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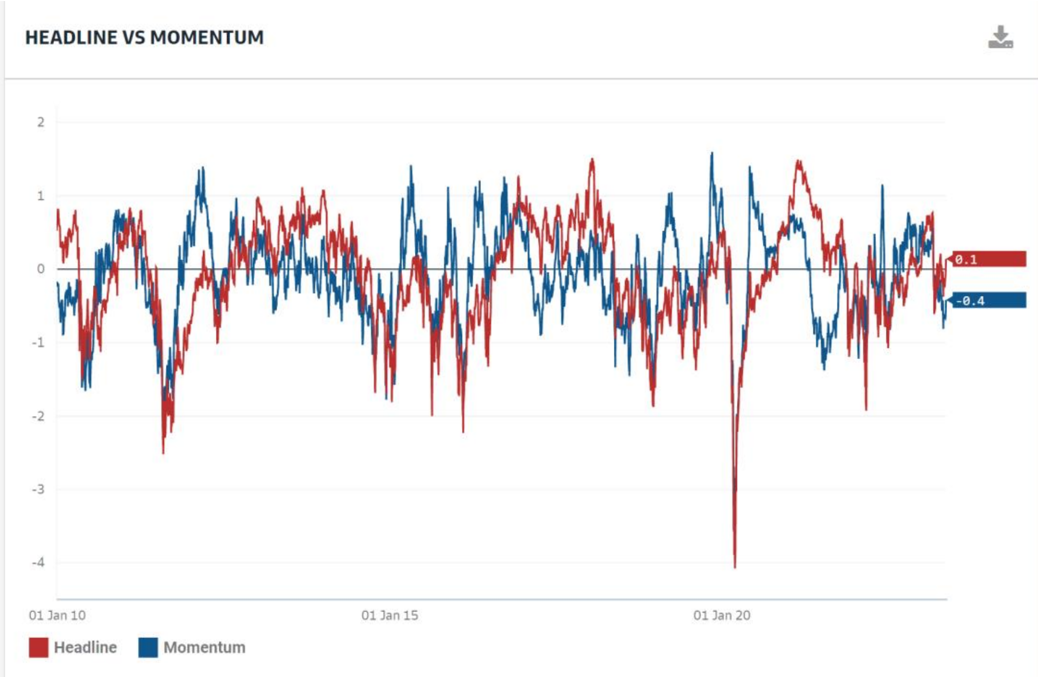
Debt ceiling angst or simply lack of good news?

Compared to the previous week, markets did not really get much 'new' news to digest, and yet last week brought a renewed bout of equity market volatility. Given bond yields experienced even larger moves (up), speculation has been blaming the latest market wobble on the unresolved US government debt ceiling negotiations. The deadline after which the US government runs out of money – and technically defaults on its financial obligations – is now likely only 5-10 business days away. Given US government bonds are deemed the bedrock of global financial markets, as the only financial instrument free of default risk, market nervousness ahead of such an impending – and portentous – deadline is wholly understandable.

Certainly, it is absolutely not the case that markets are no longer willing to lend to the US government or that there is an absence of a democratically-sanctioned budget, but rather that the US government's financial framework has an oddity that does not permit it to raise debt beyond a certain limit regardless of whether that borrowing has already been signed-off by Congress. Without going into too much detail, this separate public spending hurdle follows a different set of legislative rules and is therefore harder to get through Congress than the budget, when the party of the governing President does not have a majority in both chambers of Congress. This is currently the case since the mid-term elections in autumn last year. As such, it offers the opposition party the opportunity to hold the government to ransom in order to push through fiscal and other political concessions they would otherwise not be able to achieve in the regular legislative process.

The looming risk of default of the safest borrower known to markets must surely seem hair-raising to anyone who hears about this possibility for the first time, and observers will wonder how capital markets could have been so relatively sanguine about the whole affair over the last few months of continued political haggling. The answer lies in the fact that this is not the first time this is happening.

