

LEARN FROM THE PAST, PLAN FOR THE FUTURE

Introduction and Market Overview

The closing months of 2025 and the opening quarter of 2026 have been marked by a clear change in the investment environment. Markets entered the final quarter of last year on a relatively firm footing, supported by easing inflation, resilient economic activity, and another strong earnings season. There were increasing signs that growth was broadening beyond a small number of market leaders, while falling inflation raised expectations that the US Federal Reserve and other global central banks would have greater scope to support activity through gradual interest-rate cuts.

However, this constructive backdrop shifted sharply as geopolitical risks escalated and energy markets moved decisively higher. By the end of the first quarter of 2026, investors were grappling with a very different mix of risks, dominated by geopolitics, oil prices, inflation, and monetary policy.

The defining development of the period was the escalation of conflict in the Middle East. US-Israel military action against Iran, and Iran's subsequent response, significantly increased uncertainty across global markets. As the conflict intensified, Iran sought to exert economic pressure by targeting energy infrastructure and disrupting shipping routes, most notably through the closure of the Strait of Hormuz. This narrow passage accounts for roughly 20% of global oil flows and plays a critical role in the global energy system.

The market response was swift. Oil prices surged to their highest levels since 2022. This sharp move was not simply a reflection of supply losses, but also of fear and uncertainty around how long the disruption might last. Earlier in the quarter, a US-led operation that resulted in the removal of Venezuelan President Maduro had already raised concerns over oil supply, leaving energy markets particularly sensitive when Middle East tensions escalated.

