May 30, 2023

THIS WEEK

An Agreement but no Solution

Less than one week before the "X-date" deadline when the US was due to reach its debt ceiling on June 1st, Joe Biden's White House and the House Speaker, Kevin McCarthy, announced on Saturday that they had reached an agreement on the Fiscal Responsibility Act which aims to resolve the stand-off between Democrats and Republicans.

The agreement involves suspending the ceiling until January 1 2025 in exchange for capping discretionary spending – non-defence spending is set to remain unchanged next year and to increase by only 1% in 2025. It is estimated that this means spending will end up shrinking by around -0.1-0.2pp of GDP in each of the two years. For context, the debt ceiling agreement between the Obama White House and the House Republicans in 2011 cut spending by -0.7pp of GDP. Before the deal was struck, the Congressional Budget Office estimated that the US budget deficit would hit -5.8% of GDP next year, of which almost half will be taken up by the cost of servicing the debt burden.

The agreement still requires ratification by Congress, which is not a foregone conclusion – significant minorities of both parties have expressed their hostility to the deal and may seek to derail its passage. This being said, a sufficiently strong majority on both sides of the aisle should enable successful votes, on Wednesday in the House of Representatives and on Friday in the Senate. This is key given Treasury Secretary Yellen's announcement last week that the X-date might be delayed until next Monday June 5 rather than this Thursday.

Bottom Line

Most market participants expect a relief rally when the debt ceiling deal is finally approved. However, we would caution that it does nothing to improve the fundamental health of US government finances. Moreover, the Fitch ratings agency has already placed US debt on its negative rating watch (S&P already downgraded the US after the 2011 debt ceiling crisis). Furthermore, after the agreement, we would expect the US to resume sizeable debt issuance and rebuild its Treasury General Account at the Federal Reserve, all of which will suck liquidity away from the financial system.

Equities	Last	% 5D	% 1M	% YTD
MSCI World	2 827.93	-0.5	1.7	8.7
S&P 500	4 205.45	0.3	3.7	9.5
Nasdaq Composite	12 975.69	2.5	9.5	24.0
Russell 2000	1 773.02	0.0	2.5	0.7
STOXX 600	461.41	-1.6	-0.4	8.6
Euro STOXX 50	4 337.50	-1.3	-0.2	14.3
SMI	11 434.24	-1.2	0.6	6.6
Topix	2 145.84	-0.7	6.0	13.4
MSCI EM	972.86	-0.4	0.5	1.7
China CSI 300	3 850.95	-2.4	-2.7	-0.5
VIX	17.95	6.8	-4.7	-17.2
V2X	17.60	12.0	-6.3	-15.7

Fixed Income	Last	5D bp	1M bp	YTD bp
US 2Y	4.56	30	61	14
US 10Y	3.80	13	35	-8
German 2Y	2.94	18	17	18
German 10Y	2.54	11	14	-3
Swiss 2Y	1.08	15	7	-14
Swiss 10Y	1.03	4	0	-55
USD IG Spread	147	-6	0	4
EUR IG Spread	142	-2	5	2
USD HY Spread	446	-31	-20	-23
EUR HY Spread	480	-25	-26	-32
EM Sovereign Spread	414	-5	-12	20

Currencies	Last	% 5D	% 1M	% YTD
Dollar index	104.21	1.0	2.7	0.7
EURUSD	1.072	-0.8	-2.9	0.2
GBPUSD	1.234	-0.8	-1.0	2.2
USDJPY	140.6	1.9	5.2	7.2
EURCHF	0.971	-0.1	-1.3	-1.9
JPM EM FX Spot	50.11	0.0	-0.6	0.4
USDCNY	7.064	0.7	2.0	2.4

Commodities	Last	% 5D	% 1M	% YTD
GSCI Spot	546.86	0.6	-1.8	-10.4
Brent Crude Oil	76.95	1.8	-1.0	-10.4
Gold	1 946.46	-1.6	-2.1	6.7
Copper	8 135.00	-1.4	-4.9	-2.8
Bitcoin	26 759.28	-0.3	-5.8	61.8

