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Back on Alert

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It's only three weeks since the last edition, but a lot has happened during that period. I already had more than enough material to populate this piece before the latest hostilities in the Middle East, and that is the situation that needs to be addressed first. The good news, at least as we go to publication, is that the situation does not appear to be escalating and there are plenty of calm heads intervening to try to keep the temperature down. In financial markets, there has also been a meaningful shift in interest rate expectations over Easter, and so I will also make some comments on that.

Thankfully, things are looking a lot less fraught in the Middle East than when headlines first appeared on Saturday 13 April that Iran had launched several hundred missiles towards Israel. I think we can also be grateful that financial markets were not open when the news came out, as it could have created extreme volatility. By the time markets opened in Asia on Sunday night, traders had some decent perspective and they concluded that, in many ways, this was about as soft an attack as Iran could have launched. It was extremely well telegraphed, with rumours of its imminence circulating for days. Iran announced the launch knowing that it would take several hours for the projectiles to reach their targets, giving plenty of time to prepare. It is inconceivable that Iran was unaware of Israel's defensive shield, which is able to shoot down approaching missiles, and that this would be enhanced by the air forces of various of its allies. This shield operated extremely effectively, with virtually no damage or casualties reported. Iran's mission to the United Nations even put out a statement to the effect that the "matter [was] concluded".

And so, there was precious little evidence in markets that anything did happen. The oil price succumbed to a bit of profit taking after a strong run and safe haven bonds actually sold off a little. Any weakness in Asian equity markets was ascribed to them catching up with the decline in US equities on Friday, which was driven to a great degree by some disappointing results from a few big banks. Gold was the only asset that betrayed any emotion, rising around $15 per ounce to another new all-time high before itself settling back down again - but it has been on its own merry run which has to be ascribed to more than just the desire to own a traditional safe haven asset to hedge geopolitical risks.

Sadly, none of this means that we can pretend this never happened. Iran's actions have put the ball firmly back in Israel's court. It has effectively challenged Israel to respond while warning it that the big guns are still in reserve. It is clear from reports that Israel's allies are urging it not to retaliate, but we know from Israel's internal politics that this will be an unpopular request. Thus, the tension is unlikely to ease much in the days ahead and markets will remain on high alert for more military action in the region.

From a markets and portfolio perspective, the key variable in all of this is the oil price. Iran's own output, which these days heads mainly towards China, would be under threat from direct attacks from Israel, although the major disruption, amounting to almost a fifth of global supplies, would result from a closure of the Strait of Hormuz. How big a "geopolitical premium" should be ascribed to oil is an impossible question to answer precisely. Past estimates for the oil price during such an upheaval range from around $130 to as high as $250 per barrel versus the current $90. The latest comments from Citigroup and Goldman Sachs suggest that at $90 the Brent crude price embeds a premium of around $10. OPEC+ also has plenty of spare capacity, amounting to around 5% of daily global production if it is minded to use it.

And if the oil price does remain elevated, a lot will depend upon the response by central banks. The European Central Bank infamously raised interest rates in the summer of 2008 in response to a high oil price while not paying heed to the more deflationary forces that were about to overwhelm the banking system. Matters are complicated at the moment by the fact that inflation is proving to be a bit stickier than expected or desired. Market-implied inflation rates have picked up sharply in recent weeks, especially in the United States, giving central bankers a bit of headache.

The US Federal Reserve sits at the apex of the global central banking system and, for much of the period since the Global Financial Crisis (GFC), others have followed where the Fed has gone (with the notable exceptions of the

People's Bank of China and the Bank of Japan). At the start of this year, futures markets were pricing in six or seven quarter point US interest rate cuts during 2024, starting in March (and around the same in the UK and Europe). March has come and gone with no action, and none expected now until August or September at the earliest, with some investment banks suggesting no move until after the Presidential election which takes place on 5 November. At the extreme, there are a few commentators suggesting that the next move will be an increase, but I am suspicious of their motives.

Although much of this shift in expectations is being ascribed to sticky inflation, in the US, at least, it is thanks in part to a robust economy. GDP growth for the quarter just ended is tracking at 2.4% according to the Atlanta Fed's GDPNow forecast. The consensus forecast is for 2.2% growth over the whole year. Meanwhile, the UK and Europe are barely registering a pulse, with respective forecasts of 0.3% and 0.5%. That suggests that there could be more breaking of ranks as central banks respond to local conditions. That was the message from the European Central Bank last week as it telegraphed an interest rate cut in June.

The good news remains that interest rates are now at levels from which they can be cut if required, but we should be careful what we wish for. Rising unemployment or some sort of shock to the financial system would probably force the central bankers' hands, but at what other costs? A healthy economy even with interest rates at their current levels would be no bad thing. In many ways it would signal the end of the persistently low growth and disinflation associated with the aftermath of the GFC. However, we don't really seem to be there in the UK or Europe, and it's possible that US growth is being elevated to some extent by a persistently high fiscal deficit. Neither Joe Biden (more spending) nor Donald Trump (more tax cuts), the current contenders for the White House, appear to be in a hurry to rein in the deficit, and so US growth could well be set for this year at least.

But the bill for such largesse will eventually come due. The US government's interest bill has climbed above $1 trillion per annum, or to the equivalent of around 18% of its annual income (a figure last seen in the mid-1990s when President Clinton was overseeing a sharp reduction in the fiscal deficit). There is always the risk of bond investors displaying their concern over whether it will be paid.

Meanwhile, we are heading into the latest corporate reporting season with low expectations. Aggregate year-on-year growth for quarterly earnings is forecast to be just 3% in the US and -14% in Europe. As always, the aggregate figures hide a lot of divergence, with Energy being the biggest detractor owing to the movement (lower) in commodity prices over the period. Meanwhile, the Technology sector remains very healthy in the US, while Banks are expected to be the biggest contributors to growth on this side of the Atlantic thanks to higher interest rates. Given the valuation headwind from higher interest rates and bond yields, the onus is now falling even more heavily on companies to deliver the goods in terms of profits.

Economic Commentary

FTSE 100 weekly winners

Fresnillo PLC	14.9%
Rio Tinto plc	8.1%
BP p.l.c.	6.5%
Glencore plc	6.0%
Standard Life Aberdeen	5.9%
Shell Plc	5.6%
Shell Plc	5.6%

FTSE 100 weekly losers

Phoenix Group Holdings plc	-8.0%
Aviva plc	-6.2%
Ocado Group PLC	-6.1%
JD Sports Fashion Plc	-6.0%
Sage Group plc	-5.3%
International Consolidated Airlines Group SA	-5.3%
Standard Chartered PLC	-5.1%

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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