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Great Expectations

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

"Take nothing on its looks; take everything on evidence. There is no better rule" – Charles Dickens

July has proved a strong month for investors in the financial markets, particularly across the stock markets of Western developed economies. Returns were generated against a backdrop of economic resilience, especially in the United States where, despite the Federal Reserve having raised interest rates in excess of 5.00%-points in little over a year, growth has persisted and even exceeded expectations. The International Monetary Fund (IMF) has chipped in too, its updated World Economic Outlook publication now forecasting no recession across all key geographic regions. The Fund does, however, warn that risks to its optimistic assumptions lie to the downside in large part due to inflation's stickiness. Yet, even more important than the economy's capacity to weather the lagged impact of higher prices and the suppressing influence of higher interest rates, financial markets have responded positively to growing signs that inflationary pressures are subsiding.

What is now known is that global headline inflation, that including energy and food prices, has nearly halved from the peak levels of 2022, down from almost 8.0% to just 4.4% with the fall equally apparent across emerging and developed economies. The principal driver has been a fall in energy prices after last year's spike, especially in wholesale natural gas prices. Although this tailwind has proved enormously helpful thus far its strength is expected to diminish over coming months and indeed, the oil price has enjoyed notable strength over July as an anticipated strengthening in future demand has coincided with persistently tight supply, a reflection of the OPEC cartel's tight control on quotas and the continuing impact of sanctions on Russian oil exports.

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As investors know only too well, financial markets inhabit the future as much as being informed by the present. If the energy price effect is going to dissipate, further falls in inflation will have to be driven by falling food prices (a severe El Nino weather effect in Asia, protectionism in India and the collapse of the Black Sea grain deal are fortunately thought likely to be transient) and a drop in typically hard to shift underlying inflation. Encouragingly on this front, goods prices at the factory gate are moderating, while the lagged impact of higher interest rates should result in lower service sector prices over time. Central bankers, whose pivotal role is to set monetary conditions to a level where demand in an economy corresponds to supply, are less convinced and have continued to raise interest rates, emphasising in so doing that the labour market remains tight, threatening wage inflation and that companies are still minded to put prices up rather than bring them down.

But stepping away from the endless cut and thrust relating to where we might be in the economic cycle, whether inflation will fall in the months ahead or revive and by their actions, whether central bankers will prove the IMF wrong and induce a recession, what if all we're talking about are cyclical uncertainties in a much longer secular upturn?

Maybe, we should view the current phase in the context of a much longer timeframe? While the cyclical bull market kicked off in late-March 2020, following the market plunge induced by Covid-19's initial outbreak, the secular cycle actually began much further back in time, specifically in 1982 and following a vicious 14-year slump which saw stock markets around the world crater. To be sure there have been some notable cyclical bear markets over the ensuing years, including the 1987 crash, the "dot.com" bust at the turn of the century, the global financial crisis of 2007/08 and the European banking crisis a few years later.

But none of these events punctuating the financial market landscape have lasted and stock market valuations are currently quite high by historical standards. In a true bear market downturn, valuations should fall sharply, boosting expectations for future returns. As we make our way through the corporate reporting season aggregate profitability is still holding up pretty well and profit margins, which typically revert to the long run average have not done so.

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This lack of mean reversion is in part due to improved management practices and in part the early adoption of artificial intelligence (AI). The so-called "animal spirits" awakened by AI's potential are the icing on top of persistent rounds of financial stimulus, and on a global scale. Markets today are laser-focused on the end of the central bank tightening cycle and beyond that, a policy "pivot" to eliminate the risk of the secular cycle's completion.

Indeed, this market "faith" has been carefully cultivated by central banks themselves, preventing a turn in psychological positivity and well aware of the dangers that might be unleashed were they to lose control of the narrative. Whilst central banks are increasingly accused of hiking interest rates too far, the Federal Reserve Chairman Mr Jerome Powell recently observed that, "If we over-tighten policy we can still support economic activity". The flip side being that if central banks do too little, they risk losing control. Viewing the financial markets in long cycles suggests strongly that the secular upturn that began in 1982 is not yet complete. This implies, in turn, that once we're through this current phase prospects will brighten once again, a synchronised global economic upturn delivering strongly positive returns from financial assets. In expectation of this likelihood investors are more than happy to put up with near-term uncertainty for even better times ahead.