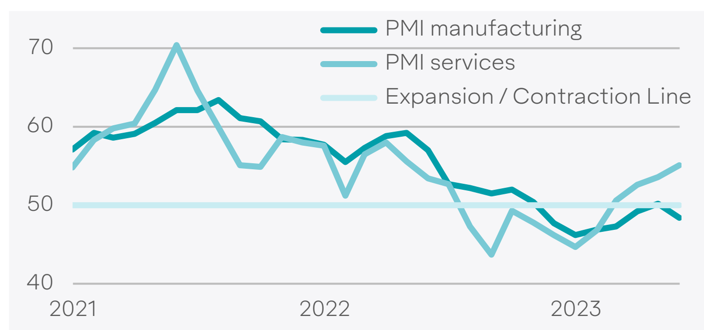
Source: Bloomberg, 26.05.2023

EQUITIES

Global . In recent weeks, the MSCI World index of global equity markets has traded in a very tight range and is virtually unchanged since end-March level. The Index closed -0.5% lower last week, its third decline in the last four weeks. Nonetheless, the index still sits above all its main daily moving averages (DMA), each of which continues to trend higher. However, a break above 2850 points – only 0.8% above Friday's close – would be needed to confirm that the recent pattern of higher highs and higher lows remains in place.

US . The S&P500 index outperformed its global peers last week with a 0.3% advance, its second straight gain taking the index back above the key 4200 point level for the first time since last August. As has been the case most of this year, the broader index has been powered higher by its largest members, the megacap tech and internet stocks. The standout last week was of course Nvidia which soared by almost a quarter last Thursday on news that Q2 sales might reach $11bn, some 50% higher than analyst estimates, as customers scramble to buy its specialised chips to power artificial intelligence ventures. The Nasdaq 100 index rose 3.6% in sympathy while the NYSE FANG+ index – which counts Nvidia among its 10 members – jumped 5.6%. As a result, the US market is becoming ever narrower with Nvidia accounting for essentially all of the S&P500's gains last Thursday. Over the week, the only two sectors to register gains were information technology and communication services (home to Google and Facebook), which rose 4.4% and 1.2% respectively. The nine remaining sectors all fell last week, with the sharpest drops recorded by materials (-3.1%) and defensive sectors like consumer staples and health care (both of which fell -2.9%).

By and large, US macro data was much better than expected last week and the Citi index of economic surprises jumped to its best level in five weeks. The flash composite purchasing manager index (PMI) for May bounced to 54.5 points, well above the 50-point frontier between expansion and contraction, while durable goods orders in April – which were expected to fall -1.0% – actually rose 1.1% month-on-month. In addition, personal income and spending both beat forecasts as did Q1 GDP growth which rose by an annualised quarterly gain of 1.3%. Moreover, the job market remains robust as witnessed by last week's initial jobless claims (i.e., new applications for unemployment benefits) which reached the lowest level since February.



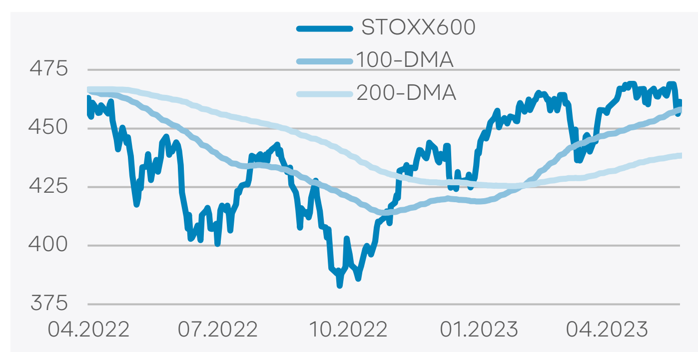
Source: Bloomberg

The S&P500 remains above all its major DMAs which are all rising, an encouraging technical formation. In addition, last week's gains helped the index break above 4200 points which represents a new high for the year, thereby confirming that the pattern of higher highs and higher lows since its October low remains intact.