WTI Crude Oil price over the past five years

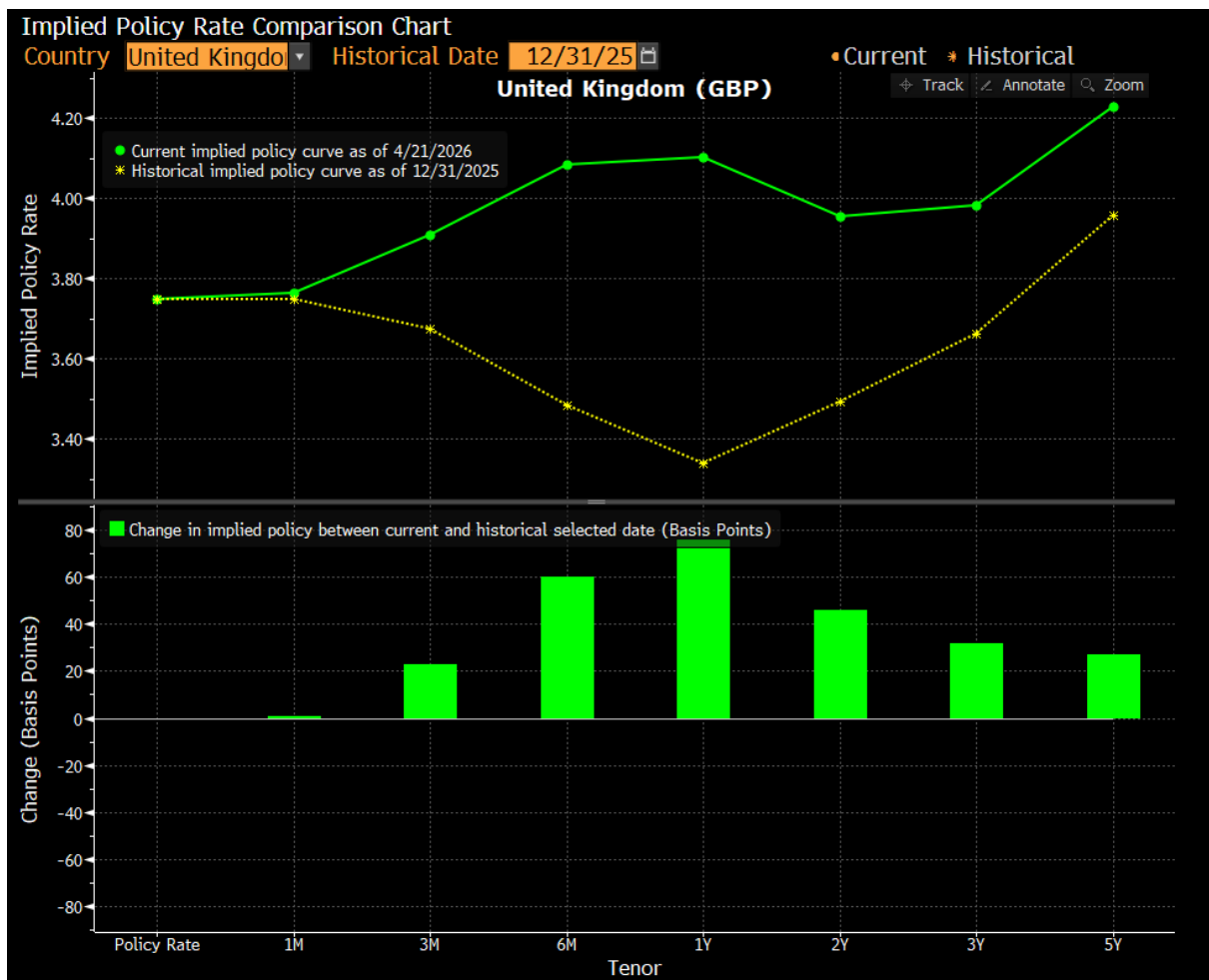


Source: Bloomberg

From a geopolitical perspective, the incentives for escalation are asymmetrical. Iran, unable to match US and Israeli military capability, has sought to maximise economic disruption by targeting oil and gas flows. From the US side, a prolonged oil-driven inflation shock would be politically damaging ahead of upcoming mid-term elections, particularly given the administration’s focus on consumer affordability. These dynamics underpin our base case that, while volatility may persist, there are strong incentives on all sides for eventual de-escalation.

