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'Recovery with risks '

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In this issue we look at a realistic base case scenario for the coming year's global economy, its financial markets and the risks that threaten it.

Firstly, the battle against inflation is won, and rates will fall. The remaining unknown is how quickly this will happen, due to the surprisingly strong US economy. The US consensus is for a soft landing, something considered improbable only six months ago. However, the longer rates are at levels the Fed itself describe as restrictive, the greater the probability that something breaks. There are emerging signs of this in the banking sector.

China and Europe face recession. China suffers from the three Ds of debt, demographics, and deflation with the liquidation of its vast residential property developer China Evergrande last week, the latest visible sign of this damaging trifecta. Meanwhile, German de-industrialisation caused by its disastrous energy policy leads the Eurozone to a significant slowdown, with financial and political consequences increasingly evident.

While the UK is not immune from these problems, its economy has greater services focus and proven more resilient than most commentators have predicted and feared. Since the Brexit vote eight years ago, expectations regarding the UK's economy have been low, capital flows into the UK have been weak, and UK assets have become cheap relative to peers.

Following a prolonged post-Brexit constitutional-level crisis, this year's general election will be a low-key affair involving the transition of power from one technocratic centrist PM to another. The UK's relationship with Europe will not feature in the campaign, and even the thorny issue of Northern Ireland is resolving. All this will be in marked contrast to elections for the next US president, the EU parliament and elsewhere.

More broadly, with increasing evidence we have seen peak ESG, Western politicians have been forced to reconsider economic growth. The Uxbridge by-election was sufficient for both the main UK parties to backtrack on flagship green policies. Brussels, Berlin, and Paris required more forceful reminders from their farmers. But the result is the same: electorates have shifted the debate, forcing politicians to be more honest about the actual cost of net zero.

As policy rates fall, yield curves normalise. They flatten and start to slope upwards again. The changing term structure of interest rates impacts asset classes differently. History suggests it increases market volatility and disperses returns, conducive to active stock picking, the value style, and smaller companies.

These macroeconomic conditions will disproportionately favour UK assets, which global investors had come to regard as value traps. As capital percolates into the UK, the most significant price action will be seen in the least liquid shares. The period after the dotcom bust in 2001 saw rates and market concentration fall with a sustained outperformance of the value style and smaller companies. Evidence of market performance in Q4 last year with was a foretaste of what is to come.

However, inevitably, there will be bumps along the road. Let's look the main known unknowns.

While the US economy can grow despite higher rates, for some, such as indebted commercial real estate landlords it is terminal. There is an emerging rerun of last year's banking difficulties, this time not based on bond values but on exposure to office blocks and apartment buildings. This time the concern is credit risk, not duration risk.

The longer rates are at current levels, the more apparent it becomes that the only entity that can afford to borrow at such elevated levels is the US government, with its exorbitant privilege of issuing the world's favoured pristine collateral; however, others are less fortunate. Without checks on the rate of sovereign debt issuance, global liquidity risks being sucked from the rest of the world into a rampant dollar—the so-called Dollar Milkshake Theory, threatening the return of the Dollar wrecking ball.

While one cannot ignore rising geopolitical tensions or the human tragedies involved, the world's hot and simmering cold wars are so far being regionally contained, the global economy is adapting effectively, and supply chains have coped. We can only hope that this remains the case.

The final risk to consider is the emerging deflationary recession based on China's looming structural problems. Last year saw the first net fixed capital divestment of foreign investors from China in twenty-five years, and its stock market remains incredibly weak. Emerging market investors are reluctant to put good money after bad, particularly after Russia's invasion of Ukraine delivered them a zero on their cheap bets on listed Russian assets. Meanwhile, Mexico has overtaken China as the US's biggest exporter. Its authorities are pulling all the levers at their disposal to reinvigorate its economy and mitigate the impact of falling asset prices, but this has, so far, been to negligible effect.

None of these risks needs to be terminal to a positive outturn for stock markets, particularly the UK smaller company segment. However, neither can they be ignored as obstacles to our base case of falling inflation, falling interest rates, normalising yield curves, and increased capital flows into the UK.

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JACKSON'S CHART - CN50 MONTHLY

An analysis by Jackson Wray

Source: [TradingView.com]

EXPLANATION

Fundamentally, China has been a market under significant pressure, but what can the technicals tell us about the next move? From the February 2021 high, the CN50 lost 48% of its value in the three years that followed, with the clear downtrend of lower and higher lows making this a healthy move from a technical standpoint. This was confirmed on the break below the upward trend line (blue) as the index moved through 12700 without a fight. Last month, the CN50 tapped the important 10650 region last seen in 2019, which holds historical importance. A rally back towards 12400 could be expected here before any continuation towards the 9180 level. However, the lower lows are shallowing, with early signs of a rounded bottom forming, indicating a slowdown in the downward pressure. This rounding formation holding could confirm lows, and a challenge to this downtrend could be about to occur, assuming markets have priced in the negative sentiment.

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- Behind the Memo: Easy Money with Howard Marks and Edward Chancellor
- China needs to learn lessons from 1990s Japan
- The Bank's blunders will send Britain into deflation

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