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Quarterly Macro Commentary

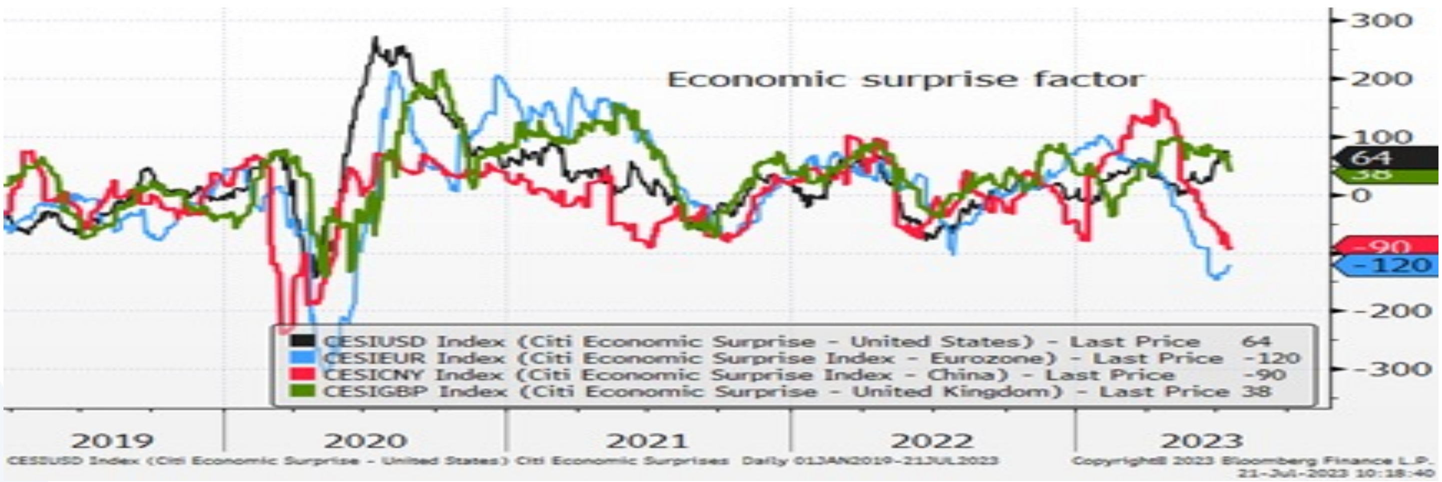
SECOND QUARTER 2023

The outstanding feature of Q2 was the apparent resilience of economic activity, primarily in the US, against a backdrop of higher interest rates and tighter credit conditions. This helped maintain a risk-on bid in equities. The key now is to remember that monetary policy is infamously subject to "long and variable" lags in terms of the impact on the real economy.

It is difficult to get a clear picture of where the major economies are heading. China has markedly slowed from the earlier re-opening surge, helping to explain a continued weakness in key commodity prices. The cyclicality of many indicators is still being disturbed as a long-term consequence of the COVID shock: the usual "entrainment" of various indicators has given way to ongoing noise as various parts of the economy operate with varying degrees of capacity and/or pricing constraints: this increases the odds of major policy errors.

We noted early in the tightening cycle that central banks seemed destined to continue raising rates "until something breaks". We have certainly had warnings, not least the US regional banking industry, but risk markets plough-on regardless, as somewhat of a "FOMO" bubble has appeared in big tech names. Now in particular the Bank of England is still talking tough, although this does need to be understood in the context that 90% of what central banks do policy-wise is jawbone the market into a particular view of interest rates, so we could be seeing bluff. The UK economy looks increasingly fragile as the lags of the blunt tools of monetary policy start to bite somewhat arbitrarily, across the economy. The US economy is currently showing signs of resilience, but with interest rates at generational highs, and equity markets already having discounted a less-bad news flow, the attractiveness of risk assets is questionable.

We appear to have gone from a period of inflation paranoia to now (in the US at least) a marked complacency about inflation, especially the threat of future commodity price shocks. The Bank of England has been explicit that their benign outlook relies on energy prices remaining where they are for the near future: a reminder that we are still largely hostages of fortune. That said, to the extent cyclical inflation concerns may be normalising, the longer-term picture will remain worrisome. With the "Green Transition" & "Bidenomics" (combining both green-investment and increasing friend-shoring of supply chains), in a world of already historically elevated levels of government debt, inflation remains the long-term exit-route of choice for several key policy dilemmas. Central banks may end up fighting their own governments.



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