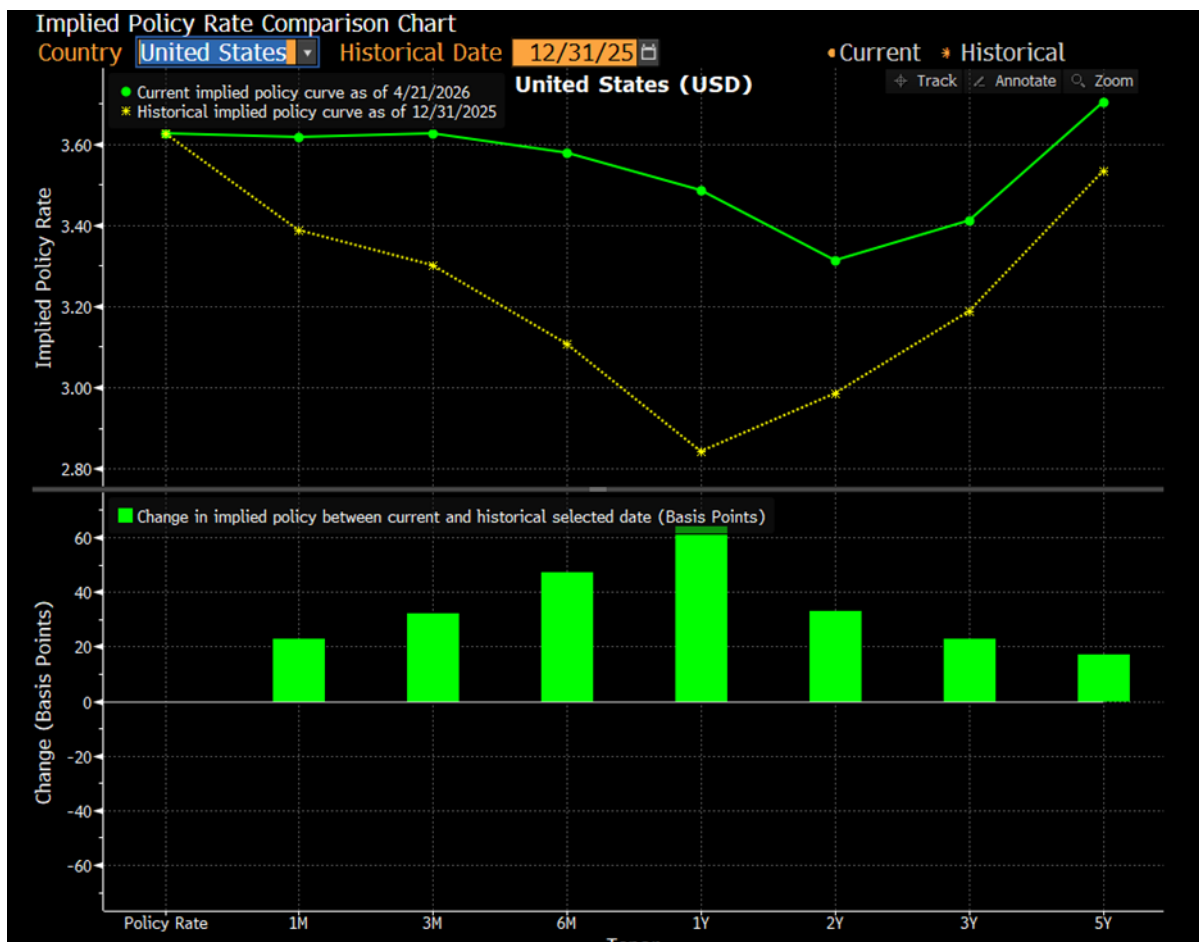
The surge in oil prices fundamentally altered the market’s inflation narrative. For much of 2024 and 2025, the dominant concern was whether growth might slow too quickly and how rapidly central banks could cut rates. As energy prices rose, that focus reversed. Markets began to price renewed upside inflation risks, pushing government bond yields higher and reducing expectations for near-term interest-rate cuts.

Market implied UK base interest rates over the next five years (latest in green, end of 2025 in yellow)



Source: Bloomberg

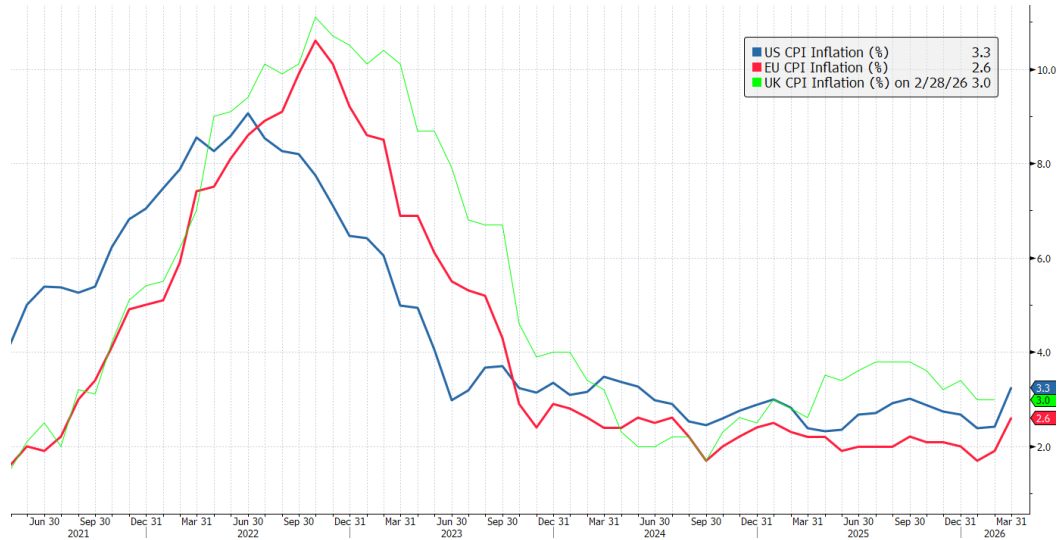
Market implied US base interest rates over the next five years (latest in green, end of 2025 in yellow)



