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Clouds of war shroud financial markets

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The month of October has a notorious reputation for those invested in financial market assets. The crash of 1987 and before it the Wall Street crash of 1929 spring readily to mind, but this year's version has been dominated, sadly, by conflict in the Middle East and more particularly by the war taking place in the Gaza strip between Israel and Hamas in retribution for the latter's attack on the 7th of the month. Hostilities have served to remind investors of the Yom Kippur war between Israel and Syria / Egypt back in 1973, an event which triggered an OPEC oil embargo and subsequent inflation and recessions across much of the developed world as the price of crude surged. Truly distressing as the humanitarian aspect of all wars is, financial markets are dispassionate, asset pricing reflecting not just that which has come to pass but speculation as to how events might unfold, scenario analysis working through every aspect of a variety of potential outcomes from negotiated settlement through to wider conflict as other countries become embroiled.

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Over and above the direct consequences an escalated conflict might deliver, weakness across both stock and bond markets reflects concerns regarding so-called second round effects, an additional uncertainty surrounding the outlook for both economies and financial markets already anticipating slow levels of economic activity in certain geographic locations and a possible contraction in others. Strange as it might be to say it, market participants are registering concern regarding possible outcomes, but not panic. Although financial asset prices have fallen, they have not plunged and conditions remain generally orderly. This is not so much a case of studied insouciance as a reflection of the fact that markets have become used to and grown resilient to geopolitical shocks.

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If Russia's invasion of Ukraine in 2022 serves as any kind of template, the financial markets' first reaction to any form of conflict lies in the commodity and more particularly the energy markets. These, as in 1973, are the most obvious channels through which wars directly impact elsewhere, yet it is noticeable that despite fears that Iran, an ally of both Hamas and Hezbollah in Lebanon, might become embroiled, the crude oil price has held steady following an initial jump. In part, this is being ascribed to the diminished importance of the Middle East as a contributor to global supply, its share of the market dropping from 40% in 1970 to around 30% today. Beyond that, US shale oil represents an alternative and more flexible source of supply and beyond again, most developed economies, including that of the eurozone in the wake of last year's energy crisis, have developed sizeable strategic reserves available for drawdown in the event of any potential supply disruption.

None of this is to say that the crude price will not spike sharply in the event of an escalation, but for now, support for financial markets is coming from a hitherto unlikely source. Having spent much of the post-pandemic period worrying about inflation's persistence central bankers and financial markets are gearing up for a very welcome surprise as price pressures continue to diminish. Of course, a slower-paced increase in the rate of inflation is not the same as outright deflation, but the encouraging news is that as the pressures of autumn 2022 drop out of annualised calculations, so price increases will abate, possibly sharply, over the autumn and winter. Furthermore, as

the lagged impact of earlier interest rate increases make their way more fully into economic activity, and rising government bond yields do much of central banks' monetary policy tightening for them, so the pressure to raise interest rates yet further is reduced.

For now, the world's most important central banks continue to pedal the same message, interest rates will remain higher for longer in order to ensure that price pressures, once vanquished, do not re-emerge. This optionality is understandable given the opaque outlook, but investors can look forward with increasing confidence to the point at which that message will be forced to adjust. For now, the fact that inflation is holding above 2%-point medium-term targets leaves no scope for any alteration, but central banks are not the best economic forecasters and mandates infer that policy must become more nuanced once price increases drop into target ranges. The UK government has targeted inflation to halve from its above 10% rate in December 2022 and will likely receive some much-needed good news on that front over the autumn. Indeed, a return to target by March / April next year cannot be ruled out, an event, were it to transpire, that could trigger lower interest rates much earlier than that envisaged by the markets or indeed, the Bank of England's own forecasts. Positive surprises such as this are in great demand right now and would surely be welcomed by investors awaiting an upturn in the economic cycle.

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