and rising political uncertainty. Near-term volatility is likely, yet opportunities persist, particularly among internationally focused UK companies trading at discounted valuations.

The European Economy

Europe remains structurally vulnerable to energy price shocks due to its heavy reliance on imported oil and gas, leaving it far more exposed than the U.S. to supply disruptions and commodity price volatility. The recent escalation of tensions in the Middle East has underscored this vulnerability, pushing energy prices higher, intensifying inflationary pressures, eroding household disposable income, and raising input costs for businesses. This creates a more challenging backdrop for both consumers and corporates, particularly in energy-intensive sectors such as industrials, chemicals, and manufacturing, while also limiting the pace of any near-term economic recovery.

The ECB has kept its deposit rate at 2.00% since June 2025, with inflation broadly around the 2% target. However, inflation risks have shifted to the upside, largely reflecting higher energy prices. Europe's heavy reliance on imported energy makes it particularly vulnerable to energy-driven inflation, raising the risk of second-round effects through wages and inflation expectations. The ECB is likely to keep rates on hold in the near term creating a more cautious growth outlook, however, higher rates are supportive for the banking sector. Monetary tightening is ill-suited to mitigating the economic impact of energy-driven inflation, especially given the burden it places on energy-intensive industries and lower-income consumers. In this context, country-specific fiscal measures are likely to be both more decisive and more effective in mitigating the economic impact.

Ongoing trade disputes, combined with European governments' decision not to join the US military campaign in the Middle East, continue to strain transatlantic relations. Although earlier US rhetoric around tariffs and Greenland's sovereignty has since been softened, these episodes have contributed to elevated policy uncertainty and weighed on sentiment, particularly in trade-exposed industries. Divergence has also emerged around peace negotiations in Ukraine, further highlighting differences in diplomatic approach. For markets, this backdrop has translated into higher risk premia and periodic volatility, reinforcing a preference for defensively positioned assets and regions less exposed to geopolitical disruption.

Manufacturing activity remains under pressure amid weaker external demand, with the downturn particularly pronounced in the automotive sector, which accounts for around 7% of EU Gross Domestic Product. European automakers continue to lag Chinese producers in both cost competitiveness and electric vehicle adoption, weighing on export growth, and broader industrial momentum across the region. Business confidence and consumer sentiment have been dented by geopolitical uncertainty and tariff-related risks. In addition, slower deployment of public investment through initiatives such as the NextGeneration EU program has reduced the short-term multiplier effect. Although areas such as defence spending, digital investment, and temporary relief from U.S. tariff adjustments provide some cushioning, the broader environment argues for a neutral positioning toward European markets.