Source: Bloomberg

The link between oil, inflation, and monetary policy has therefore become the central macro theme. Upcoming inflation prints in the US and UK will be closely scrutinised, as they will be the first to fully capture the impact of higher energy costs. Headline inflation is likely to move back above 3% across developed economies. While this would represent the highest readings in two years, it remains modest compared with the peaks seen in 2022.

UK, EU and US Consumer Price Index (CPI) over the past 5 years



Source: Bloomberg

Crucially, longer-term inflation expectations remain well anchored. Market-based measures and survey data suggest that consumers and businesses still view the shock as temporary rather than structural. This distinction matters greatly for central banks. If inflation expectations remain contained, policymakers will have more flexibility to look through short-term volatility once energy prices stabilise.

Financial markets responded in a manner consistent with past geopolitical shocks. Equity and bond markets sold off globally, while the US dollar strengthened amid a flight to safety. Trades that had been popular prior to the conflict unwound rapidly. In several cases, price action appeared driven more by positioning than by fundamentals.

Performance of trade-weighted USD over the first quarter



Source: Bloomberg

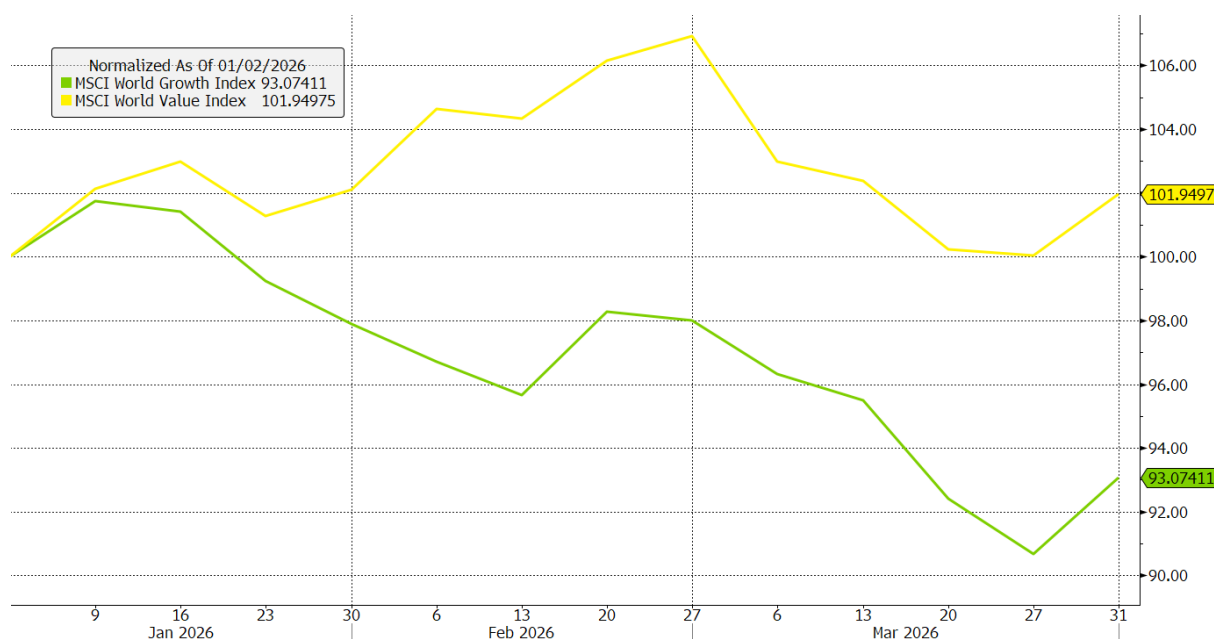
A good example of this dynamic was gold. Despite being widely regarded as a “safe haven” asset, gold prices declined meaningfully during the early stages of the conflict. This counter-intuitive move reflected speculative positioning built up in advance of the event rather than a sober assessment of fundamentals. History suggests that when market behaviour becomes this reflexive, opportunities often emerge for disciplined investors.