As the most recent and much renowned Goldman Sachs market risk appetite indicator below clearly indicates, risk appetite has been rising rather than crashing as it last did during the depths of the COVID market meltdown in 2020:



Source: Goldman Sachs Risk Appetite Indicator, 24 May 2023

Markets have taken solace from repeated pledges by Democrat president Joe Biden and the Republican Leader of the House Kevin McCarthy that they will not allow the US to go into default. Perhaps even more from the fact that, in the aftermath of the 2011 episode, there was a cross-party consensus that in the end the episode had benefitted no-one but had caused economic harm.

Despite all this, it is hard to deny the degree of causality between the market downdraft early last week and there now being only a very limited number of days left to resolve the debt ceiling deadline. There are suggestions of meaningful progress towards resolution being made and stock markets around the world have been bouncing.

So, another cliff-edge (most likely) circumnavigated, with calmer times returning as with previous episodes? The answer is yes, but only to an extent. This is because after the stock market bounce-back, the bigger market move of the week remains. Bond yields have moved higher again, in some instances, like the UK, reaching levels not seen since last autumn, after the Truss government's ill-fated mini-budget. As we know by now, higher bond yields put downward pressure on equity valuations, unless they are caused by an improved growth outlook. Last week's step up in bond yields came at the same time as inflation reports (such as in the UK) showed that inflation – while trending downwards – is nevertheless proving stickier and more persistent than had been expected by central banks. At the same time, Germany was reported to have been in recession over the winter quarters and China's COVID recovery has disappointed this far against the high expectations earlier in the year. Against this backdrop, expectations of central banks reversing their rate hike policy towards rate cuts has been further pushed out towards the end of this year and even the first quarter of next year, and expectations of resurging economic growth over the second half of this year have been dampened. This is likely to have been the cause of the bond yield increase last week, while a risk-off dynamics from debt ceiling angst should have pushed yields down with bonds seen as safe havens in times of stress.

From this angle, it is far more remarkable that risk asset markets took the developments of the week overall in their stride, whereas in the past, most yield step-ups of this magnitude would have upset the market balance from the valuation side.

It is unsurprising then, that we currently observe more disagreement within the investment research community than usual. In fact, there are many strong arguments pointing towards an eventual downturn – even if that only takes place next year – and equally good reasonings why the global economy might just muddle its way through the downdraft forces of 2023, and keep going forward for longer than conventional economic theory would otherwise suggest.

For those who have already looked beyond the likely resolution of the debt ceiling cliff, the next market threat will likely be the impending liquidity drain caused by the US government which must replenish its empty coffers by issuing $1 trillion of new bonds into markets. But there may be some reassurance that most of the $2.4 trillion of cash currently deposited by US money market funds in the US Federal Reserve's Reverse Repo facility is expected to be attracted by the higher rates the US government will have on offer than the US central bank. Perhaps this insight better explains some of the upbeat market sentiment last Friday than the positive vibes from the debt ceiling negotiators.

New EU fiscal rules

Europe's economy has appeared strangely resilient over the last six months. That may sound surprising, and got a bit of a sobering reality check, given last week's announcement that Germany – the continent's largest economy – was officially in recession through the winter. German gross domestic product (GDP) fell 0.3% in the first three months of this year, following a 0.5% decline in the last quarter of 2022, putting it officially in technical recession. But the problems could undoubtedly have been much worse. Given Germany's (and Europe's in general) previous dependence on Russian energy, last winter was expected to be incredibly bleak with expectations of widespread production shutdowns. In the end, a combination of milder weather which supported construction spending, the faster establishment of liquified natural gas (LNG) supplies from North America and better-than-expected energy storage meant the eurozone emerged without an overall contraction of growth. At least so far, although the recent German numbers are likely to weigh on revised eurozone growth performance – nevertheless, a decent result all things considered.

