May 15, 2023

THIS WEEK

Debt, Deficits and Sustainability

In recent decades, US federal debt has risen inexorably, from 53.1% of GDP at the turn of the century to 108.7% in 2019, according to the International Monetary Fund (IMF). Deficit spending to cushion the pandemic's impact pushed the debt/GDP ratio up to 133.5% in 2020 and it's projected to still be at 122.2% at the end of this year. In their seminal 2009 book *This Time is Different*, ex-IMF economists Reinhart and Rogoff argued that economic growth potential might be impaired at debt/GDP ratios above 90%.

Concerns about sovereign debt are not unique to the US, but it is the only major country apart from Denmark to have self-imposed a debt ceiling. Importantly, the US limit is set as a dollar amount, meaning that nominal increases in debt as the economy grows over time will push debt levels ever closer to the ceiling resulting in frequent breaches – Congress has increased the ceiling 78 times since 1960, on average more than once per year. In contrast, since Denmark introduced its ceiling in 1993, it has never been breached.

The problems with the US ceiling are manifold. First, the limit is typically set very close to prevailing debt levels, leaving little room for manoeuvre as spending increases. Second, it takes no account of growth in the economy over time. Third, it has become a political football which has encouraged grandstanding by politicians on both sides of the aisle.

Yet again, US debt is bumping up against its ceiling and Treasury Secretary Janet Yellen fears that the country will run out of money and risk default as soon as June 1. Yet again, extremists in Congress – this time the right-wing Freedom Caucus in the House and progressives among Democrats – are refusing to compromise. And yet again, market tensions are rising – the cost of insuring against US default over the next year stands at its highest level ever

Bottom Line

The overwhelming majority of market participants expect a last-minute solution to the debt ceiling crisis but the motivation to compromise may only come if politicians see significant market turbulence. But the drama should not distract investors from the real problem which is the unsustainable trajectory of US public finances.

Equities	Last	% 5D	% 1M	% YTD
MSCI World	2 809.35	-0.4	0.5	7.9
S&P 500	4 124.08	-0.3	0.8	7.4
Nasdaq Composite	12 284.74	0.4	3.0	17.4
Russell 2000	1 740.85	-1.1	-1.9	-1.2
STOXX 600	465.49	0.0	0.7	9.6
Euro STOXX 50	4 317.88	-0.5	-0.4	13.8
SMI	11 564.73	0.1	3.0	7.8
Topix	2 096.39	1.0	4.5	10.8
MSCI EM	973.00	-0.9	-2.1	1.7
China CSI 300	3 937.76	-2.0	-3.9	1.7
VIX	17.03	-0.9	-10.8	-21.4
V2X	17.01	-7.0	-8.7	-18.6

Fixed Income	Last	5D bp	1M bp	YTD bp
US 2Y	3.99	7	3	-44
US 10Y	3.46	3	7	-41
German 2Y	2.59	2	-20	-17
German 10Y	2.28	-2	-9	-30
Swiss 2Y	0.90	-4	-12	-32
Swiss 10Y	0.93	-12	-8	-65
USD IG Spread	155	-1	8	12
EUR IG Spread	142	1	1	1
USD HY Spread	471	0	12	2
EUR HY Spread	511	1	13	-1
EM Sovereign Spread	417	-7	3	23

Currencies	Last	% 5D	% 1M	% YTD
Dollar index	102.68	1.4	1.2	-0.8
EURUSD	1.085	-1.5	-1.3	1.3
GBPUSD	1.246	-1.4	-0.2	3.1
USDJPY	135.7	0.7	1.9	3.5
EURCHF	0.975	-0.7	-1.1	-1.5
JPM EM FX Spot	50.74	-0.5	0.2	1.7
USDCNY	6.959	0.7	1.3	0.9

Commodities	Last	% 5D	% 1M	% YTD
GSCI Spot	538.91	-1.2	-9.8	-11.7
Brent Crude Oil	74.17	-1.5	-15.1	-13.7
Gold	2 010.77	-0.3	-0.2	10.2
Copper	8 253.00	-3.8	-7.4	-1.4
Bitcoin	26 447.70	-10.4	-11.7	59.9

