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OUT OF THE ORDINARY

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Fairy Tale Economics

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Once upon a time there were three... economies, which lived in an ever changing world of increasing geopolitical, social and financial complexity. Or something like that. We are all familiar with the story of Goldilocks and the three bears: how she sneaks into the bears' house, proceeds to try (amongst other things) three bowls of porridge and declares one "just right". This one bowl is neither too hot nor too cold, giving rise to the story's protagonist receiving her own eponymous 'Goldilocks' principle. The concept has wide

ranging use, from cognitive science to astrobiology, going back at least as far as Ancient Greece when Aristotle analysed the golden mean in his discussion of ethics, reflecting the Delphic maxim "nothing in excess".

We are interested, though, in the fabled Goldilocks economy in which both moderate economic growth and low inflation are sustained in harmony. Ultimately, this balance is what Central Banks strive for through their monetary policy cycles. While arguably this fairy tale ending to an economic cycle has yet to be achieved in recent modern history, as we often lurch from boom to bust, Central Banks and governments (and we the general investing public) nevertheless continue to live in hope.

So, as we continue through corporate earnings and the monthly economic readings, let's consider the bowls of porridge of three global economies to get a taste for how each might be faring so far.

UK: the big bear

This adjective should definitely not give us a false sense of self-importance, as inflation in the UK is notably more challenging by comparison to Western peers while economic growth languishes: a potentially precarious position. The Bank of England has maintained its rhetoric around the need for further rate rises against obstinate inflation numbers. Although down from May, the June Consumer Price Index (CPI) number stood at 7.9%, while UK second quarter GDP came in at a modest 0.2% expansion. While in context against its own data over the last year the UK's recent numbers appear to be moving in the right direction, they are still absolutely elevated and deflated in the wrong areas. Contrast to the Eurozone's recent 5.5% CPI number and this bowl tastes far too hot.

China: the middle bear

After China's burdensome lockdowns, few initially predicted the ultimate reopening of the Chinese economy to be so anticlimactic. This month China reported trade data showing that imports fell by 12.4% year-on-year in US dollars, while exports declined 14.5% on the same basis. For context, the latter descent is the largest fall since the start of the pandemic hit in February 2020. The CPI reading of -0.3% in July against 0.0% in June shows that while the west grapples with inflation (too hot) China is struggling with deflation. This bowl is certainly too cold.

US: the little bear?

Confusingly, to my mind at least, it is not the middle bear's porridge that was just right, but the little bear's. That brings us to the economy that some have dared to whisper with trepidation in the same breath as "Goldilocks". We now have July's CPI print, coming in at 3.2%, which marks an increase from June's 3% though, crucially, is line with expectations. As we have seen from the other two, this number is not only in the middle but also the closest to the generally agreed 2% inflation target that most Central Banks hold. The Federal Reserve might see this data as good reason to maintain, not raise, rates in their September meeting. Against the backdrop of a second quarter GDP number of 2.4%, the economic data are starting to make this bowl taste just right. The maxim "nothing in excess" might not be totally out of place here. However, "excess" is certainly being thrown about when it comes to the US stock market.

Consensus in contrarianism

Having had the opportunity to speak to a reasonable number and cross-section of US fund managers so far this year, most have been cautioning against getting too caught up in 2023's stock market strength.

Notwithstanding the cynic's calling out the active manager's opportunism in 'talking up their own book' (particularly as many lag the very index they criticise), their arguments on high-level US stock market overvaluation and index concentration flying in the face of economic reality, do make some

sense. Likewise, it has broadly paid off for active managers to be somewhat contrarian in their views in the past, as they need to do something different to the market if they are to beat it. But at what point does contrarianism become the consensus? Clearly not all active managers have been so decidedly pessimistic on the rally, but just like 'the most talked about recession in history', there is a sense that the professional investment crowd is very much fearful while the driving forces of the S&P 500 are firmly in greed mode.

Even Wall Street's so-called biggest bear, Mike Wilson, has swerved from his year-to-date doom and gloom market neigh saying. Writing in a July research note that the market is in a policy-driven, late cycle phase in which stocks are in a 2019-like rally, he now thinks the market has further to run. Remember that before the onset of COVID many macroeconomic pundits were expecting the end of the economic cycle. The era of easy monetary policy had to end while rates had been slowly ratcheted higher, bringing fears of a tightening-induced recession. Sounds familiar?

Note that while year to date the S&P 500 is up around 17% in US dollars when including dividends paid, the index was up just over 30% by the end of 2019 for that year. The economy and inflation in the US may be good relative to other countries, but are they that good? To reiterate this rather odd investing environment we find ourselves in, given how many keep repeating the 'stretched valuations' mantra, perhaps the truly contrarian active management position is to be bullish.

Happily ever after?

Taking account of the economic data and stock market activity, particularly in the US, we might question in what sense we may or may not be in an economic fairy tale. In one sense the US might yet realise the fairy tale ending of moderate growth, low inflation and adequate stock market returns. But perhaps hoping for such a scenario while the upper echelons of the stock market are priced for perfection and inflation remains stubbornly above target is a different kind of fairy tale altogether: one that defies reality and economic history. There is an important difference between a well-tempered balance and a benign, yet fragile environment.

Whether or not central banks manage to produce the perfect bowl of porridge, a balanced approach to investing, diversifying to prepare for a range of eventualities, is often best in times of such extreme fairy tales on both ends of the spectrum. Indeed, perhaps we should heed Aristotle's golden mean, not by thinking of it, somewhat disparagingly, as 'sitting' but rather as 'balancing' on the fence.

Economic Commentary

FTSE 100 weekly winners

InterContinental Hotels Group PLC	6.0%
Admiral Group plc	3.9%
Reckitt Benckiser Group plc	2.8%
Burberry Group plc	2.1%
Standard Chartered PLC	1.8%
GSK plc	1.8%
Hikma Pharmaceuticals Plc	1.8%

FTSE 100 weekly losers

Abrdn plc	-15.0%
Just Eat Takeaway.com N.V.	-9.2%
Antofagasta plc	-7.2%
Entain PLC	-6.2%
Scottish Mortgage Investment Trust Plc	-6.1%
Rio Tinto plc	-5.7%
Flutter Entertainment Plc	-5.4%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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