In other news sure to cheer Brussels, Greece – the epicentre of past euro crises – is on course to regain its investment-grade credit rating this year. It is already the fastest-growing economy in the bloc, and the unexpectedly big election win for Greece's centre-right government recently pushed bond yields down dramatically, in a further sign that markets are regaining confidence. The spread between Greece and Italy (the other source of European debt fears) is now at its largest in favour of Athens for many years. European policymakers will consider this vindication for what were, at times, unpopular and economically damaging policies. It could well embolden eurocrats in similar discussions with Italy. The significant difference remains of course that Greece went through a year-long International Monetary Fund (IMF) and European restructuring programme, while Italy has stood on its own two feet – leaving aside the fact that the European Central Bank (ECB) had been buying eurozone debt for years through its quantitative easing (QE) programme (like all western economies' central banks).

With the good news, however, came a serious deterioration of Europe's national finances. This is due to another reason that last winter's energy crisis did not hit Europe's economy as hard – namely that government subsidies softened the blow of sky-high energy prices on the spending power of private households. The subsidies severely worsened the eurozone's fiscal metrics, just after it had already taken an even more severe hit from the pandemic. In truth, even the Greek story is far from a success of European policy. After a decade of public spending cuts, tax rises and reforms – much of it at the behest of the troika (the European Commission (EC), ECB and the IMF combined) – Greece's debt-to-GDP ratio remains worse than in 2012. Its economy, meanwhile, is still smaller than it was in 2008. Strict budgetary rules have hindered growth, but without that growth debts are all the harder to pay off.

This is, of course, a well-worn criticism of the eurozone in general. Detractors argue that monetary union cannot properly function without fiscal union. Nations with separate currencies can adjust their monetary policies (and hence, alter currency values) to best fit their terms of trade, offering weaker economies a strategy for quick readjustment. Regions in a fiscal union (like US states) are eligible for certain fiscal transfers, increasing investment and balancing growth. Meanwhile, eurozone nations suffering from sluggish growth can do neither.

On the flipside, more fiscally prudent nations, like those in Northern Europe, are worried that profligacy in other economies could impact their currency or bond valuations. To prevent this, the bloc has fiscal rules its members must abide by. The most well-known of these are the debt-to-GDP targets which prohibit national debt from exceeding 60% of GDP and the annual fiscal deficit from going above 3% of GDP. These form key parts of the European Union (EU) Stability and Growth Pact (SGP).

These rules have always been enforced lightly. France and Germany were two of the first nations to break them – shortly after the SGP came into force – but avoided fines thanks to votes by EU finance ministers. New exceptions and procedures have been added over the years, but the pandemic – and the massive public debt required to bridge the economic void of the lockdowns – was seen by many as a nail in the coffin for the SGP. Currently, debt ratios for the eurozone as a whole, as well as its largest national economies (with the exception of Germany), are well above the 60% level.

The EC is currently writing proposals for reforming the bloc's fiscal rules, which it argues even more urgently must be updated in light of the pandemic and Europe's energy supply crisis. The EC does not want to change the 60% and 3% targets but, given the poor track record of achieving them, the discussion is more about how to reach these goals. Its original proposals a few months ago were for bespoke plans for each nation, similar to the IMF's national lending agreements (of course without disbursing any money).

Germany and the Netherlands have opposed such tailor-made plans, arguing there must be minimum targets for indebted countries. They suggest numerical targets are the only way to ensure tangible progress on debt reduction, and point out that the existing rules are full of exceptions for economic hardships anyway – as evidenced by historical adherence to the rules.

Proponents of the tailor-made approach, though, argue countries would be much more likely to stick to the rules if they were bilaterally agreed, instead of imposed by central diktat. This could also avoid pro-cyclical policies which demand austerity through tough economic periods and spending in times of growth. That could be a big help for nations that might need more time to implement budget adjustments. Fiscal transitions, and especially structural reforms, can be very costly at the beginning, as some industries might need to be closed or reformed, while productive infrastructure is put in place.

Something that policymakers will not openly discuss, but are very likely worried about, is that a lack of common rules might lead to preferential treatment for certain countries. However, even under the new framework, bespoke repayment plans must be approved by the European Council, meaning national governments have the final say. Another old problem is that the EU lacks credible punishments for fiscally profligate nations – at least larger ones like Italy. It can withhold some funds from some central pots for special programmes, but there is no big EU budget through which to exert genuine pressure.