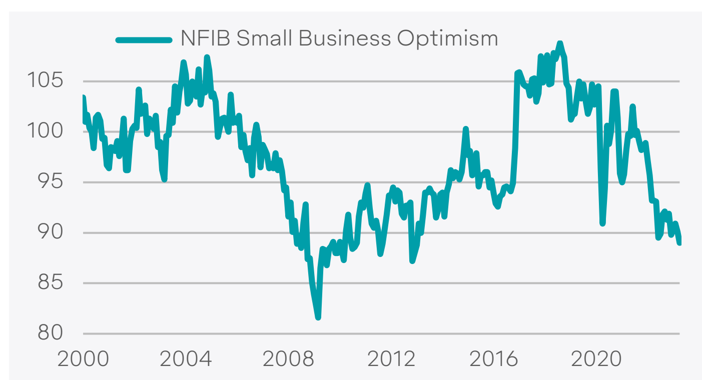
Source: Bloomberg, 12.05.2023

EQUITIES

Global . In recent weeks, the MSCI World index of global equity markets has traded in a very tight range and is virtually unchanged from its end-March level. The Index closed -0.4% 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 1.4% above Friday's close – would be needed to confirm that the recent pattern of higher highs and higher lows remains in place.

US . Like the MSCI World, the S&P500 index has traded sideways since late March. Last week, the index shed -0.3%, the third fall in four weeks. Yet again, the megacap tech and internet stocks – which have powered higher this year – outperformed the broader market. The NYSE FANG+ index – named after Meta's Facebook, Amazon, Netflix and Alphabet's Google, four of its ten members – rose 3.2% last week, taking year-to-date gains to 43.0%. This concentration in returns also showed in sector performance with only two advances. Communication services – which includes Meta and Alphabet – jumped 4.2% after dropping -2.3% the previous week while consumer discretionary edged 0.5% higher. The sharpest declines came in energy (which dropped -2.1% on continued weakness in crude prices), materials (down -2.0% on worries about recession) while health care and financials both shed -1.1%.

There was a generally downbeat tone to US macro data last week. The first estimate of May consumer confidence from the University of Michigan fell sharply on declines in current sentiment and expectations. The National Federation of Independent Businesses April index fell again, to the lowest level since January 2013, a worrying sign given the importance of small businesses in job creation. Moreover, last week's initial jobless claims (i.e., new applications for unemployment benefits) jumped to the highest level since October 2021. Finally, wholesale inventories were flat in March while sales fell -2.1%, boosting the inventory to sales ratio, which could be a drag on future production.

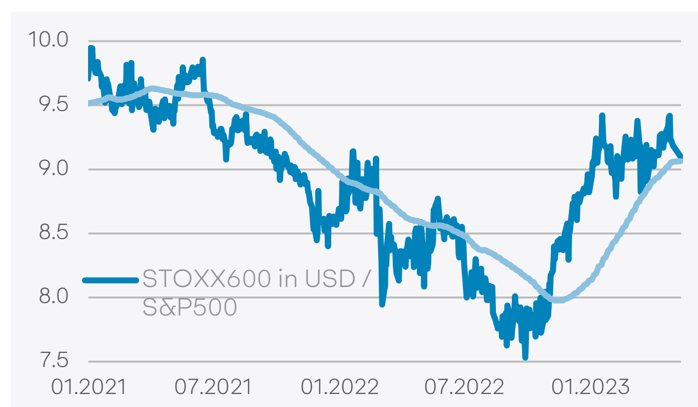


Source: Bloomberg

Now that over 90% of S&P500 members have reported, the Q1 earnings season has confirmed our analysis in recent weeks – massive 6.5% outperformance of consensus expectations but blotted by a -3.2% year-on-year decline in earnings. This marks the second consecutive quarterly decline in profits and Q2 is expected to make it three in a row. The obvious question is when will this profits recession end? Consensus forecasts suggest a pickup in Q3 but this flies in the face of warning signs like the inverted yield curve or the Conference Board's Leading Economic Indicator which has been trending lower since last summer.

No change to the S&P500 index's technical picture. The S&P500 remains above all its major DMAs, an encouraging technical formation. The index has also formed a pattern of higher highs and higher lows since its October low. The pattern will remain intact if the S&P500 manages to break above the 4200 level – 1.8% above Friday's close – which would take it to new year-to-date highs.

Europe . After a strong run of outperformance since last autumn, European equities have underperformed the US twice in the last three weeks. 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 unchanged while the Euro STOXX 50 (which covers the largest companies in the Eurozone) shed -0.3%, both underperforming the S&P500 which rose 1.4% in euro terms, thanks mainly to dollar strength. The biggest gainer last week was Denmark which rose 3.7%, boosted by its largest member Novo Nordisk which jumped 7.5%. The other notable winner was Greece, the region's top performer this year, which gained 1.5% to take year-to-date returns to 21.5%. The underperformers were led by Finland, Austria and Sweden, which fell -1.5%, -1.2% and -0.8% respectively last week. In terms of sectors, health care continued to lead the way jumping 1.3% last week, also boosted by Novo Nordisk, the biggest stock in the sector. And among the laggards, the worst decline was recorded by real estate and communication services which dropped -4.1% and -1.2% respectively (all figures in EUR terms).

