Summer 2026

market outlook.

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contents.

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The UK Economy

Over the quarter, the FTSE 100 reached new all-time highs, driven by the strong performance of globally diversified large-cap companies. Large-cap equities continued to outperform more domestically focused mid and small-cap stocks, reflecting subdued UK growth and greater overseas earnings exposure. Financials benefited from relatively elevated interest rates, while energy and commodity stocks experienced volatility amid fluctuations in oil and gas prices driven by geopolitical developments. Meanwhile, continued M&A activity and private equity interest highlighted the valuation discount of the UK market relative to international peers, providing further support for equities.

UK economic growth remained positive but subdued, constrained by weak consumer confidence, soft business investment and a gradually slowing labour market. Inflation continued to moderate, although progress towards the Bank of England's 2% target was tempered by energy price volatility. Labour market conditions also softened, with signs of increasing spare capacity, easing wage growth and weaker recruitment activity.

The Bank of England maintained a cautious approach to monetary policy, balancing easing domestic inflationary pressures against ongoing risks from energy costs and global economic uncertainty. The interaction between fiscal policy, economic growth, inflation and interest rates is likely to remain a key driver of UK equity and gilt market performance over the coming quarters.

The most significant domestic development during the period was the arrival of a new Prime Minister and Cabinet, marking a potential shift in the UK's economic and fiscal policy direction. Early government announcements have focused on boosting growth through increased investment, infrastructure development and housing construction, although investors remain mindful of the potential implications for government borrowing and public finances. Attention has also turned to how these ambitions, alongside priorities such as defence and industrial investment, will be balanced against fiscal discipline. Looking ahead, the Autumn Budget is expected to provide greater clarity on taxation, borrowing, spending plans and the government's broader economic strategy.

The European Economy

Europe entered the quarter with subdued economic momentum, although activity has proven relatively resilient despite higher energy prices and ongoing geopolitical uncertainty. Nevertheless, the economic backdrop remains challenging. Domestic demand is weak, while longstanding issues around productivity and competitiveness continue to constrain the region's longer-term growth potential. Labour market conditions have softened, with employment growth moderating, weighing on consumer confidence and household spending. Inflation has proven more persistent than expected, although recent price pressures have been driven primarily by higher oil prices resulting from tensions in the Middle East. Against this backdrop, policymakers face a delicate balancing act: supporting economic growth in an environment of weakening demand and a softer labour market, while ensuring inflation remains on a sustainable path back towards target.

In June, the European Central Bank (ECB) became one of the first major central banks to raise interest rates by 0.25%, taking the deposit rate to 2.25%, before leaving policy unchanged in July. Policymakers likely judged that responding to the energy-driven inflation shock was important to maintain credibility and keep inflation expectations anchored, particularly given Europe's reliance on imported energy and its sensitivity to higher energy prices. By acting early, the ECB has strengthened its flexibility to respond should growth weaken more materially, while retaining scope to ease policy later if inflation moderates. While tighter monetary policy may weigh on near-term activity, the ECB's measured and data-dependent approach should help reduce policy uncertainty and provide a stable backdrop for European equities.

European corporates continue to face a challenging environment, particularly those in export-oriented sectors. Luxury goods companies remain under pressure, particularly from weakness in their key market, China, where domestic demand and consumer confidence continue to be subdued. The sector also faces ongoing uncertainty surrounding global trade, further weighing on growth prospects. Given the strategic importance of the automotive industry to Europe, which supports approximately 13.8 million jobs across the EU and accounts for more than 7% of EU GDP, the sector remains a critical driver of economic growth and employment across the region. However, intensifying competition from Chinese automakers has added to industry headwinds, with BMW and Volkswagen Group reporting lower profits and signalling potential large-scale job cuts as part of broader cost-cutting efforts. European equities trade at a discount to US peers but remain exposed to global trade, energy and demand shocks, especially through the automotive sector.

