RAYMOND JAMES

Restoring credibility

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**"Never fear shadows. They simply mean there's a light shining nearby"
– Ruth E. Renkel**

Financial markets continued their revival from the early summer lows through November as investors' perceptions regarding the risks prevalent throughout 2022 diminished somewhat. That those risks had not disappeared completely was evidenced by violent protests breaking out across China at the end of the month in response to the new Chinese government's apparent desire to persist with its aggressive "zero Covid" policy. Prior to the outbreak, financial markets had responded positively to a highly constructive engagement between President Biden and the reinstalled President Xi of China at the G-20 Summit in Bali, which might lead to a new era of rapprochement between the world's largest and most significant economies. A more upbeat assessment of Chinese economic prospects might yet evolve, but investors have been dealt a reminder that financial market gains are typically hard won and that bond and stock prices seldom go up in a straight line without pausing for breath.

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On the domestic front, the newly installed Chancellor of the Exchequer delivered a tricky balancing act, satisfying the financial markets that the new government led by Prime Minister Rishi Sunak and Mr Jeremy Hunt were a credible alliance, whilst providing assistance to the economy when it needed it most. True, the Chancellor did unveil the most aggressive combination of tax increases and spending cuts since Mr George Osborne's austerity Budget of 2010, however the majority of the squeeze is not scheduled for the next two years and in the very near-term, enough headroom has been created to provide support to limit both the length and severity of the economic downturn. A muted response to the Chancellor's statement in the gilt-edged market and sterling's continued revival on the foreign exchanges point to the fact that relieved financial markets are prepared to give the government the benefit of the doubt.

The complete fiscal policy reversal from that proposed by the short-lived Truss/Kwarteng administration may have been sufficient to ensure that interest rates do not rise as much as had previously been feared. Admittedly, with headline inflation standing at 11.1%, a new 40-year high and few signs that it might be about to come off the boil, the Bank of England clearly believes that yet more base rate increases are necessary to ensure that the 2% target is achievable over the medium term. The really good news on the inflation front over November came from the United States where prices, both to consumers and at the factory gate, finally began to dissipate. With the price of semi-manufactured goods on a clear downward path, it is thought likely that the latest data might be more than just a flash in the pan and the beginning of a much-desired reversal of the recent upward trend.

The point at which the Bank of England believes that its work has been done will likely be determined by the reversal of still stubborn underlying inflationary pressures. The data make clear that domestic price pressures are still building, with service sector inflation hitting a new 30-year high over the month. Indeed, still elevated household inflation expectations have resulted in a wave of strike action which shows little sign of diminishing as the festive season approaches. The Bank is keenly aware that higher interest rates impart a braking effect on economic activity, and with a lag. Strike action and industrial protest will hardly help the economy's cause, so achieving the right balance between fighting inflation and salvaging economic activity may furrow more than a few brows on the City's Threadneedle Street in the run-up to Christmas and beyond into the New Year.

The restoration of fiscal policy credibility and the successful fight to quell inflationary pressures are critical components of investors' outlook perceptions. Bond and stock markets are typically forward-looking indicators, inhabiting the future as much as being informed by the present. The UK's economic slowdown is part of a more widespread deceleration. This is fully appreciated by financial markets and largely discounted during the weakness apparent earlier in the year. The extent to which that weakness transmits to the diverse corporate sector is perhaps the single biggest imponderable and "known unknown" that investors must come to terms with over the months ahead. In contrast, the travails of the wider world, whilst sombre and enduring, are at least proving no worse than previously expected. What might the topography of the investing landscape look like in twelve months' time? It will be the strength of the grounds for cautious optimism that will serve to grow the autumn's green shoots into something more durable in the future.

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