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When the balloon goes up

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A new term has entered the financial market lexicon, "geoeconomics". Financial markets have long learned to live with geopolitics, a redrawing of the political map, but have historically found its evolution difficult to price properly, preferring instead to focus on perceived outcomes and the assessment as to how they might impact on economies and by extension financial assets. But what happens when the worlds of geopolitics and economics become inextricably entangled? Geoeconomics, a portmanteau word combining the two is a suitable term for developments on the world stage to which financial markets can no longer turn a blind eye. Critically, and this has become obvious as the war in Ukraine passes the anniversary of its initiation, economics is no longer a part of the fallout from geopolitical events, but an intrinsic feature.

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Financial markets have entered a state of persistent reappraisal, adjusting to each move on the chessboard as great power competition plays out. Having enjoyed the best start to any year for over two decades in early 2023, markets have become more circumspect over February. The discovery of what were purported to be spy balloons over North America caught the imagination of the general public, in one part for what they might signify and another for what feels like an anachronism, a throw-back to a world before satellite technology and hyper-connectivity. Whatever their purpose, the balloons have served as a portal through which can be glimpsed profound tectonic shifts, a crunch as political landmasses collide, abrasively, against each other.

Early 2023 idealism associated with inflationary pressures that were thought likely to have peaked, an economic "soft landing" and consumers' capacity to digest and withstand higher interest rates and a higher cost of living, the Chinese economic reopening and the fortuitous benefit of a relatively mild European winter, have run their course. Markets have spent much of February casting about for, if not a new theme, then the validation of early year enthusiasm. What is interesting is the extent to which investors, whilst only too relieved to participate in the rally in financial asset prices after a dismal 2022, remain cautious regarding near-term prospects. Stock and bond prices have risen, but sentiment is brittle even as worst-case expectations as they pertain to the real economy have been sidestepped.

Having failed to unearth a new catalyst, the market's tone has pivoted. Recessionary conditions, although postponed, have not been cancelled. Inflationary pressures although on a slowly descending path are proving sticky and hard to budge. Central banks the world over have raised interest rates aggressively in an effort to suppress demand, but labour markets remain tight and households are, for now, weathering the storm. Senior officials whose job it is to oversee the prosecution of monetary policy have insisted that there is to be, for now, no let-up in their vigilance and rates will continue to grind higher. In response, the mood across financial markets has flipped, investors no longer interested in how high, but how high for how long? Meanwhile, the world's geopolitical (geoeconomic) flashpoints, in particular Ukraine and Taiwan, remain a profound cause for concern.

Thus, it is the interlinkage existing between diplomatic, political and now, sadly, military ambitions umbilically associated with economic dominance and the control of scarce resources through supply chains that form the basis of geoeconomics and the tail risks associated with higher for longer inflationary pressures that have served to shatter market complacency into a million pieces. Much will have to go right and very little to go wrong if all the king's horses and all the king's men are successfully to put humpty together again. It seems as if globalised ambitions and the fostering of "togetherness" are little more than a relic of yesteryear. A new era of multipolarity and fragmentation has dawned, central to which lies an increasingly ambitious China. Shrugging off the rebukes of US Secretary of State Mr Anthony Blinken and UK Foreign Secretary Mr James Cleverly in Munich, China's top diplomatic official, Mr Wang Yi went hot foot to Moscow, thought likely the precursor to another summit between President's Putin and Xi before too long.

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How best to position for the redrawing of the map is surely the biggest challenge facing investors in the world's financial markets. So profound are the uncertainties that few will argue against the cautious (defensive) positioning forming the bedrock of portfolio construction until such time as the dust settles. And settle the dust will, even if it takes time. Financial markets are both endlessly resilient and resourceful. The consequences of events now moving at warp speed will take time properly to digest and discount, but this will happen and when it does the opportunities created will likely prove both substantial and long-lasting. As we search for these opportunities it is this that keeps us both optimistic and constructive for the longer term.