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Foundations for the future

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"The best way to predict the future is to create it" – Peter Drucker

A sharp drop in inflationary pressures across developed international economies has encouraged financial markets to call central bankers' strongly held "higher for longer" position into question. Stock and government bond markets have rebounded with confidence off end of October lows in response to financial futures markets implying that monetary policy setters will adopt a dovish pivot to an easing bias sooner than had previously been expected, despite their protestations to the contrary. The most recent adjustment indicates that interest rates could begin their downward path over the first half of next year. Augmenting the positive shift in investor sentiment over November, the geopolitical stresses so apparent over October have shown strong signs of easing. Earlier concerns regarding a possible escalation in the conflict in the Middle East have so far proved groundless and in part consequence, perturbations regarding a possible spike in energy prices have proved wide of the mark. More encouragingly still, the meeting between President Biden and his Chinese counterpart President Xi Jinping in San Francisco has built on earlier diplomatic initiatives and served to further reduce tensions between the two superpowers. Providing that all sides in flashpoint locations keep talking, so the chances of a disorderly escalation should diminish.

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Serving as a backdrop to the two leaders' discussions lies a highly divergent economic performance. The US economy has proved remarkably resilient thus far, despite the Federal Reserve's aggressive rate hiking programme aimed at driving down inflation. In contrast, the Chinese economy has lost the momentum it enjoyed following the post-pandemic reopening earlier in the year, requiring Beijing to step in with a series of measures aimed at restoring confidence, particularly in the country's gigantic property sector. Prospects for both matter a lot to investors with broadly diversified geographical exposure and financial markets are as focused on what the future might hold as much as what the past has delivered. What makes the outlook so unclear is that having enjoyed a buoyant third quarter, US activity is expected to slow appreciably in coming months. History teaches us that eventual outcomes, as an economy slows, are notoriously hard to predict with accuracy. Can the much-desired "soft landing" be delivered, or might an over-zealous approach to vanquishing inflation tip the country into a contraction? In contrast, China ends 2023 in a state of stimulus-driven recovery. But here too prospects are far from assured, structural headwinds building as the past's over-reliance on investment reaches its limits.

Crossing the East China Sea, confirmation that the Japanese economy contracted over the third quarter of the year has only served to deepen the uncertainty surrounding prospects for a possible departure from the Bank of Japan's long-held ultra-loose monetary policy. Although inflationary pressures have rekindled, subdued economic activity points to unutilised capacity, an excess slack which in the context of an ever-declining population is a recipe for deflationary conditions to resurface. Domestic demand is under downward pressure due to falling investment, weak government spending and no better than flat consumer spending. On top of that Japan's export activity subtracted from the overall economic performance too. Japan is not yet in a recession, economic activity oscillating between growth and contraction, however, GDP is still 4.2% lower than prior to the pandemic-induced shutdown. In the context of which the country's stock market has fared strongly, resilience ascribed in part to a weak currency and in part to additional budgetary stimulus which, embattled prime minister Mr Fumio Kishida hopes, might boost his sagging opinion poll ratings.

> *Jeremy Hunt had an uncomfortable decision to make before unveiling his government's fiscal policy priorities.*

If Mr Kishida has concerns regarding his popularity in Japan they are nothing compared to those of the embattled UK administration. Facing a slump in opinion polls ahead of a general election that must be held before the end of January 2025, Prime Minister Mr Rishi Sunak has taken a bold, if risky, decision to return controversial former prime minister Mr David Cameron, now Lord Cameron, to high office as Foreign Secretary, the most high-profile in a series of senior ministerial reshuffles. Against a backdrop of a flatlining economy, still too high for comfort inflationary pressures and a base rate of interest at a 15-year high the Chancellor of the Exchequer, Mr Jeremy Hunt had an uncomfortable decision to make before unveiling his government's fiscal policy priorities. Should he assuage a hostile electorate by loosening the purse strings; cutting taxes and/or increasing spending, or should he, faced by a still tight labour market, not run the risk associated with fuelling demand and risk a potential re-acceleration in price pressures? The latter path would surely force the Bank of England to maintain interest rates at higher levels and for longer than markets, by their pricing, clearly anticipate. Ultimately, he opted for a modest £14.3bn "give-away" (0.5% of GDP), cutting employees' National Insurance tax and incentivising businesses partially, and temporarily, reversing the envisaged fiscal policy tightening set in train in 2022, before re-tightening from fiscal year 2024/25.

In contrast to the UK, the majority of national governments forming part of the Euro Area have committed to fiscal restraint for the next few years. National budgets aimed at returning deficits as a share of GDP down towards the 3% ceiling envisaged in the region's foundation through the Growth and Stability Pact have already passed into law. The notable exception is, however, Italy which, over the month, challenged credit rating agencies to downgrade its standing by enacting a mildly expansionary budget for 2024. For now, the agencies are holding fire, aware that senior European Union officials are overhauling budget deficit cap parameters and building in a degree of latitude should individual national circumstances warrant it. Notwithstanding this proposed adjustment, regional fiscal policy is unlikely to help drive an economic expansion, the single currency area still teetering on the brink of recession in part the consequence of tighter credit conditions and slump in bank lending the result of the European Central Bank's aggressive rate hiking programme.

And so we embark on the final few weeks of 2023, a period which has historically proved highly favourable for positive returns from financial assets. The past year has proved tough and presented numerous and diverse challenges, manifesting in a roller coaster year for investors. That these challenges have been confronted and overcome bears testimony to financial markets' considerable resilience. Thus, we can look forward with confidence to a future in which the foundations laid over November can be built on in the weeks and months ahead.