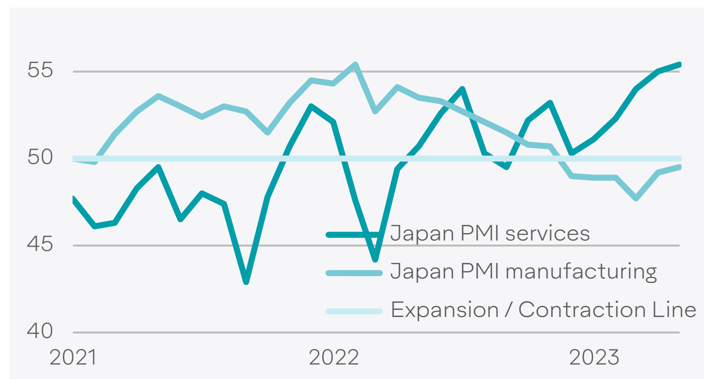


Source: Bloomberg

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 let-downs than positive surprises – for the second consecutive week. For example, German industrial production fell -3.4% month-on-month in March and the outlook is bleak – March factory orders plunged -10.7% MoM, a decline which has only been exceeded during German reunification and the pandemic.

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 and all major DMAs continue to trend steadily higher.

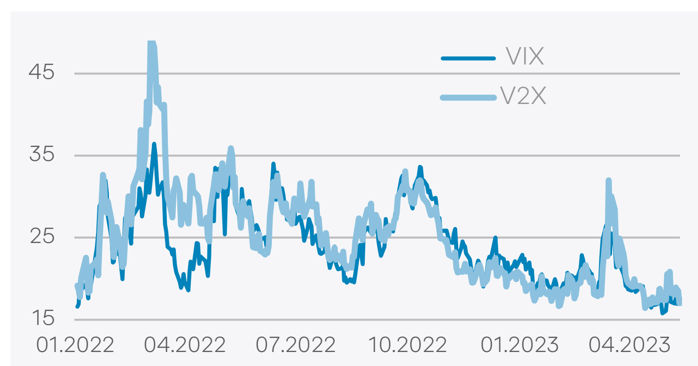
Asia . Last week, China published its April trade data. Growth in exports slowed from 14.8% YoY to 8.5%, which is encouraging for the health of global demand. However, imports slumped -7.9% YoY, which suggests that domestic demand is coming off the boil. In Japan on the other hand, demand for services remains robust. The Jibun Bank purchasing manager index (PMI) April survey for services jumped from 54.9 to 55.4, well above the 50-point dividing line between contraction and expansion and the highest level in the past three years.



Source: Bloomberg

Thailand led Asian equity markets higher last week with a 3.7% gain, as hopes grew that yesterday's election might mark a shift away from military rule. Japan was boosted by better macro data and stocks rose 3.0% over the week, followed by India which gained 2.4%. The laggards included Singapore which fell -1.2% and regional heavyweight China which shed -1.0% (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 weakness in equity markets last week, Europe's V2X index tumbled -7.0% and is back close to 18-month lows. The US VIX index ticked -0.9% lower to 17.0 points, still well below its 23.5 average over the past twelve months.



Source: Bloomberg

Style factors . For the second consecutive week, Growth was the only factor to gain ground, edging 0.3% higher and outperforming Value which tumbled -1.2%. Quality was flat last week while Momentum eased -0.3% lower but the other big loser was High Dividend which fell -1.1%.

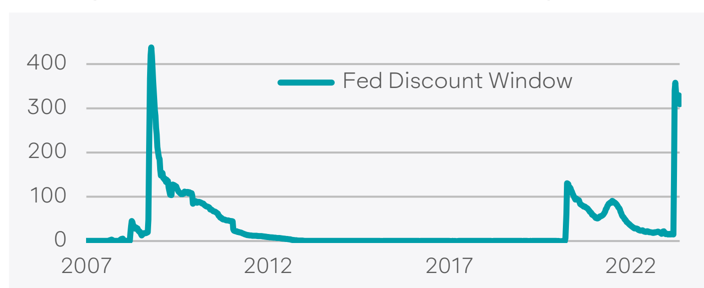
Bottom Line

We maintain our equity exposure at Neutral.

