Rathbones
Look forward

Review of the week

27 February 2023

A way forward?

A new deal for the Northern Irish border is imminent, bringing hope of greater clarity on Brexit for the UK. Meanwhile, the outlook for global inflation only gets foggier.

Do we build our environment or does our environment build us?

The idea that our buildings can influence our habits, the gradient of our lawns can alter our mood, that the shape of our skylines can bolster our ambition, has been argued over for years. It seems intuitive that we are affected by our environment, it just depends how much and in which ways. The debate, surely, must not be that our environment comes to define us - it surely does - but whether we can manipulate our surroundings to control behavioural change in predictable ways. This is a tough task. Economists are kept up at night by unintended consequences; architects no doubt have similar nightmares.

One place where the lived environment and economic reality helped usher in change was Northern Ireland. The great elegance of the Good Friday Agreement, which ended 30 years of horror, acrimony and bloodshed in Ireland, was that it used the porous nature of the EU's trading bloc to erase some of the physical division between the Republic and the northern region. The complex agreement took a lot of goodwill and forgiveness from both sides, it included a whole raft of political compromises and changes, and it also allowed free movement across the border. While it shouldn't be overplayed, this dissolution of borders between the Republic, Northern Ireland and Great Britain was immensely helpful to the agreement. Republicans saw a more united Ireland; unionists saw stronger ties with the UK.

It wasn't perfect. Violence continued after the official truce was signed and trouble continues to flare up even today. There were other changes to the environment, too, with checkpoints disappearing but thick, high 'peace walls' put up instead to separate Catholic and Protestant communities within Belfast. Yet the island of Ireland has come a long way since 1998. Cross-border trade increased, people could take jobs wherever it made sense, the Troubles were over.

This delicate state of affairs has been an unresolvable problem since former Prime Minister Boris Johnson's Brexit deal was first proofed. Northern Ireland was always going to be the most tightly bound of all the knots that built up over decades of life within the EU's trading bloc. Brexit is about putting daylight between where the UK ends and the Continent begins. Unfortunately, almost by definition, that puts dangerous divisions through Ireland once more. Johnson's solution - the Northern Ireland protocol - was to put this border between Northern Ireland and Great Britain. This concerned unionists, who felt they were being cut off from the rest of the UK and would be increasingly subject to EU law, to which they have little input. The protocol has precipitated years of wrangling since. Stormont has been without a government for more than 380 days because of unionist MPs' boycott of the North Irish Assembly. However, the alternative would be a border between the Republic and Northern Ireland. Not enticing.

UK Prime Minister Rishi Sunak has been hammering out a deal with the EU over Northern Ireland and hopes to announce the terms this week. It will no doubt be extremely complicated - news reports say it runs to more than 100 pages - and it will not please everyone. It will also need to be accepted by the EU, Ireland, Northern Ireland and the UK Parliament. It's a tough ask, but it's been kicked down the road for too long already.

A new deal is likely to improve the UK's economic performance, as long as businesses believe that it will stick. Business investment in the UK, both from domestic enterprises and foreign investors, has been very, very weak since 2016 - far more than other developed nations. There is rare agreement among economists, citing evidence derived from various methods and sources, that this dearth of investment is due to the trade shock brought about by Brexit and the subsequent political uncertainty. A steadfast agreement on Northern Ireland would remove the risk that there would be a 'no-deal' Brexit after all - a major source of political uncertainty. However, if this comes to pass it won't alter our forecast that the UK will experience the worst recession among major western economies (albeit not a severe recession by historical comparison).

Last year, the FTSE All-Share index significantly outperformed global equities due to its higher weightings to defensive sectors, to natural resources businesses and to banks (which benefitted from rising interest rates around the world). Yet the benchmark UK stock market still trades at a substantial discount to the rest of the world. An article published last year in the Journal of International Money and Finance found evidence that Brexit substantially reduced global equity fund managers' portfolio allocations to the UK, and that these patterns of adjustment were not applicable across Europe. Our own analysis has found that, before 2016, the UK market didn't trade at a discount to Europe or the US once differences in industry weightings had been ironed out. Similarly, we found that a discount didn't use to exist between UK and overseas companies with equivalent sales growth forecasts. A further reduction in political uncertainty should help to reduce that discount.

Bonded to a view

It's getting a bit boring talking about inflation, but markets are completely focused on it.

Stock have been on a tear since October, driven higher by the belief that sky-high inflation is all over bar the shouting. But it's a fickle sort of belief. There seems to be a lot of selling when cracks appear in the narrative. To see how this popular view about the demise of inflation flows through markets, you need to look at bond markets.

Inflation tends to have a big effect on government bond prices because higher inflation makes it more likely that central banks will hike interest rates. Government bonds are very sensitive to changes in prevailing interest rates. When those rates move higher, it means bondholders have a worse interest rate than what they could get if they invest today, so their bond is worth less (and the yield rises). And the longer they are locked into receiving that poor interest rate – the longer until the bond matures – the bigger the fall in the price of their bond. Similarly, if prevailing interest rates fall then bondholders enjoy a better rate than they can get from the market. Therefore, their bond is worth more (and the yield falls into line with prevailing rates).

So what's happened with bond prices lately? They have been all over the place. The 10-year US Treasury, arguably the benchmark bond for global markets, yielded about 4.25% in October. In the few months since it has bounced up and down between 3.40% and 4.00%. In other words, the price of the Treasury has been up and down like a yo-yo as investors change their expectations of inflation and where rates should peak (and how long they'll stay there).

In February, the prices of Treasuries have become very erratic indeed. An index that measures their price volatility – the MOVE index – has increased significantly, suggesting that investors are becoming much less certain that inflation is coming down rapidly – and therefore concerned that interest rates may go higher than hoped. The last time this MOVE index peaked was in October, before solid falls in inflation drove Treasury volatility lower and stock markets higher. To us, it looks like the equity rally was driven by investors thinking the inflation outlook was clearer, and that the Fed wouldn't need to hike much more than it already had.

In February, the outlook has got a bit more complicated, as we thought it might. We still feel that there's a greater chance that inflation gets caught at a level higher than the 2% target for some time than there is that inflation drops rapidly back to where we're all used to seeing it.

With Treasury market volatility back at significant highs, stocks could be vulnerable to a further correction. Because of this, we're continuing to argue for staying defensively positioned, in stocks and assets that should weather higher rates and possible recession better than their counterparts. If you're interested in hearing more about how we see the world and are investing money on your behalf, you can sign up for our next Investment Insights webinar on 12 April here.

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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