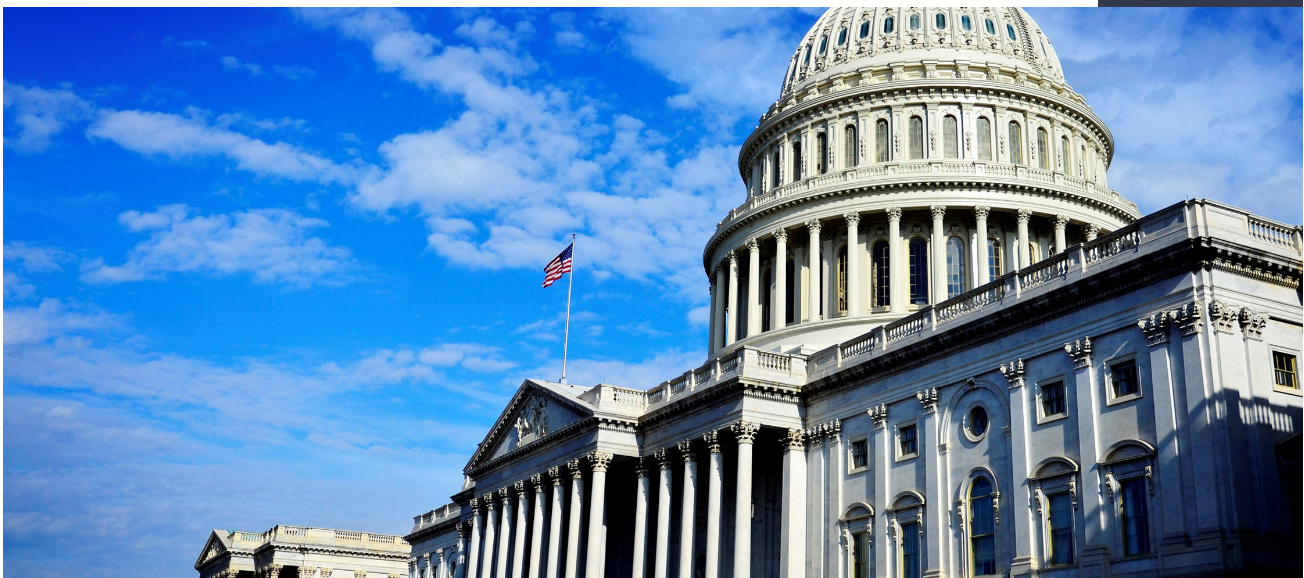
Investec

OUT OF THE ORDINARY

WEEKLY DIGEST | 18 April 2023

Dancing on the ceiling



John Wyn-Evans
Head of Investment Strategy

Following the Easter long weekend, we asked whether the quiet period in markets around the holiday was the ‘pause that refreshes’ or the ‘calm before the storm’. We didn’t get a definitive answer last week, and supporters of both outcomes could say they have evidence to support their case. On the one hand, there were further signs that the US economy is not capitulating. There were no nasty surprises in the latest inflation data; producer price data was benign, and March retail sales and industrial production beat consensus forecasts. The

week was rounded off by better-than-expected results from banks Wells Fargo, Citigroup and JP Morgan, which came as a relief after March's squall in the banking sector. In Europe, sentiment was bolstered by blow-out Q1 numbers from LVMH. This was all reflected in another positive week for risk assets, with equities gaining ground and credit spreads tightening.

On the other side of the ledger was the idea that 'good news is bad news', at least eventually. If the economy is not lying down, the risk is that inflation will not subside fast enough towards central bank targets, and that this will lead to the requirement for further rises in interest rates. Influential Federal Open Market Committee (FOMC) member Christopher Waller made exactly that point in a speech on Friday. His views were backed up by a big jump in the one-year inflation expectations number in the monthly University of Michigan Sentiment Survey. All of this was reflected in a poor week for bond markets, with the Bloomberg Global Aggregate Index losing 71bps.