Europe . After a strong run of outperformance since last autumn, European equities have underperformed the US for three weeks in a row. The STOXX 600 (a pan-European index which covers the Eurozone as well as non-euro markets like the UK and Switzerland) ended last week down -1.6% while the Euro STOXX 50 (which covers the largest companies in the Eurozone) dropped -1.3%, both underperforming the S&P500 which rose 1.3% in euro terms, thanks mainly to dollar strength. The biggest gainer last week was Greece, the region's top performer this year, which gained 7.6% to take year-to-date returns to 32.2%, as investors reacted positively to the prospect of the centre-right retaining power after the general elections. The underperformers were led by Italy and Portugal which both dropped -2.9% followed by Sweden which shed -2.7%. In terms of sectors, the only gainer last week was information technology which rose 2.0% while the ten other sectors all lost ground over the week (all figures in EUR terms).

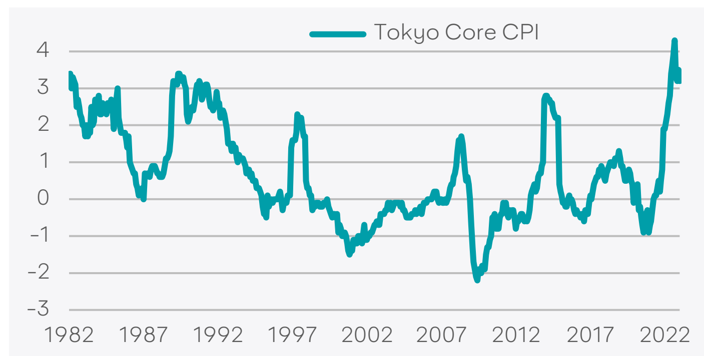
The majority of last week's macro data came in below forecasts and Citi's economic surprise index dropped further into negative territory – which reflects more letdowns than positive surprises – for the fourth consecutive week. For example, the consumer confidence for Germany, France and the Eurozone as a whole all came in below expectations. The same was true for business confidence – the domestic surveys in Germany, France and Italy all disappointed as did the Eurozone's flash composite PMI, which was dragged lower by weakness in manufacturing which is now close to recession levels. Moreover, it emerged last week that the German economy is already in recession – Q1 GDP growth was revised lower from 0.0% quarter-on-quarter to -0.3%, the second consecutive decline.

The technical picture for European stocks continues to look supportive. The STOXX 600's bullish pattern of higher highs and higher lows which began last September remains intact the index closed above all its major DMAs after dipping below the 50- and 100-DMAs mid-week.



Source: Bloomberg

Asia . Japan's flash PMI data for May was encouraging last week. The Jibun Bank survey for manufacturing moved back into expansion territory while confidence in services jumped from 55.4 to 56.3, well above the 50-mark dividing line between contraction and expansion and the highest level in the past three years. Moreover, there were tentative signs of easing price pressures – in Tokyo, both headline and core inflation in May came in at 3.2% year-on-year, undershooting expectations for 3.4% and April's 3.5%.

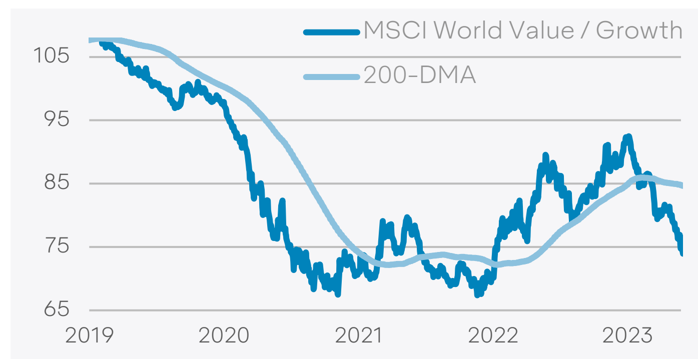


Source: Bloomberg

India was the best-performing Asian market last week with a 2.9% jump which took it back into positive territory for the year to date. The other strong performers were tech-heavy – Taiwan gained 2.7%, consolidating its position as the best-performing regional market this year, followed by South Korea which rose 1.9%. The laggards were driven by disappointment about China's recovery – Australia, source of much of their raw material imports, fell -3.1% followed by Hong Kong which dropped -2.9% and mainland China itself which shed -2.2% (all figures in euro terms).