There is a substantial body of evidence showing that markets tend to follow a familiar pattern during geopolitical events: an initial sharp decline, a period of stabilisation, and then recovery as uncertainty gradually clears. While no two events are identical in duration or magnitude, human behaviour plays an important role. Constant newsflow, emotive headlines, and uncertainty can cause even rational investors to overreact. Managing portfolios through such periods requires accepting short-term volatility as the price paid for higher long-term returns.

Equity performance over the period reflected these broader dynamics. For a second consecutive quarter, US equities underperformed markets outside the US. Large US technology stocks, in particular, faced pressure as investors scrutinised the scale, timing, and returns of rapidly rising AI-related capital expenditure. While earnings growth remained strong, sentiment weakened as concerns grew around capital intensity and near-term cash returns.

In contrast, value-oriented segments of the market performed better than growth, supported by rising commodity prices and higher interest rates. Emerging markets delivered positive returns, outperforming developed markets amid heightened volatility. Strength in Latin America, driven by energy and materials exposure, offset weakness elsewhere. This episode reinforced the diversification benefits of maintaining exposure beyond traditional developed-market equities.

MSCI Value vs Growth over the first quarter

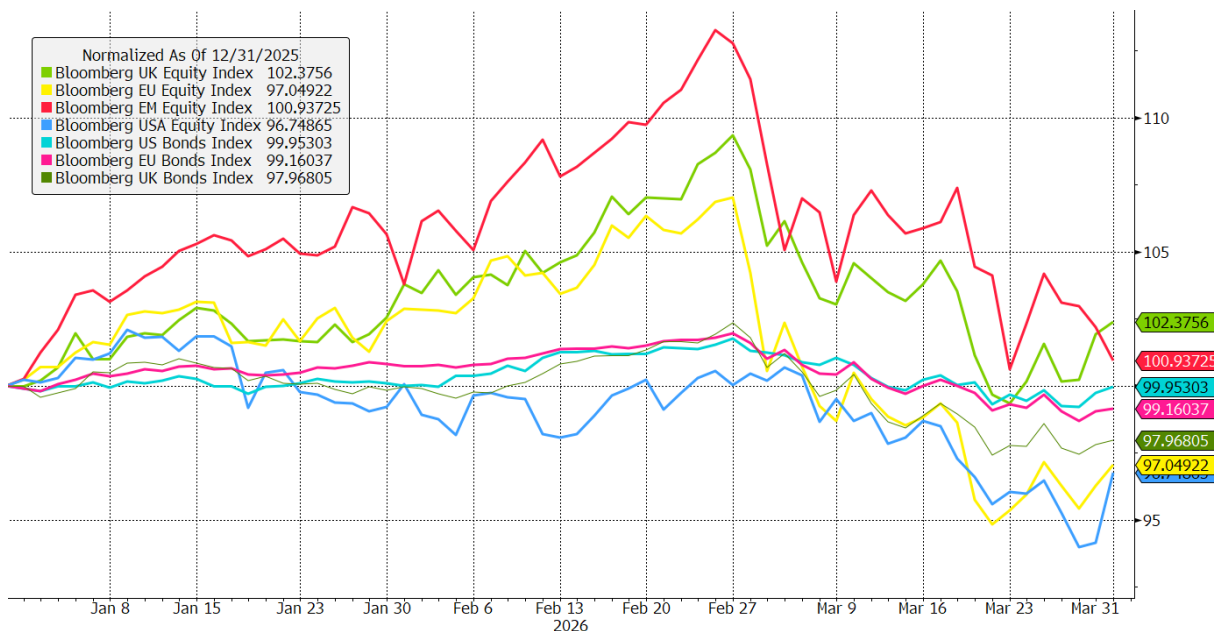


Source: Bloomberg

UK equities proved relatively resilient. The FTSE 100 passed the 10,000 level for the first time, supported by its weighting toward commodities. A weaker sterling provided an additional tailwind for internationally exposed companies. Japanese equities also performed well, aided by yen weakness and a decisive election victory for the ruling Liberal Democratic Party, reinforcing expectations for pro-growth policies, fiscal support, and continued corporate reform.

European equities were more challenged. Higher gas prices, lingering geopolitical exposure, and reliance on imported energy weighed on sentiment. However, even here, company fundamentals remained broadly intact, with weakness driven more by macro uncertainty than by a deterioration in earnings prospects.