For the next few weeks, though, at least until the next Federal Reserve meeting on 3 May, investors' focus will be firmly on the first quarter reporting season, mainly on the US to begin with. The monster week will be the one beginning next Monday, 24 April, during which around half of the S&P 500 by market cap and around 20% of the STOXX Europe 600 will release earnings.

As usual, the investment banking community provides us with much more granular detail about the US than anywhere else, and it seems likely that the outcome over there will do a lot to set the tone in the rest of the world. Using consensus data from FactSet, Goldman Sachs projects that Q1 2023 US earnings will be 7% lower than Q1 2022. Is this the dropping shoe for which we have waited so long? Possibly not. The same consensus suggests that this will be the low point in the earnings cycle in terms of year-on-year performance, with the final three quarters of 2023 forecast at -6%, +2% and +9%.

If markets tend to bottom around or even before the earnings trough (depending on whose data one looks at), then that might suggest the low is in and we should just stop worrying. However, there remains a big gap between bottom-up analyst forecasts and top-down strategists' expectations for earnings, and we are inclined to wait for this to resolve itself before allocating more funds to equity risk.

As we have discussed a lot in the past few months, the nature of this cycle is very different to anything that we have experienced for possibly as long as three decades, driven as it is by central banks deliberately trying to squeeze inflation out of the economy. The phrase "long and variable lags", as it pertains to the transmission of monetary policy, is often repeated, and is frustratingly vague, especially so when the structure of mortgage, credit and private lending markets has evolved to such an extent that the current timescales might be quite different to what they were historically.

What are the expectations of a recession or earnings downturn?

I was on a number of calls last week in which strategists laid out very clearly their theses for exactly the sort of recession and earnings downturn that we, and others, have been patiently awaiting. Commentary that I received from Citigroup, MRB Partners and BCA Research all expressed similar opinions. Investment banks Morgan Stanley, JP Morgan and Bank of America are in the same camp, and so we don't feel as if we're out on a limb. Even so, there is a quite a range of expectations as to where the S&P 500 might fall to, with the most bearish being around the 3000 mark (vs last Friday's close of 4137), which would equate roughly to a 15x PE multiple on around $200 of earnings. This, in turn, would be a 10% year-on-year fall (and, indeed about a 10% fall from the current consensus). But, of course, as long as things keep surprising to the upside in the short term, investors are not positioned for that, and equities can continue to squeeze higher.

The straws in the wind that support the more cautious view are things like Bank of America credit card spending data, where there have been some signs of activity rolling over. Also, some of the credit card and auto loan delinquency numbers. But the real concern is the slow but sure tightening of lending standards and credit availability against a background of much higher interest rates for those having to refinance loans, especially in the non-quoted small business sector. It looks as though we are going to have to remain patient.

What impact will there be on the US debt ceiling?

One other issue that is going to become more salient over the next few months is the thorny one of the US debt ceiling. Owing to seemingly sensible, but actually highly impractical, rules put in place in the dim and distant past, Congress regularly has to go into negotiations to raise the ceiling for the amount of debt that the government is allowed to issue. It's based on a nominal figure and so takes no account of inflation or the size of the underlying economy. As US politics has become more partisan in its nature, debt ceiling negotiations have become more and more contentious, especially when no single party has overall control, as is the case now.

Past episodes have led to temporary shutdowns in government services and even to a ratings agency downgrade to the country's credit rating. The government has already effectively hit the ceiling and is running down its cash balances at the Federal Reserve (Treasury General Account) as well as "borrowing" funds from various Federal agencies to tide itself over (so called extraordinary measures). The good news is that with 18 April being the last day for US citizens to file their tax returns, tax receipts will start flowing in over the next few weeks. It will be worth keeping an eye on how strong these are, with the caveat that last year's financial market action will leave little by way of capital gains tax to pay. Indeed, tax loss selling was a feature of market activity in the run up to the calendar year end.

Although the US Treasury has conservatively guided to 5 June as the 'X-date' upon which it calculates that the money will run out, analysis that we have seen suggests that it's going to be more like mid-August or even September. Even so, this only delays the inevitable bun fight that is going to break out in Congress. How close will the Republicans push the country towards the default cliff? Nobody really believes that they will go over it, but Credit Default Swap (CDS) spreads (prices) have been edging up in anticipation of a scare. A CDS is effectively an insurance policy against an issuer defaulting on its debt.