FIXED INCOME

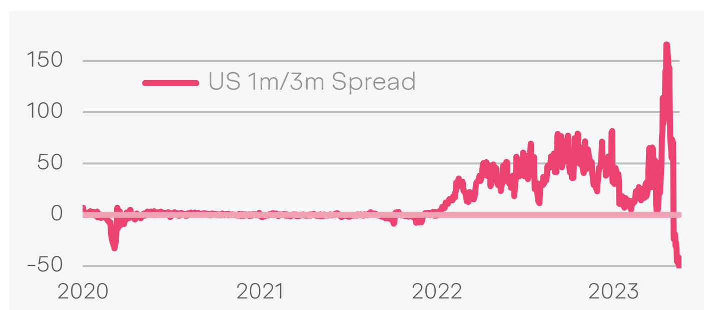
Last week, the Bloomberg Global Aggregate Index, a proxy for diversified high quality bonds, fell -0.5%, its first decline in three weeks. The index remains above all its main DMAs but has tracked sideways in a very tight +/-0.8% range since mid-March. Every attempt to break above the early-February high has petered out so far.

US . Last week, there was a big -$20.6bn 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 -14.1% from its late-March high. As highlighted as couple of weeks ago, the failed First Republic Bank was one of the biggest users of the discount window before its subsequent sale to JPMorgan, which should have little use for this emergency facility. The stress surrounding the banking sector would appear to be diminishing for now.



Source: Bloomberg

The abnormal volatility at the near end of the US Treasury yield curve continued last week. Three-month (3m) bill yields dropped -5bp to 5.15%, but 1m yields continued their recent surge gaining 17bp to 5.61% after soaring 117bp the previous week. These extreme moves are apparently driven by money-market funds exiting 1m and 2m maturities and rotating into longer-dated securities to avoid volatility around the debt ceiling (see page 1). This in turn has forced the Treasury to offer much higher yields to secure 1m funding. In longer maturities, yields rose modestly – up 3bp for ten-year (10y) Treasuries and 7bp for 2y, in line with the easing in risk aversion seen in lower implied volatility.

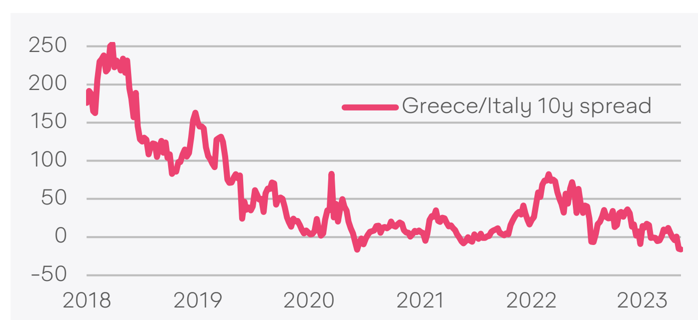


For many investors, the big takeaway from last week's April inflation report was the slowdown in core services prices ex-shelter which rose by only 0.1% MoM. However, we are less sanguine – there were big increases in prices of shelter, used cars, leisure and energy. This pushed headline inflation up to 0.4% MoM after 0.1% in March and left core price increases unchanged at 0.4% MoM – we remain a long way from the Fed's 2% objective for now. And consumers fear that sticky inflation might persist – the May Michigan survey showed that inflation is still expected to be at 4.5% in 12 months' time while the 5-10y expectations rose from 3.0% to 3.2%, the highest long-run outlook since 2014.

Europe . Persistent inflationary pressures are putting upward pressure on the entire yield curve. Last week saw the final April inflation prints for three of the Eurozone's largest economies. In France, headline inflation rose to 6.9% YoY from 6.7% while prices in Spain accelerated from 3.1% to 3.8% YoY, In Germany, the YOY rate of inflation did decelerate to 7.6% from 7.8% but it's still uncomfortably high. The European Central Bank remains on high alert and investors expect two further 25bp hikes in deposit rates by this September.

German 10y yields eased another -2bp lower last week but remain 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 8bp to 2.84%, no surprise given the discount to the current 3.25% deposit rate, not to mention the forthcoming hikes. Nonetheless, the 3m10y and 2y10y yield spreads – which are often taken as early warning of recession risks – remain deeply inverted at -56bp and -32bp respectively.

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 191bp, 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 174bp, which means that the Greece/Italy 10y spread is at the most inverted level on record.



Source: Bloomberg

Credit markets . Last week, there was little to report on credit spreads – the difference in yields between corporate and sovereign bonds. Investment grade spreads tightened by -1bp in dollars and widened by 1bp in euros while high yield spreads were flat in USD and 1bp wider in EUR over the week.

Bottom Line

Overall, we remain defensive in our fixed income allocations.