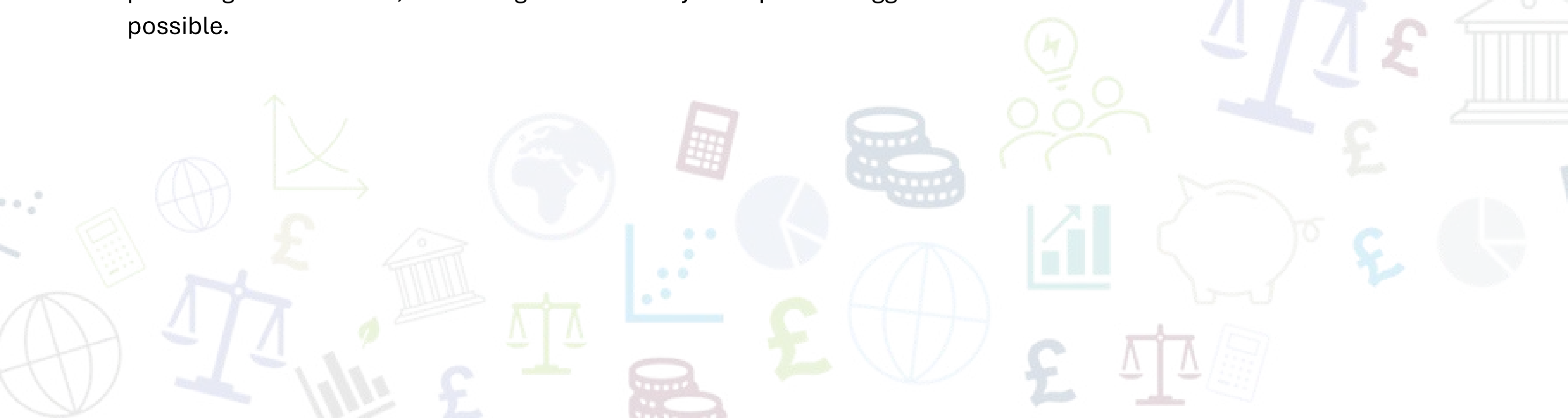
The US Economy

The US-Iran conflict appears to have been a strategic miscalculation by President Trump, driving a further decline in approval ratings. This has been compounded by domestic controversies around ICE immigration enforcement and the Epstein files alongside a more confrontational trade policy that has tested geopolitical relationships. This appears to reflect a more lasting loss of support ahead of the mid-terms, increasing the likelihood of a divided government. Markets could likely see this as a boon limiting further disruptive policies, reducing uncertainty/noise.

The Federal Reserve has held rates steady as it balances competing risks. Inflation pressures remain, driven by elevated energy prices, tariffs, resilient demand and record tax refunds supporting consumption. While premature easing could undermine policy credibility at the same time, further tightening risks a policy error. Despite market concerns over President Trump's calls for aggressive rate cuts in addition to the nomination of his new Fed chair, the Fed is expected to retain its institutional independence. Jerome Powell is due to step down as Chair in May 2026 but will remain on the Board with equal voting rights. Overall, a steady policy path appears most likely, with a higher-for-longer rate environment supportive of the banking sector, anchoring expectations, supporting the U.S. dollar and helping stabilise markets.

Despite ongoing geopolitical risks, the U.S. economic and corporate backdrop remains resilient. Progress toward ceasefires has prompted a renewed rotation into equities, particularly large-cap technology, reflecting investor preference for fundamentals. U.S. companies, led by Big Tech, delivered strong first-quarter results, with solid revenue growth, healthy margins, and robust cash flows more than offsetting concerns around elevated AI investment. Equity markets have responded positively, indicating that macro uncertainty has not derailed corporate momentum.

The geopolitical backdrop remains centred on the US–Iran conflict, where it is in President Trump's best interests to secure a swift resolution given the political and economic costs of prolonged escalation. While the conflict has strained geopolitical relations and carries a heavy humanitarian toll, such events have historically had only a limited and temporary impact on markets. Focus remains on the Strait of Hormuz, a key artery for global energy flows, with disruption pushing up global oil and gas prices. Encouragingly, ceasefire developments have supported a rebound, and US equities have remained resilient. Ultimately, the reopening and stability of the Strait of Hormuz is the key condition for markets, with any short-term dislocations creating selective opportunities for investors. Despite posturing on both sides, the willingness to talk by both parties suggest a resolution to the Strait in the short term is possible.



The Japanese Economy

Japanese equities performed well over the quarter, supported by improving domestic demand and renewed corporate investment. The election result has reinforced expectations of a pro-growth policy agenda, with potential fiscal stimulus aimed at tax reform and increased investment in strategic areas such as AI and advanced technology, where Japan is currently lagging global peers. While the scale and timing of any stimulus remain uncertain, the direction of policy is supportive, and markets have responded positively.

While Prime Minister Takaichi's policy agenda has been welcomed by some, the fiscal viability of her plans has also come under scrutiny, with critics arguing that her proposals may be overly ambitious. There are concerns that her approach could generate a revenue shortfall, unsettling bond markets and driving up the cost of government borrowing. These fears have been exacerbated by rumours of a supplementary budget that could rely heavily on the issuance of new debt. Currency weakness continues as the Yen is caught between improved growth prospects, potential for rate hikes and concerns that sustained fiscal loosening could weaken confidence in Japan's debt trajectory.

While Japan relies heavily on Middle Eastern oil, it is not fully exposed to potential disruptions in the Strait of Hormuz. The government recently announced that it holds oil reserves equivalent to 143 days of supply (partly state-owned) which it plans to begin releasing from May if further pressure on global supply needs to be eased. Japan has also accelerated efforts to diversify its energy sources, with the Prime Minister stating that the country will secure more than half of its crude oil from alternative suppliers by May this year when compared with last year, easing domestic oil price pressures in the short term.