Despite ongoing challenges European equities have continued to perform resiliently. Corporate earnings have remained broadly robust despite a challenging external environment, while economic activity has proven stronger than many anticipated. Looking ahead, relatively attractive valuations and an accommodative European Central Bank should provide a constructive backdrop for markets. However, further fiscal support will be crucial to sustaining growth momentum and reinforcing the region's recovery. If Europe continues to navigate these challenges successfully and energy-related inflation pressures moderate, the region could see further upside as the economic outlook improves and valuations become more attractive.

The US Economy

The U.S. economy continues to demonstrate impressive resilience. Headline inflation eased to 3.5% in June, supported in part by lower energy prices during the temporary U.S.-Iran ceasefire, while underlying inflation remains contained despite ongoing economic strength. The labour market has moderated from exceptionally tight levels but remains healthy, with unemployment low at 4.2% and wage growth continuing to support household incomes. Consumer spending has remained robust, reflecting strong household balance sheets and confidence. Although payroll growth and labour force participation have moderated, lower immigration has eased labour supply, helping maintain healthy labour market conditions. Together, resilient consumption, solid employment and stable inflation support corporate earnings and the medium-term outlook for U.S. equities.

President Trump's approval ratings have softened given his erratic trade policy and renewed tensions in the Middle East following the breakdown of the U.S.-Iran ceasefire. As the November mid-term elections approach, a loss of Republican control of the House of Representatives may be viewed favourably if it reduces the likelihood of more disruptive fiscal or trade policy initiatives. While tensions between the U.S. and Iran continue to generate episodes of volatility, markets appear increasingly willing to distinguish between geopolitical risks and the broader economic outlook. This is reflected in the relative stability of oil prices, with diversified global supply chains and substantial strategic reserves, particularly in China, helping to mitigate potential supply disruptions and prevent a broader energy crisis. Provided tensions do not escalate materially, any progress towards de-escalation could provide an additional tailwind for equity markets.

Technology and AI continued to drive U.S. equity markets, underpinned by strong earnings and sustained AI investment. While valuations of some large technology companies remain under scrutiny, many well-established firms continue to deliver robust earnings growth, leaving the long-term investment case intact. Elevated valuations among the largest technology companies have prompted comparisons with previous technology cycles. However, today's environment is underpinned by much stronger profitability, cash generation and balance sheet strength. Valuation concerns may therefore be overstated, particularly as many companies continue to exceed ambitious earnings expectations, while short-term market reactions to otherwise robust results can create attractive entry points into high-quality businesses.

The Federal Reserve has, as expected, held interest rates at 3.50%-3.75% this year, supported by an economy that remains resilient despite restrictive monetary policy. Although June's inflation data was encouraging, the subsequent recovery in oil prices and continued strength in employment have reinforced policymakers' view that inflation risks remain skewed to the upside, limiting the urgency for rate cuts. Importantly, despite political scrutiny surrounding the appointment of Chair Kevin Warsh, the Federal Reserve has continued to demonstrate its independence by remaining data-dependent and keeping press conferences deliberately uninformative. Interest rates are likely to remain higher for longer than markets anticipated at the start of the year, reflecting economic resilience rather than policy error. Stable policy expectations, combined with robust corporate fundamentals, continue to provide a supportive environment for equities and the dollar over the medium term.