CURRENCIES

There was a significant shift higher in the dollar index – which measures its value against its six major trading partners among advanced economies – over last week. The index jumped 1.4% over the week to its highest level since mid-March, closing above its 50-DMA. 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. The next resistance level is around 103.0 where the 100-DMA lies and then at 106.0 where the 200 is trending lower.

EUR. With the reversal higher in the dollar last week, the euro dropped -1.5% against the greenback. For now, traders are ignoring the euro-supportive shrinking rate differential between the two currencies (see **This Week** dated May 8) and are focusing on the dollar's safe haven properties. However, this is only the second weekly fall against the USD in the past eleven weeks and the technical picture still looks positive for the euro. We expect this period of consolidation to continue in coming weeks before traders attempt to push the euro towards the next technical target at Q1 2022's highs at around 1.15.

GBP. Sterling dropped -1.4% against the US dollar last week, its first significant weekly fall since early March. The pound closed the week just below the 1.25 support level but well above the 50-DMA, unlike the euro. The technical picture looks encouraging with all major DMAs trending higher. Like the euro, sterling is supported by expected interest rate differentials. The Bank of England hiked base rates again last week by 25bp to 4.5% and more increases are expected – the UK is the only country in Western Europe where March headline CPI was still in double digits at 10.1%.

CNY. The renminbi dipped -0.7% lower against the US dollar, its fourth decline in the last five weeks. The pick-up in growth has missed expectations and inflation has undershot forecasts – last week, the April consumer price index rose only 0.1% YoY, down from 0.7% in March and perilously close to deflation. The technical picture has deteriorated – the CNY dipped below the declining 200-DMA last week and sits on the support level created by December's highs and March's lows. The next support lies around -4.5% lower around the early November's cycle lows.

JPY. The yen fell -0.7% against the dollar last week, its fourth decline in five weeks. It still trades above the 200-DMA against the USD which should offer some support. Traders have attempted to push the yen below its 200-DMA twice in recent weeks, but so far with no success.

COMMODITIES

GSCI. Broad-based weakness the GSCI spot commodity index -1.2% lower last week, making it four straight weekly declines. Industrial metals led the declines with a -4.3% tumble, followed by energy and soft commodities which shed -0.9% and -0.8% respectively. Precious metals remain rather resilient with a modest -0.2% decline on the week. 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 a vigorous four-week 18.3% rally from mid-March to mid-April, the last four weeks have seen Brent crude oil tumble -14.1%, taking prices back towards their lows for the year. OPEC+'s surprise weekend announcement of output target cuts in early April has been well and truly forgotten.

The recent weakness in crude prices has coincided with renewed selling from the US Strategic Petroleum Reserves, a total of -9.6 million barrels (mb) over the past six weeks taking the SPR to its lowest level since September 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. Moreover, traders are fretting about a downturn in activity which could depress demand.

Natural gas prices in Europe fell another -10.4% last week, taking the year-to-date decline to -57.1% and prices to their lowest level since July 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 38.6% full as opposed to today's level of 63.0%.

Metals. With the exception of iron ore on the Dalian exchange which rose 0.6% in dollar terms, industrial metals all fell heavily last week. The weakest was nickel which plummeted -9.4% taking year-to-date losses to -26.1%. Zinc was also weak shedding -5.1%, closely followed by aluminium and copper which both lost -3.8%, taking the latter into negative territory for the year so far.

Gold prices were relatively resilient easing -0.3% lower to $2011 per ounce (/oz). Platinum also held up well, only losing -0.1% on the week. The World Platinum Investment Council expects this year's supply/demand deficit to be the largest since its records began in the 1970s, which should help support prices.

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

AGENDA

Monday May 15th . Eurozone March industrial production. European Commission spring forecasts for GDP, inflation, employment and budget balances. **US** NY Fed Empire manufacturing survey. **Japan** April producer price index (PPI).

Tuesday May 16th . China April retail sales and industrial productions. **Eurozone** 1Q GDP. **Germany** May ZEW economic survey. **International Energy Agency** oil market report. **US** April retail sales and industrial production. May NAHB housing market index. **UK** March unemployment rate. **Canada** April consumer price index (CPI). **EU** Ecofin meeting of finance ministers.

Wednesday May 17th . US April housing starts and building permits. **Eurozone** final April CPI. **Japan** preliminary Q1 GDP and March industrial production.

Thursday May 18th . Japan April trade balance. **Ascension Day** markets closed in France, Germany and Switzerland. **US** April leading economic indicator and existing home sales.

Friday May 19th . Japan April CPI. **Germany** April PPI. **UK** May GFK consumer confidence survey. **G7** 2023 summit opens in Hiroshima.

Sunday May 21st . Greece general election.

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