

Cleared for landing

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It is something of an obsession in professional investment circles to speculate on 'hard' and 'soft' landings, but what does it mean?

Talk of landings comes after a disruption in the economic cycle. Economists and investors fret over whether the cycle can return to balance without passing through a process of purging. The global economy has encountered two major disruptions over the past two years. First is the turn in the interest rate cycle from the 'zero bound' which was induced through monetary policy as an antidote to the risk of recession following the financial crisis that began in 2008. Second is the disruption to global supply chains which began with Covid lockdown and was massively accelerated by the Russian aggression against Ukraine. Either one of these would ordinarily pose a significant challenge to the investment environment. Yet stock markets have been surprisingly resilient and are currently performing well. What are we to make of this?

An interest rate rise from 0.25% to 5.50% is a disruption in anyone's book. It puts great strain on corporate balance sheets and free cash flow where companies are heavily borrowed and are exposed to the rate rise. It also stretches national budgets where more of the revenue raised through taxes is spent on servicing debt, leaving less to fund public services and infrastructure investment. A classic reading of economics would incline towards a recession to bring interest rates down. This would be a hard landing.

Disrupted and broken supply chains, threatened by hostilities targeted on supplies and supply routes, and challenged by the threat of political action which would limit supply, for example to the semiconductor manufacturing capacity of Taiwan, would be expected fuel rising and enduring inflation. But what we find is a much more flexible world of substitution and fleetness in establishing new supply lines. One example is how effectively Russia found new markets in India and China for its oil to replace its European market; another is the scale of investment in new semiconductor production in countries such as Malaysia and Vietnam. We inhabit a world which exhibits much greater flexibility in the allocation of investment capital than ever before, and one in which political and ideological alliances are possibly more nuanced than in decades past.

There is growing evidence that inflation is in structural decline. The interest rate cycle has not yet turned, and we would not expect it to return to the ultra-low levels of only two years ago. But what we perceive is a greater tolerance in the global economy for a higher cost of capital and – just possibly – the beginning of a new cycle of innovation and growth. We are confident that the speed with which AI is emerging across the economic frontier will drive productivity and margin gain.

It would be foolish not to acknowledge that the world is in a more volatile and potentially hostile condition than has been the experience of the last four or five decades. There are many dangling shoes which could yet drop – national deficits, future pandemics, and an escalation of belligerence being among them – but the market indicators are beginning to point to a cycle in which higher cost of capital can be accommodated and inflation will moderate. The runway may just be clearing for takeoff after a period when investors had become disheartened with returns.

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