A spiralling CDS spread played an important role in undermining confidence in Credit Suisse just a few weeks ago, although we must also be wary of a 'tail wagging the dog' effect. Just a single €5 million trade in Deutsche Bank's CDS in March set the hares running on concerns about its solvency and knocked as much as €1.5 billion off its market valuation in one day! Even so, there is some information in the direction of these markets. The five-year CDS spread on US government debt has shot up from 25bps (0.25%) at the turn of the year to 46bps now. Some buyers will be taking out insurance. Others will be speculating on a rising default probability. Buyers of this contract are effectively committed to paying an annual insurance premium of 0.45% of the face value of a US Treasury bond for the next five years. That eats up quite a lot of one's prospective 3.65% yield to maturity but does afford peaceful nights' sleep for holders. For speculators, there is the potential for a return of many times the stake.

Interestingly, the one-year CDS has moved even more aggressively, from 16bps in December to 92bps now. This reflects the fact that the debt ceiling has to be resolved this year. And it if is, then it should be laid to rest for another few years. But it will inevitably return to haunt us.

A US debt default goes into the low probability/high impact category of risks. We have no explicit insurance against it, although we believe that some of the alternative funds through which we invest will have exposure. But, along with the risk to economic and earnings growth cited earlier, it is another factor that keeps our recommended risk appetite below neutral.

Economic Commentary

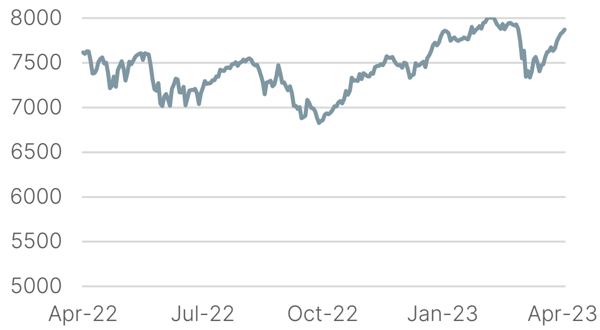
FTSE 100 weekly winners

Antofagasta plc	9.0%
Schroders PLC	7.8%
Glencore plc	7.7%
BT Group plc	7.6%
Croda International Plc	7.5%
Barratt Developments PLC	7.3%
Smith & Nephew plc	7.3%

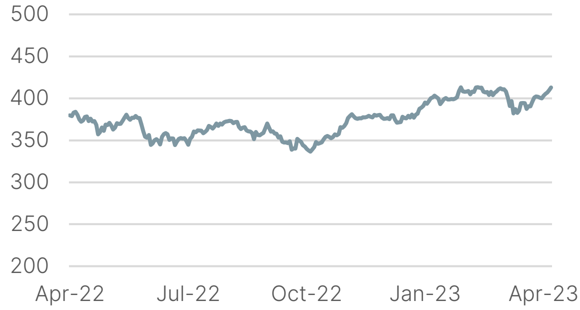
FTSE 100 weekly losers

National Grid plc	-0.9%
Reckitt Benckiser Group plc	-0.8%
JD Sports Fashion Plc	-0.3%
Severn Trent Plc	-0.3%
International Consolidated Airlines Group SA	-0.2%
United Utilities Group PLC	-0.2%
Smiths Group Plc	0.0%

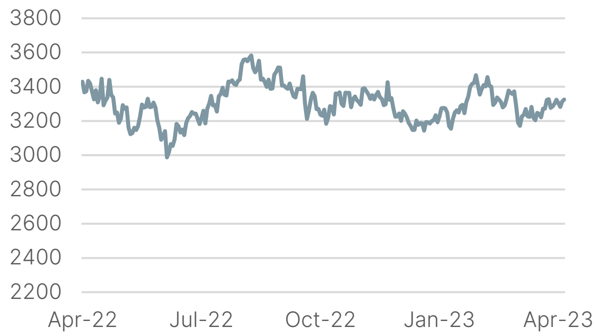
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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