If some such budget can be established by the end of June (when negotiations heat up), that would be a transformative, though unlikely, step. Whatever formal framework is agreed, it is most likely going to go through a typical European compromise – enforcement and genuine progress will (as usual) come down to goodwill and political engagement.

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30th May 2023

Global Equity Markets

Market	Fri 14:30	% 1 Week	% 1 Week in sterling terms	Technical Short Medium	Valuations Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7609	-2.1	-2.1	→ →	4.1	10.3	10.2	13.3
UK FTSE 250	18781	-2.9	-2.9	↘ →	3.6	10.7	10.1	14.6
UK FTSE All-Share	4144	-2.2	-2.2	→ →	4.0	10.4	10.2	13.5
UK FTSE Small	6177	-1.1	-1.1	↘ →	3.9	9.2	8.2	12.8
France CAC 40	7286	-3.0	-2.9	→ ↗	3.1	12.5	12.2	14.1
Germany DAX 40	15885	-2.4	-2.4	↗ ↗	3.6	11.4	10.9	12.9
US Dow	32830	-2.2	-1.6	→ →	2.1	17.5	16.5	16.4
US S&P 500	4161	-1.1	-0.5	↗ →	1.6	19.2	18.2	17.5
US NASDAQ comp	12736	+0.2	+0.8	↗ ↗	0.8	28.5	25.8	22.8
Japan Nikkei 225	31011	+0.7	+0.2	↗ →	2.0	18.1	17.6	16.7
World Bloomberg	1512	-1.4	-0.8	↗ →	2.4	13.7	13.5	13.8
China mainland	3851	-2.4	-2.5	↗ →	2.2	16.7	16.1	16.3
Emerging Bloomberg	1096	-0.7	-0.1	↘ →	2.5	11.9	11.2	12.0

Top 6 Gainers

Company	%
Whitbread	+2728.4
AstraZeneca	+329.4
Haleon	+63.2
Admiral	+4.0
Berkeley Holdings	+4.0
Smurfit Kappa	+2.8

Bottom 6 Decliners

Company	%
Unilever	-13.5
London Stock Exchange	-13.5
Persimmon	-9.9
Taylor Wimpey	-9.1
ConvaTec	-8.9
Intertek	-8.5

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.36	+0.28
UK Govt 15yr Gilt	+4.61	+0.24
US Govt 10yr Treasury	+3.84	+0.14
France Govt 10yr OAT	+3.12	+0.05
Germany Govt 10yr Bund	+2.54	+0.05
Japan Govt 20yr JGB	+1.02	+0.03

Currencies

Pair	last	%1W
USD per GBP	1.236	-0.6
GBP per EUR	0.868	+0.0
USD per EUR	1.073	-0.6
JPY per USD	140.22	+1.2
CNY per USD	7.063	+0.7
USD per Bitcoin	26,498	-1.5

Commodities

Cmdty	last	%1W
Oil Brent $:bl	77.1	+0.7
Gold $:oz	1948.6	-0.6
Silver $:oz	23.2	-1.9
Copper $:lb	364.2	-2.2
Alumnm $:mt	2220.8	-2.2
S&P soft crops	242.6	-4.7

UK Mortgage Rate Estimates

Rates (LTV c.75%)	26-May	26-Apr
UK BoE base rate	4.50	4.25
2yr fixed	5.78	4.76
3yr fixed	5.56	4.55
5yr fixed	5.16	4.27
10yr fixed	5.08	4.36
Standard variable	7.41	7.22

5/26/2023
Prices taken at 2:30pm today and 2:30pm last Friday (where possible)
Bloomberg equity indices are similar to those published by MSCI
LTM PE is the index price as a ratio of last 12 months earnings
NTM PE is the index price as a ratio of next 12 months earnings as forecast by analysts
Mortgage estimates are derived from sterling swaps markets

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values

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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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