The turning point?

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"Every exit is an entrance to somewhere else" – Tom Stoppard (Rosencrantz and Guildenstern Are Dead)

How appropriate it is that at the year's turning point the financial markets of the world find themselves at no less a juncture. The past, a foreign country in which "They did things differently there"; the future, a step into the unknown. "We cross our bridges when we come to them and burn them behind us". Quo vadis? The global economy, having previously shown signs of acceleration as the adverse effects of the previous surge in post-pandemic inflation's surge subsided, allowing room for a broad swathe of central banks to begin the process of lowering interest rates, is under pressure again. Although a cost of living crisis lingers like a pall of acrid smoke in the air, real – inflation-adjusted – incomes have at least improved somewhat. But now political factors have intervened, potentially jeopardising the recovery just as momentum starts to build.

The UK's General Election delivered the expected substantial majority to the Labour Party in the House of Commons, albeit on a very low share of the overall vote, while in France the hastily called elections for the lower house National Assembly have resulted in even greater fragmentation than existed previously. But from the standpoint of international financial markets, developments in US politics took precedence. The televised debate between President Biden and his challenger Mr Donald Trump, an event the latter won comfortably, kick-started a sequence of events culminating in the former's withdrawal from November's race. Republican Party momentum gathered strength following the failed assassination attempt on Mr Trump at a rally in Pennsylvania, forcing Democrats into a swift rearguard action the highlight of which proved to be Vice President Ms Kamala Harris emerging with widespread endorsement ahead of August's confirmatory Convention.

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In the stock market, events described above have delivered a sea-change. Every investment strategy that worked over the past year or more suddenly hit a brick wall. Everything from the much-vaunted artificial intelligence technology trade (hitherto comfortably the most popular momentum strategy) to the Japanese yen (the global investing community's borrowing currency of choice) altered course. The gold price, having hit a record high, gave ground as investors turned away from a perceived inflation hedge while yen strength against the dollar is more a hedge against deflation as markets continued to bet that decelerating inflationary pressure and a more balanced US labour market could prompt the Federal Reserve into its first rate cut. This, a strengthening in the odds of a Trump victory in November (and Republican Party clean sweep in Congressional elections), prior to a re-energised Democrat challenge and an economic soft landing, delivered a notable rotation away from giant technology and into more domestically focused smaller companies, especially in the United States. Simultaneously, the UK stock market's ongoing resilience is an indication that so-called value (economically sensitive) investments might be back in vogue again.

Although less striking than developments in the stock market, price action across developed economy sovereign bond markets has been telling too. Specifically, while shorter-dated bond yields have edged lower as the number of central banks now actively cutting interest rates has increased, including the European Central Bank, Bank of Canada and the People's Bank of China, yields of those bonds offering a longer duration to maturity have risen. The adjustment feels like a non-confirmation of the optimism apparent across developed stock markets. Typically, falling short-dated yields and rising longer dated yields are an indication of imminent recession and beyond that, that markets are increasingly concerned by the generally weak state of numerous countries' public finances including, notably but far from exclusively, those of the United States and United Kingdom.

Beyond the two major asset classes, subdued commodity prices, including the crude oil price, are a reflection of investor concern regarding the health of the global economy, including that of the world's second largest, China, where the conclusion of the ruling Communist Party's economic policy-setting agenda failed to deliver anything sufficiently concrete to address numerous and wide-ranging structural challenges.

The two stand-out central banks so far refusing to be drawn into doing their bit to encourage economic activity are the US Federal Reserve and the Bank of England. Senior officials continue to agonise over residual inflationary pressures even as the pace of price increases decelerates to the extent that, in the case of the latter, headline consumer price inflation has held at the 2% target level for a second consecutive month. Financial market pricing reflects a growing conviction that interest rate cuts, oft postponed, will finally take place in the early autumn, but even this cannot be assured.

The newly installed Labour administration in the UK is facing pressure to raise public sector pay, especially for teachers and NHS workers, possibly requiring tax hikes to ensure that public finances at least remain in check, whilst risking restoking inflationary fires. In the US a recession and / or sharp rise in unemployment could force government bond yields higher as markets discount a possible further deterioration in the national accounts. What, though, if (US) politicians demand that the Federal Reserve funds the country's ballooning deficit via an enforced return to quantitative bond purchases or a Japanese-style yield curve control? How might the mighty dollar respond to that?

Who said that the summer months are a time for leisurely repose? While financial market headlines are forcing short-term investors to wait anxiously, and Micawberishly, for something to turn up, those investors adopting a longer-term approach to investing do at least have the relative luxury of waiting to see how prevailing uncertainties resolve themselves. Encouragingly, through all of the above, markets have remained orderly and disciplined. Market sentiment indicators provide clear evidence that those investors holding broadly diversified portfolios for the longer term are happy to hold the line. There will be plenty of time to adjust allocations as necessary once the future can be assessed with a higher degree of conviction in the months ahead.