Inflation in the region is expected to continue rising in the short term as the effects of the conflict in the Middle East feed through into prices. March inflation already surprised to the upside, although this was driven primarily by higher energy costs, with core inflation (excluding energy) remaining subdued. The labour market continues to show signs of tightness, with the job to applicant ratio elevated at 1.19, indicating ongoing demand for workers. However, rising headline inflation albeit likely temporary risks eroding real wage growth, particularly if nominal wage gains fail to keep pace. Against this backdrop, and as has been the case across other major economies, we expect the Bank of Japan to proceed cautiously with any potential monetary tightening, preferring to wait for further confirmation from inflation and wage data before committing to its next steps. However, let's not forget, unlike other major economies, Japan is targeting stickier inflation that sits reliably higher around its 2% target.

Emerging Markets & Asia Economy

Asia and emerging markets have been among the best-performing regions globally year-to-date, with performance proving resilient despite significant geopolitical disruption, including the closure of the Strait of Hormuz, through which a substantial share of the region's energy flows. Markets have absorbed higher energy prices better than expected, supported by diversified supply arrangements, strategic reserves, and structurally lower energy intensity across many economies. Against this backdrop, and with valuations still attractive relative to developed markets, the investment case is increasingly anchored in fundamentals rather than short-term geopolitical headlines.

China's equity outlook is underpinned by policy direction, energy resilience and a renewed focus on domestic capacity building. While China is a major consumer of oil transiting the Strait of Hormuz, its avoidance of direct involvement in Middle East tensions has helped contain geopolitical spillovers. This is reinforced by a diversified energy mix including domestic coal, rapidly expanding renewables, substantial strategic reserves, and a wide supplier base, reducing vulnerability to external energy shocks and supporting equity market performance. At the same time, rising Chinese imports of US ethane, a critical plastics input, following supply disruptions through the Strait of Hormuz signal pragmatic cooperation and deepening economic interdependence, suggesting that underlying trade dynamics remain constructive despite elevated geopolitical noise.

·In India, equities have lagged peers in 2026 amid elevated valuations, currency weakness and sensitivity to higher oil prices, reflecting reliance on crude imports. However, political dynamics remain stabilising. Exit polls indicate that Prime Minister Narendra Modi's Bharatiya Janata Party has regained support, reinforcing expectations of a larger majority and policy continuity, and providing a constructive backdrop for equity markets. Attention is turning to Brazil's election, where polls indicate a neck-and-neck race between Luiz Inácio Lula da Silva and Flávio Bolsonaro and a possible second-round run-off, though political uncertainty has yet to materially affect market conditions.

Several countries are benefiting from rising investment in AI components and systems, supported by strong startup activity and attractive valuations. Improving sentiment in South Korea and Taiwan reflects a robust semiconductor and AI cycle, with high-performance computing demand driving earnings, while prior US Supreme Court tariff rulings have left much of the region in a comparatively favourable position. Asia and emerging markets continue to offer compelling valuations, with structural themes, including supply-chain diversification, digitalisation, AI investment and the energy transition, supporting growth and a constructive regional outlook despite ongoing uncertainty.

Fixed Interest

The quarter has seen government bond yields move higher, with the UK hit particularly hard. The sell off can largely be attributed to higher inflation expectations, and the changing outlook for the path of interest rates.

A mix of robust corporate balance sheets and strong demand are making it difficult for spreads to materially widen. However, while spreads remain generally tight, there are still pockets of value to be found.

While returns for the year are marginally negative, all in yields are now higher. Over the long term, bonds still offer value, but we remain cognisant of potential volatility stemming from the Iranian conflict and ongoing domestic political uncertainty within the UK.

Inflation has risen moderately in the UK, but it is not yet clear whether the current spike will be transitory or more entrenched. Ultimately, bonds are already pricing in reasonable levels on inflation and higher starting yields put the asset class in a much stronger position relative to the 2022 sell off.

If you would like to discuss this or any other aspect of your portfolio, please do not hesitate to contact us on 0800 049 2011, Monday to Friday 9am-5pm or you can email us at affinity.advise@wealthatwork.co.uk

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