Volatility . Implied volatility indices – also known as "fear" indices – measure the cost of option protection, which soars in times of trouble. Despite the resilience in the US equity market last week, the US VIX index rose 6.8% while Europe's V2X index soared 12.0%. However, at 17.9 and 17.6 points respectively, both sit well below the 23.0 average over the past twelve months.

Style factors . Last week, Quality and Growth – which are home to the market-leading tech and internet megacaps – were the only factors to gain ground, up 1.2% and 0.5% respectively. Value continued its recent run of underperformance shedding -1.7%, hot on the heels of Momentum which dropped -2.3%.



Source: Bloomberg

Bottom Line

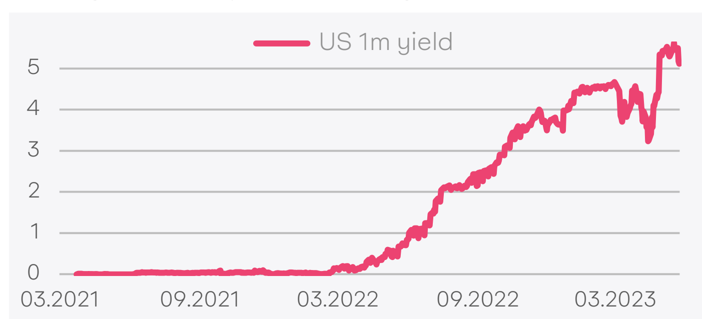
We maintain our equity exposure at Neutral.

FIXED INCOME

Last week, the Bloomberg Global Aggregate Index, a proxy for diversified high quality bonds, dropped -1.1%, its third consecutive decline, and is now up only 0.5% for the year to date. The index has broken below its 50- and 100-DMAs and now rests on the 200-DMA, which has been flat since mid-March. This level represents key support which must hold if the rally from October's lows is to continue.

US . The last-minute agreement on the debt ceiling crisis removed some of the stress and volatility at the near end of the US Treasury yield curve. The yield on one-month (1m) Treasury bills rose another 12bp to 5.60% last week, well above the 5.0-5.25% key rate range, but then tumbled -39bp after the Memorial Day long weekend as traders breathed a sigh of relief. The stress in T-bills was apparently driven by money-market funds exiting 1m maturities and rotating into longer-dated securities to avoid debt ceiling risk. This in turn had forced the Treasury to offer much higher yields to secure short-term funding.

Last week, there was a big -$13.4bn decline in commercial bank borrowing at the Fed's discount window (which currently enables banks to post Treasury bonds at par in exchange for liquidity for up to 90 days) taking the total down -16.0% from its late-March high. However, there has been a steady rise in borrowing from the Fed's new Bank Term Funding Program (which offers similar conditions for longer-term liquidity) which grew a further $2.8bn last week. Nonetheless, the overall trend in bank borrowing from the Fed is downward, suggesting that the stress surrounding the banking sector may be diminishing for now.