Major Markets Total Return in Q1 2026 (% , rebased to 100)



Source: Bloomberg

Bond markets were volatile throughout the period. Rising energy prices fuelled inflation concerns and pushed government bond yields higher, which caused bond prices to fall. This was particularly the case in the UK, where dependence on natural gas left the economy more exposed to the energy shock. Nevertheless, high-quality sovereign bonds continued to play an important role as portfolio diversifiers during periods of equity weakness.

Chart of 10-year UK Government Bond yield over the quarter

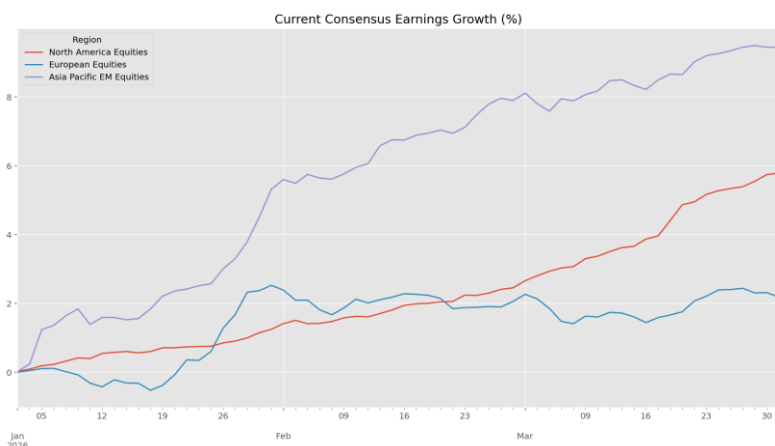


Source: Bloomberg

Looking ahead, the evolution of the Middle East conflict remains the key swing factor for markets. At quarter-end, the Strait of Hormuz remained closed, with negotiations ongoing. Any credible progress toward de-escalation would likely lead to a sharp fall in oil prices, an easing of inflation fears, and rapid improvement in both equity and bond markets. Conversely, a prolonged disruption would increase risks to growth and keep inflation elevated for longer.

Importantly, recent market weakness has not been accompanied by a collapse in corporate fundamentals. Earnings expectations remain positive, particularly in the US and Asia Pac EM region, and balance sheets are generally strong. Much of the volatility has been driven by uncertainty and positioning rather than by structural deterioration. This distinction is critical for long-term investors.

US, EU and Asia Pac EM Corporate Consensus Earnings Upgrade (%)



Source: Bloomberg

Periods like this are uncomfortable, but they are not unusual. Volatility is an inherent feature of investing and a key reason why long-term returns from diversified portfolios exceed those available from cash. Maintaining discipline, diversification, and a long-term perspective is essential. While geopolitics will continue to generate headlines, markets have a long history of adapting, recovering, and ultimately refocusing on fundamentals once uncertainty begins to clear.