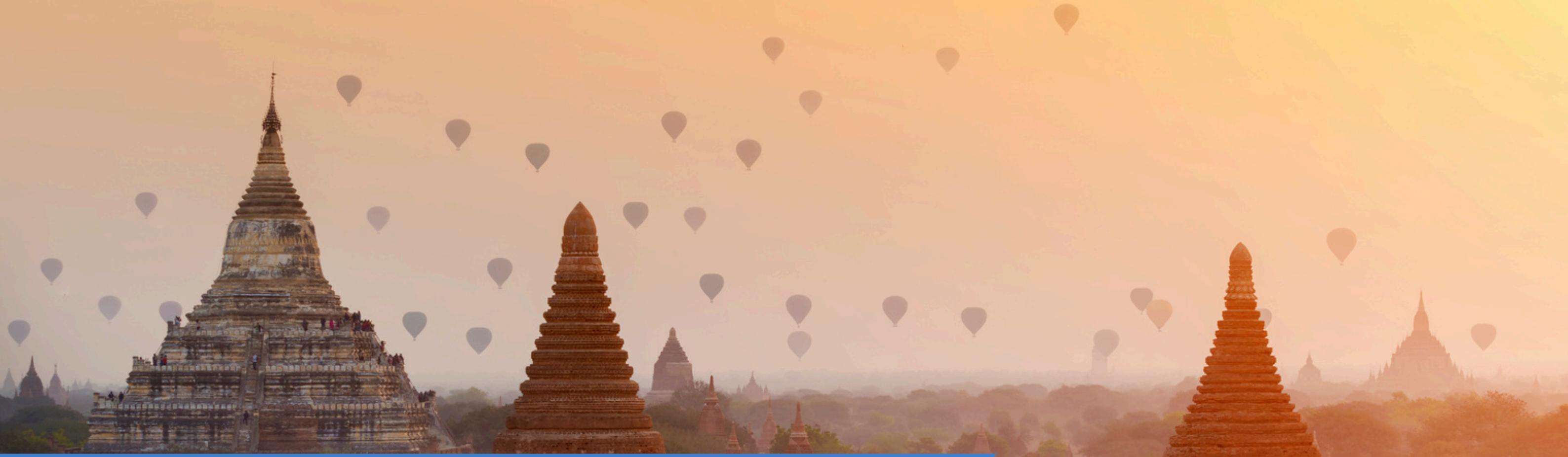
The Japanese Economy

Japanese equities delivered strong gains in the second quarter, driven by AI-related investment, improving earnings prospects and a weaker yen, while financials benefited from the Bank of Japan's gradual policy normalisation. The yen remains an important driver of Japanese equity performance and has remained relatively weak against the U.S. as expectations for further BoJ tightening remain restrained relative to other major central banks. While the weaker yen has increased import costs and contributed to cost-of-living pressures for households, it has enhanced the global competitiveness of Japanese exporters by increasing the value of overseas earnings when repatriated. This has benefited export-oriented sectors such as technology, industrials, and manufacturing. The U.S. has shown a willingness to support yen stability through coordinated intervention with Japanese authorities, helping to mitigate the risk of excessive volatility.

The BoJ is expected to maintain a cautious tightening path following its June rate increase. While policymakers have adopted a more hawkish stance in response to rising inflation, they remain reluctant to raise rates too aggressively given uncertainty over the durability of wage growth, higher energy prices and the fact that other major central banks remain on hold. Inflationary pressures have been driven largely by imported costs, with tensions in the Middle East contributing to higher energy and raw material prices. However, core inflation has remained below the BoJ's 2% target for five consecutive months, suggesting underlying price pressures are not yet firmly entrenched. With Japan also playing a significant role in global bond markets, policymakers are likely to prioritise stability and avoid the risk of overtightening. As a result, financial conditions should remain relatively accommodative and supportive of equities, with smaller companies potentially benefiting as domestic investment strengthens.

Prime Minister Takaichi's pro-growth agenda has been well received by markets. It includes plans for tax reform and approximately $2.3 trillion in public and private investment by 2040 across 17 industrial sectors, with around one-third of the funding earmarked for AI, semiconductors, and other advanced technologies. The strategy seeks to revitalise private-sector investment and strengthen Japan's competitiveness in areas where it has historically lagged other major economies, particularly in AI and digital infrastructure. This has supported strong performance among semiconductor and technology-related companies, as markets position for higher capital expenditure, improved productivity and a larger role for Japan within global technology supply chains. Over time, these initiatives could provide a meaningful boost to both corporate earnings and the economy's long-term growth potential.

Despite Japan's reliance on Middle Eastern energy imports, policymakers have sought to mitigate the impact of higher oil prices through strategic reserves and diversified energy supplies. While lower energy costs may temper inflation in an economy that has long struggled with weak price growth, they also provide some relief for households at a time when real wage growth remains modest. Looking ahead, targeted fiscal and domestic investment initiatives could provide further support for smaller companies, which are well positioned to benefit from increased capital expenditure, stronger corporate activity and efforts to enhance Japan's long-term growth potential.