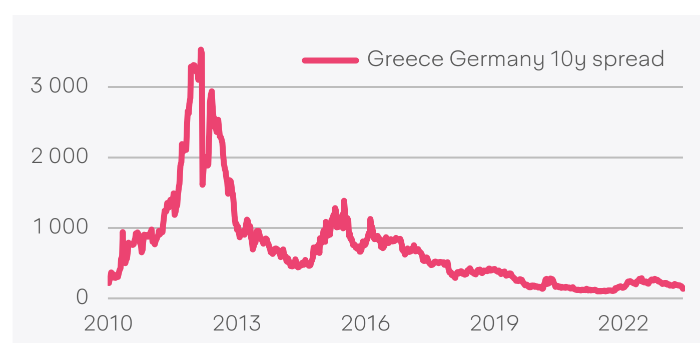
Source: Bloomberg

Statements from Fed officials were pretty unanimously hawkish last week – for example, the St Louis Fed president Jim Bullard said he still expects another two rate hikes this year, a stark contrast to recent market speculation that rate cuts were imminent. Moreover, prices for core personal consumption expenditures – core PCE, the Fed's favourite inflation gauge – rose an above-consensus 0.4% month-on-month in April, taking YoY inflation up to 4.7% from 4.6%. As a result, the probability of a 25bp hike at the Fed's next policy meeting on June 14th has shot up from 18% a week ago to 69%. In addition, the peak in rates this year is now expected to be 5.5%, up from 5.1%, and end-2023 rates are now pencilled in at 5.0%. This shift in sentiment prefigures a marked tightening in financial conditions.

Europe . Persistent inflationary pressures are putting upward pressure on the entire yield curve. Last week, German ten-year (10y) yields rose 11bp to 2.54%, the high end of the narrow 2.1-2.6% band which has prevailed since mid-March. Yields remain stuck in the pattern of higher highs and higher lows which commenced with last year's late-summer surge in yields. Last week also saw German 3m bill yields rise another 3bp to 2.92%, still closing in on the European Central Bank's (ECB) deposit-rate target at 3.25%. Although the 3m10y yield spread – which is often taken as early warning of recession risks – tightened by 8bp last week, it remains deeply inverted at -38bp which does not augur well.

The ECB is widely expected to hike by another 25bp at its next meeting on June 15th – the probability according to the Bloomberg calculator is now up to 97% – and a further 25bp hike is slated by September. Moreover, unlike in the US, traders do not expect any cuts before year-end.

Overall risk appetite across the Eurozone remains rather robust. The yield spread between 10y Italian BTP yields and German Bunds was unchanged last week at 186bp, well below the 250bp level which often rings alarm bells on traders' desks. Astonishingly perhaps, the spread on Greek 10y bonds versus Bunds is currently even lower at only 138bp, as traders react positively to the Greek election results.



Source: Bloomberg

Credit markets . Corporate credit spreads – the difference in yields with sovereign bonds – have traded in a narrow range since March and last week's trading to nothing to change this. Investment grade spreads tightened by -6bp in dollars and -2bp in euros while high yield spreads declined by -31bp in USD and -25bp in EUR over the week.

Bottom Line
Overall, we remain defensive in our fixed income allocations.

CURRENCIES

There has been a significant shift higher in the dollar index – which measures its value against its six major trading partners among advanced economies – over the past three weeks. The index jumped 1.0% last week to its highest level since early March, closing above both the 50- and 100-DMAs. Paradoxically, the revival may have been triggered by the US debt ceiling crisis – in times of stress, traders' knee-jerk reaction is to seek safety in dollars, even if the US is the cause of the worries. If the rally is to continue, the next major resistance level is around 106.0 where the 200-DMA is trending lower.

EUR . The euro has failed to advance against the US dollar for four consecutive weeks and its decline has taken it below the 50- and 100-DMAs, both of which have flattened out. Last week, it dropped -0.8% against the greenback as debt-ceiling worries pushed short-dated yields higher thereby widening the interest rate differential. Moreover, the shift higher in rate hike expectations in the US further bolstered confidence. Nonetheless, we still see upside potential for the single currency and view recent weakness as a healthy correction after the strong surges in November to January and March to April. We would expect the euro to find support above the 200-DMA which currently sits just below 1.05, some -2.2% below Friday's close. International investors appear to be starting to rebuild positions in euros while European investors are tempted to repatriate assets to take advantage of the more attractive yields on offer.

GBP . Sterling continued to lose ground against the US dollar last week, its third consecutive decline taking it back to late-March levels having failed to break decisively above the 1.25 resistance level in recent weeks. The technical picture still looks encouraging however with all major DMAs trending higher. Moreover, sterling is supported by expected interest rate differentials. The Bank of England is expected to hike rates by up to 100bp by the end of this year to attempt to quell inflation – the April inflation figures published last week showed both headline and core price rises well above forecasts.

