RAYMOND JAMES

Mind the gap!

Jeremy Batstone-Carr, *European Strategist, Raymond James Investment Services*

Travellers on London's underground network will be all too familiar with the polite, but pointed, instruction to be careful when boarding the train of the gap between it and the platform. Minding the gap is and has forever been a feature of the financial markets as they endlessly attempt to price and reprice for an often kaleidoscoping future. But gaps between where we are now and where we might like to be are numerous and challenging, both for policymakers as they seek to steer a course to a brighter future and for investors seeking positive returns from stock and bond markets.

Take the gap between the UK's inflation problem and persistent affordability crisis, and the Conservative administration's target to cut price pressures in half by the end of the year. Plans received an unpleasant jolt with the publication of the latest consumer price data. Yes, the headline rate did fall back into single digits, dropping from 10.1% in March to 8.7% in April, well below last October's peak, but that was where the good news ended, and it is still far too high for comfort.

The International Monetary Fund (IMF) has reworked its economic forecasts and now believes that the country's economy will perform sufficiently well to avoid a recession this year. This upgraded outlook is, however, caveated by the continuing pressure on households associated with a still far too high cost of living. While energy prices are falling, slowly, food prices remain very close to March's 44-year high. This is deeply perturbing to the Bank of England having already raised the base rate of interest in twelve successive hikes from just 0.10% in December 2021 to 4.50%. More so, the strong possibility that inflation's persistence is being driven less by global trends and more by domestic factors. In consequence of which, interest rates may have to be raised even further if the genie is to return to the bottle and stay there. As both inflation and monetary policy operate with a lag, it is far from certain that the UK will achieve the bridge to an economic nirvana envisaged by the Bank of England, the Office for Budgetary Responsibility and now the IMF too, at least not this year.

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What, too, of the gap between politicians on either side of the political divide in the United States, as they spent May attempting to find sufficient common ground to head off a crisis associated with the country's yawning debt limit and the threat of default (technical as it may be), which had the credit rating agencies poised to downgrade the country's creditworthiness, just as they did in August 2011. Financial markets have long memories and can recall without difficulty the brinkmanship characterising earlier debt ceiling negotiations. On each previous occasion, crises were averted at the 11th hour and with an agreement to raise the ceiling the ultimate goal desired by both sides, the most important outstanding question being how to do so without loss of face. History has repeated itself as, by the end of the month, compromise to raise the limit, yet again, had been reached between President Biden and Mr Kevin McCarthy, leader of the majority Republican Party in the House of Representatives. The harder sell is to radical politicians on both sides of a deeply divided Congress, where approval is required to pass the legislation into law.

In the context of these uncertainties, financial markets have proved remarkably resilient throughout 2023 to date. But here too another gaping chasm has opened up, most clearly apparent in the US stock market between the performance of the giant technology companies on the one hand and the rest of the market on the other, including the still embattled banking sector. With the usual hype typical of periodic stock market crazes, enthusiasm for artificial intelligence has shifted into overdrive. The general nature and application of new technology surely the theme dominating all else as we approach the end of the first half of the year. But unlike the “dot.com” bubble before it, the key differentiator this time is that it is the existing tech giants that are driving a profoundly bifurcated stock market higher, not some cash-burning start-up business. Furthermore, it is the hitherto unprecedented speed with which the new technology is being adopted that has raised debate regarding the potential repercussions for society at large and for the economy, on the other side of the divide, potentially too good to be true productivity benefits.

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Over and above all this, the extreme cleaving of the geopolitical landscape, a gulf emerging as wide as the Pacific Ocean itself and amplified in the concluding communiqué at the summit of seven of the most industrialised economies on the planet, the G-7, in Hiroshima. Of course, the admonishment of Russia featured prominently, as did eternal support for embattled Ukraine. But beyond that, leaders went further along the process of securing and shortening supply chains by “onshoring” and “safeshoring” activities away from China, whilst deploring in the strongest possible terms the latter’s territorial ambitions, particularly with regard to Taiwan. A series of tectonic collisions in the planet’s most politically and militarily significant plates is thought likely the precursor, over time, to a profound fracturing into two distinct geoeconomic blocs, one dominated by the US and its allies and the other by China.

For investors in financial markets negotiating potholes and circumnavigating crevasses is in the very nature of investment. Managing risk is as critical an activity at the heart of success as assessing reward. But it is in the process of correctly positioning for maximum resilience over the very short term that one lays the foundation stones for a much brighter future as the economic cycle turns, inflationary pressures subside and central banks embark on the process of reversing the rate hikes of the present and recent past, a synchronised upturn thought likely to be the dominant feature of the investing landscape in 2024. Yes, developed economies will do well to avoid slipping into a period of contraction before that, but this has been well-flagged and financial markets are ready for it. More importantly, investors will soon begin to position to bridge the gap that separates where we are now from a more prosperous future.