Review of the week

13 February 2023

# The uncertainty principle

**After years of upheaval, huge stimulus and changing habits from work to play, the paths of economic growth and inflation disappear into a fog as thick as a February morning. That's why we're still cautious about 2023.**

The pound had a good week, especially against the euro, buoyed by GDP data that was better than the IMF had predicted.

Back in the summer, the IMF thought Britain's economy would grow 3.2% in 2022. It actually came in at 4.0%, with greater government spending, a rundown in household and business savings and a boost in business investment offsetting a deflating housing market and falling real incomes (adjusted for inflation). Despite that better-than-expected result, the UK still shrunk 0.5% in the December and is the only G7 nation whose economy is smaller than before the pandemic. After shrinking 0.2% in the third quarter, Q4's 0% outturn avoided one technical definition of recession (two consecutive quarters of negative growth), but given just £75 million less expenditure would have landed us in recession, does that technicality really make a difference? To put £75m into context, the NHS spends that every four hours.

To be fair, as soon as you heard the IMF laying the UK's economic woes on thick, you just knew it was going to be a bit wide of the mark. You can easily imagine tens of millions of miffed Brits subconsciously spending a little bit more over the past few months just to show the world that it isn't quite so terrible living here in Blighty; the act of measurement affecting the outcome. Werner Heisenberg's Uncertainty Principle in a pub near you. Or it could be the old reliable: economies are so extremely complicated - and confounding because they are the result of millions of human decisions - that trying to forecast anything with decimal-point accuracy is a fool's errand.

Still, we do agree in principle with the IMF's prognosis for the UK. A shallow recession seems inevitable, and it's likely to go on for longer than anywhere else. The main reason we agree with the IMF is because the UK faces the longest stagnation in real wages since the 1800s: British paypackets, adjusted for inflation, are forecast to remain below 2008 levels until around 2027. Bleak. So make sure you take advantage of all the tax allowances you can, while you can!

One IMF prediction that we do not agree with is that the UK will be the only major economy to contract in 2023. While we think the UK is the most vulnerable to shrinking GDP, it seems likely that Europe and the US will also fall into a mild recession this year. Although, uncertainty around the start of these recessions could still mean this prediction is still consistent with those nations' economies growing over calendar 2023, highlighting the arbitrariness of calendar-based reporting.

Having made that statement, we admit it is extremely difficult to track what's going on with economies right now. Much more than normal. There have been so many shocks, so many wrenching changes in markets, from energy and labour through to computer chips and lumber, that many economic signals seem less reliable than they used to. We started the year advocating a bias to defensive stocks - those whose sales should hold up best in a downturn, yet also wouldn't benefit from any uptick in economic fortunes. However, stock markets have roared higher in late 2022 and early 2023, benefiting racier businesses and those that offer more opportunities for revenue growth.

While we have been wrong in the past few months, we still believe it's right to be cautious this year. Much of the recent market gains have been driven by overoptimistic investors hoping that the US Federal Reserve (Fed) will soon stop raising rates and even start cutting them before the year is out. This might happen. But, looking at the evidence before us, we think it's much more likely that inflation remains higher than people hope for longer, pushing the Fed (and other central banks) to hike rates more than currently forecast and keep them at that level for longer. And that could cause an outsized fall in the values of racier stocks. We think that fall would be greater than any increase in value if the Fed does pause quicker than we expect. Meanwhile, we expect company profit forecasts to fall with economic growth.

When we make investment decisions, it's not with a hard-headed assurance that X will happen and Y won't. Rather, we are trying to determine – to the best of our ability and with the information that we have – what likelihood there is that X or Y could happen. And then, crucially, we determine *what effect X or Y would have* on the prices of stocks and bonds. Both are important.

### Flying a kite

In the good old days, weather balloons getting shot out of the sky used to spark nothing more than some fun yarns from UFO enthusiasts. These days they're exacerbating a steady escalation in an economic war between America and China. Although, it's nice to see some journalists still asking whether there's an extraterrestrial explanation. The truth is out there…

US fighter jets have shot down four high-flying objects in its airspace over the past eight days. Two of them have been confirmed as Chinese balloons, almost certainly spy apparatus. The first spy balloon, spotted the week before last, captivated Americans, who watched it float across their country over a weekend before it was shot down over the sea. Another slow-motion chase for the ages to go along with the Balloon Boy alien abduction hoax of 2009.

But jokes aside, the balloons couldn't have come at a worse time. The fact that an unknown number of these machines had been flitting across the US, seemingly for a considerable period of time, has raised questions about the efficacy of US airspace security. If any internal arguments between Republicans and Democrats get acrimonious, it only heightens concerns about a lack of agreement over the need to raise the US debt ceiling.

The US Congress is constrained by law to keep borrowing beneath a certain level (currently $31.4 trillion). Periodically, it must pass laws to increase this amount to ensure that the government can sell bonds to raise the cash needed to pay for spending already approved by Congress in budgetary acts. This political theatre always becomes a game of chicken between the Democrats and Republicans, which is bonkers because the consequences of the US defaulting on its debts because it can't raise more debt would be catastrophic.

The US actually hit its debt limit about a month back. Treasury Secretary Janet Yellen wrote an open letter to Congress imploring them to agree on an uplift and setting out "extraordinary measures" that she hoped would delay default until early June. Congressional leaders are yet to make any agreements, the news-cycle swiftly moved on and the clock continues to tick down. A cynic would think it's a great time to sow discord among a rival's leadership!

Historically, debt-ceiling brinkmanship – even when it has shut down the government – has never had made any lasting impact on financial markets. But the possibility of a default seems above zero this time. We're preparing an investment strategy and roadmap, and we'll keep you updated.

There're also the external consequences of the balloon debacle. America has already added six more Chinese companies to its export blacklist for their alleged ties to the first downed balloon. China has flatly denied that the balloons are for spying, arguing they are weather balloons that came unmoored. There's a risk that China retaliates, sparking another tit-for-tat exchange as we saw several years ago. Globalisation is already fraying a bit, strained by both the upheaval of the pandemic and the war in Ukraine, but also by the increasing friction between the world's two superpowers: China and the US. Yet more division between these two economies would hurt global trade, increase the cost of goods and impede the world's technological progress. At the very least, it adds a risk premium to Chinese companies dependent on foreign sales, and foreign businesses dependent on Chinese consumers.

All over a few balloons.

*If you have any questions or comments, or if there's anything you would like to see covered, please get in touch by emailing review@rathbones.com. We'd love to hear from you.*

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## Important information