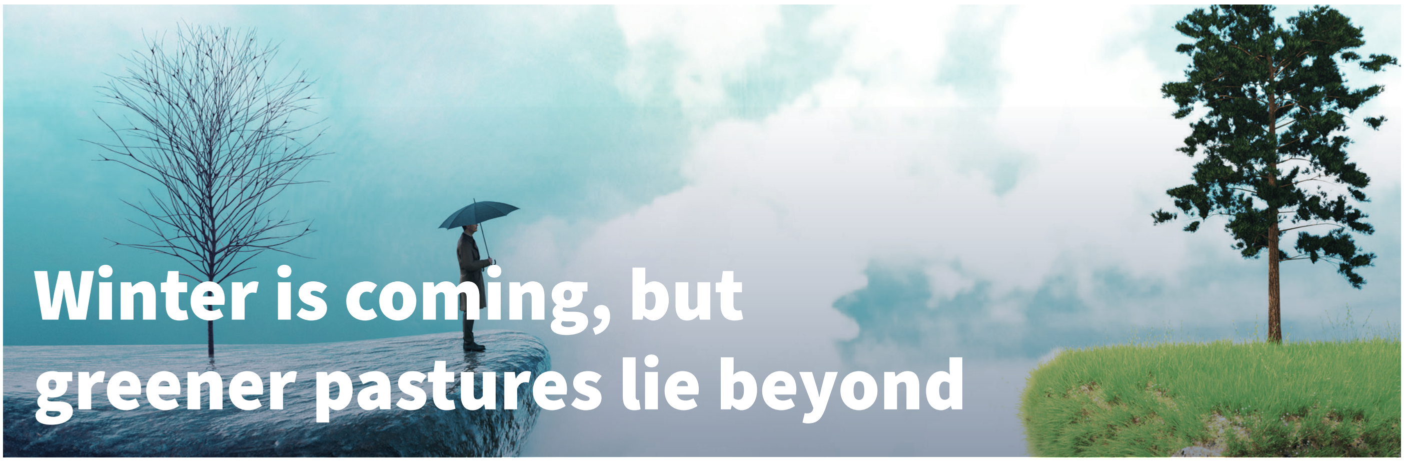
RAYMOND JAMES



Winter is coming, but greener pastures lie beyond

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

"It isn't what we say or think that defines us, but what we do" – Jane Austen, Sense and Sensibility

The summer months are typically characterised by limited news, thin trading volumes and illiquid conditions which, can serve to accentuate moves in financial asset prices both to the up and the downside. The summer of 2022 has proved an exception. Seldom in the long City careers of many financial market observers have we experienced so much uncertainty, be it geopolitical, political, economic or to do with financial markets themselves. Volatility across both bond and stock markets alike is far more elevated than is typically the case as summer slowly evolves into what looks like a difficult autumn and winter ahead.

An energy price crisis is now front and centre, making headline news and posing a huge problem for whoever takes the keys to No 10 Downing Street. But eye-watering energy price bills are merely the tip of a very large iceberg. The US economy is slowing down at a time when inflationary pressures are elevated, and the country's central bank is dead set on raising interest rates, evident in its intent on restoring the genie to its bottle even at the cost of additional economic weakness. In Europe, French President M. Emmanuel Macron tells the local population and business community still recovering from the pandemic that "the age of abundance is over" as Russia continues military operations in Ukraine and commodity price pressures, including food and oil, revive after a two-month hiatus. Over in Asia, US House of Representatives Speaker, Ms Nancy Pelosi carried out her visit to Taiwan, prompting a bellicose response from Beijing and naval manoeuvres in waters around the Island, most perturbingly involving the over-flight of live missiles. A blockade of Taiwan's exports, particularly the silicon chips for which it is famed, would cast a long shadow.

> *Eye-watering energy price bills are merely the tip of a very large iceberg.*

In the United Kingdom, the Bank of England shocked the nation and financial markets by making a recession outlook its base case for the medium term. While higher interest rates will certainly play a part, the forecast recession of 2023 will indeed be driven by high energy prices, consequent high inflation and a severe contraction in the spending power of both households and businesses in real, inflation-adjusted terms.

This, in turn, raises two important questions. Firstly, how deep might the UK's recession be and secondly, how long might it last?

> *How deep might the UK's recession be and secondly, how long might it last?*

The Bank forecasts a contraction in GDP of 2.2%, but there are good reasons for believing the Bank's forecast to be too pessimistic. Despite the very obvious pressure on household finances posed by eye-watering energy bills, in the round household and business balance sheets are fairly healthy. A hit to real incomes could result in a comparatively mild, say 1% activity contraction, which, while painful, would be nothing like the severity of the Bank's forecast or indeed the six contractions experienced since 1970, including, of course, the massive 21.5% plunge at the apex of the Covid-19 crisis in 2020.

In terms of duration, the Bank's recession forecast may again prove too pessimistic. Whilst four consecutive quarters certainly matches the length of previous downturns, the severity of the impact will likely be most keenly felt over the winter months, beyond which a slow revival may ensue, especially if falls in both residential and business investment prove to be smaller than in the past. Furthermore, with available workers hard to come by, firms may be more reticent to lay employees off than might have been the case in the past. Elsewhere, the first half of 2022's weakness in global financial markets, from which the UK's stock market was relatively unscathed given its heavy weighting to the energy and basic resource sectors, has served to take much of the earlier bubble-related froth away- and reduced the chances of a major asset price collapse over the autumn.

Indeed, were stock markets to experience a halt to the July – August revival and subsequent pull-back, a not altogether uncommon autumnal eventuality, following a welcome revival off end-June lows, this would feel like an excellent investment opportunity for longer-term investors interested more in long-term returns than short-term speculation, but we have to get there first. Remember, financial markets, whilst responding to current events, are typically attempting to discount the future too.