Emerging Markets & Asia Economy

Asian and emerging market equities have been among the strongest performers year to date, demonstrating resilience despite energy market volatility linked to the Middle East. Performance has been supported by improving investor risk appetite, attractive relative valuations and continued investment in artificial intelligence infrastructure. North Asian markets, particularly Taiwan and South Korea, have been key beneficiaries of this trend. In South Korea, companies such as SK Hynix and Samsung Electronics have delivered strong share price gains, supported by robust demand for memory chips and semiconductor technologies. While sentiment has fluctuated as the market reassess the pace and sustainability of AI-related demand relative to elevated capital expenditure, pullbacks have generally proven to be short-lived, with strong earnings growth and continued demand for technologies attracting investors back into the sector.

Chinese policymakers continue to prioritise economic stability through targeted liquidity support, with recent reverse repo operations injecting substantial funds into the banking system. Under these operations, the People's Bank of China purchases securities from financial institutions with an agreement to sell them back later, providing short-term liquidity that supports lending, credit availability, financial market stability and the Renminbi. While these measures have improved financial conditions, the recovery remains uneven and consumer demand subdued, leaving equity market performance driven more by strategically supported sectors than consumption-led growth. Chinese equities have benefited from resilient technology exports, strong AI-related demand, and an active pipeline of large-scale IPOs. These trends align with the government's broader industrial strategy, with the current Five-Year Plan prioritising AI, semiconductors, digital infrastructure and green energy as China transitions towards a more sustainable growth model. In addition, China's substantial energy reserves, rapidly expanding solar generation capacity, and adoption of electric vehicles have reduced the country's reliance on imported oil. This has helped cushion both the Chinese and global economy from higher energy prices during the Middle East conflict, while supporting China's medium- to long-term growth outlook.

The performance of Indian equities has lagged that of regional peers year-to-date. However, performance improved during the quarter, as investors refocused on the country's compelling long-term growth fundamentals. India's investment case remains underpinned by ongoing infrastructure investment, expanding manufacturing capacity, rising domestic consumption, and favourable demographics. In June, the government introduced tax exemptions on listed shares and bonds to encourage foreign portfolio investment and support capital inflows. Meanwhile, political protests and heightened scrutiny of the Bharatiya Janata Party have introduced an element of near-term uncertainty. However, these developments may also strengthen institutional accountability and support the continuation of economic reforms. Regardless of near-term challenges, India's long-term growth outlook remains attractive. The combination of robust structural drivers, policy support, and ongoing economic development should continue to underpin growth, any improvement in earnings momentum and stabilisation in the geopolitical environment could create a more compelling entry point for investors later in the year.

Latin American markets delivered a mixed performance over the quarter. Brazil remained a key focus, with resilient economic activity and continued structural reform progress offset by concerns around fiscal sustainability and uncertainty ahead of the 2026 presidential election. Political developments are likely to remain a significant driver of sentiment, with a potential re-election of President Lula da Silva raising concerns about increased trade tensions and policy uncertainty, while a return of Jair Bolsonaro could be viewed more favourably by markets given expectations of closer alignment with US economic policy. The region's investment outlook is supported by attractive valuations, easing inflation and expected policy easing, although domestic politics and global trade shifts may drive market volatility.

Fixed Interest

Starting yields are high and yield curves are upward sloping, meaning investors can lock in attractive levels of income today and are rewarded with higher yields for investing in longer-term maturities. This creates a favourable starting point for fixed income investors.

Returns from corporate bonds have been relatively flat year to date. Rising yields have weighed on bond prices, but the income earned from these bonds has offset losses.

Spreads on corporate bonds remain relatively tight, with balance sheets appearing healthy.

We anticipate that several government bond markets might face idiosyncratic issues. In the UK, the recent change of Prime Minister could generate increased volatility in the lead up to the Budget announcement. If investors can look through this near-term volatility, this is an attractive entry point to investment grade credit across the maturity spectrum.

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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