CNY . The renminbi dipped -0.7% lower against the US dollar, its sixth decline in the last seven weeks. Disappointing economic data have pushed Citi's economic surprise index to its lowest level since January, and the stock market has lagged global peers. Moreover, the technical picture has deteriorated – the CNY is now well below the declining 200-DMA and the 50- and 100-DMAs have both rolled over. The next support lies around -3.3% lower around the early November's cycle lows.

JPY . The yen fell -1.9% against the dollar last week, its sixth decline in seven weeks. The yen has broken through the 200-DMA support after successfully bouncing from it twice so far this year. Although a relief rally is possible after such sustained selling, further downside beckons.

COMMODITIES

GSCI . The GSCI spot commodity index gained 0.6% last week, its second consecutive advance. Energy outperformed with a 1.1% gain but metals were weak – industrial metals dropped -1.8% hot on the heels of precious metals which shed -2.0%. The spot index remains stuck below the major DMAs which are all trending lower and continues the pattern of lower highs and lower lows which started last summer – a technical configuration which is likely to offer strong resistance to any rally attempts.

Energy . After registering a new low for the year on May 3rd, Brent crude prices have moved modestly higher with two back-to-back weekly gains of 1.9% and 1.8%. Prices sit below all major DMAs which will offer resistance to any attempts to rally further.

OPEC+'s surprise weekend announcement of output target cuts in early April has been well and truly forgotten as traders focus on weak economic data in China and Europe. Moreover, the US has resumed selling from its Strategic Petroleum Reserve – over the past nine weeks, it has sold -16.1 million barrels (mb), taking the SPR to its lowest level since August 1983. The Biden administration had promised that it would seek to rebuild the reserve but appears to have abandoned those plans in light of OPEC+'s production cuts. Next weekend will see another OPEC meeting – will further attempts to buttress oil prices be forthcoming?

Natural gas prices in Europe fell another -18.7% last week, taking the year-to-date decline to -67.9% and prices to their lowest level since May 2021, well ahead of the Ukraine invasion in February 2022. Thanks to the development of new infrastructure to import liquefied natural gas and the diversification of suppliers away from the over-reliance on Russia, European importers have made great strides in refilling their storage capacity. This time last year, storage tanks were only 45.3% full as opposed to today's level of 67.3%.

Metals . The weakness in industrial metals was broad-based last week. Nickel – the weakest of the metals so far this year, down -29.6% – was rather resilient, limiting last week's decline to -0.5%. At the other extreme, iron ore on the Dalian exchange plummeted -7.5% in dollar terms while zinc tumbled -5.5%. Losses in copper and aluminium – the most resilient metals this year – were limited to -1.4% and -2.0% last week

Gold prices recorded their third consecutive weekly loss, down -1.6% on the week to $1946 per ounce. Prices are close to the 100-DMA at $1935 which represents the first level of support with further support $1830 where the February/ March correction bottomed and the 200-DMA now sits.

Bottom Line

Paradoxically, risk aversion linked to the US debt ceiling crisis has pushed safe-haven flows towards the US dollar.

WOOD MAN.

AGENDA

Tuesday May 30th . Japan April job market. **US** Conference Board May consumer confidence, March house price index. **Eurozone** May economic, industrial, services and consumer confidence surveys.

Wednesday May 31st . China National Bureau of Statistics May manufacturing, services and composite purchasing manager indices (PMI). **Germany** May consumer price index (CPI) and unemployment rate. **France** May CPI. **Japan** April retail sales and industrial production. **US** Federal Reserve Beige Book qualitative review of economic conditions from the twelve regional Feds.

Thursday June 1st . European Central Bank minutes from May 4 monetary policy meeting. **Eurozone** May provisional CPI. **PMI** final May surveys for US, Eurozone, UK and Japan. **US** Institute of Supply Management (ISM) May manufacturing confidence survey. ADP May employment report. **China** Caixin manufacturing, services and composite PMI for May. **Germany** April retail sales.

Friday June 2nd . France April industrial production, **US** May non-farm payrolls and unemployment report.

Sunday June 4th . OPEC energy ministers meeting in Vienna.

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