ARIA | CAPITAL

INVESTMENT INSIGHT

A weekly look inside the investment world.

One of the penalties for refusing to participate in politics is that you end up being governed by your inferiors.
Plato

Friday, 20 January 2023

In this week's Investment Insight

Hitting the roof
The US debt ceiling has developed into a disconcertingly regular game of chicken between opposing sides of the US houses of congress. With the ceiling due to be reached yesterday, the prospect, once again, looms imminently. On previous occasions, once a period of stand-off, negotiation and even unpaid civil servants passed, the ceiling was raised and order restored. However, the stakes are particularly high this time. The US Treasury Secretary, Janet Yellen, warned last week that "failure to meet the government's obligations would cause irreparable harm to the US economy, the livelihoods of all Americans, and global financial stability." Strong words indeed. In The Inside Track we explore the implications.

Bear rating
Plenty of uncertainty and risk remains in asset markets as 2023 kicks off. Last year's drawdowns have certainly helped to restore some semblance of value, but does that mean it's time to embrace risk once again? Historically speaking, the answer to this has depended on the nature of the bear market. In Pic of the Week we look at the different types and the length each might last.

Newswire
Some interesting nuggets from this week's newswires.

Market view
A visual snapshot of recent market performance.

The Inside Track: Hitting the roof

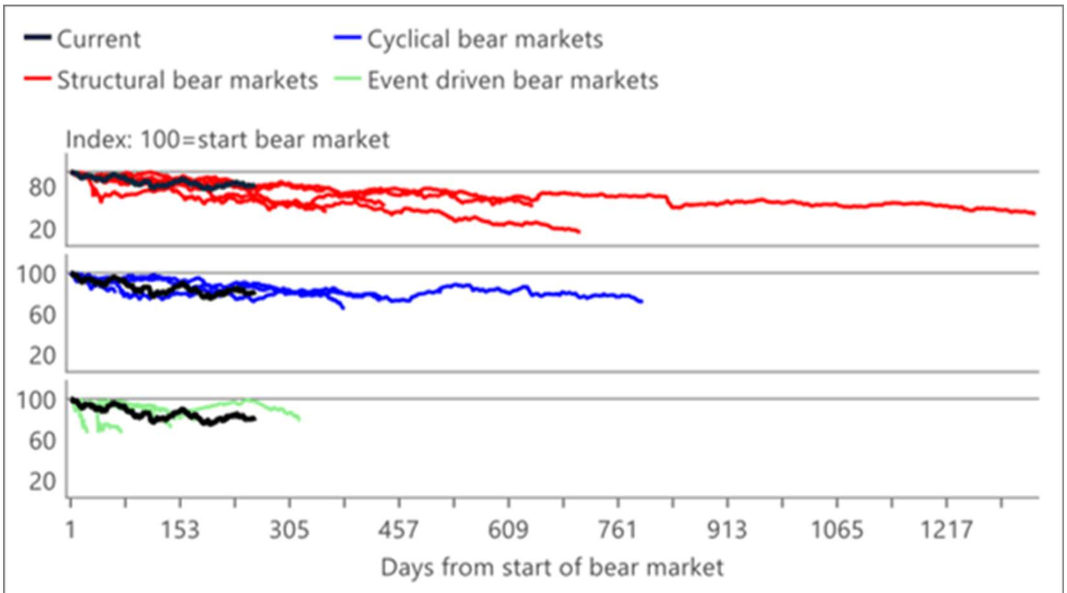
The largest known systemic risk facing asset markets globally at the moment is the possibility of the US defaulting on its debt obligations, which would be the consequence of congress failing to raise the US debt ceiling for the 103rd time since World War II. Janet Yellen issued a grave, if possibly premature, warning last week of the dire consequences for Americans, and the global economy, of politicians failing to get their act together. It would seem like a black and white decision for the opposing sides of the houses of congress but it will likely be seized upon as an opportunity to score political points and extract political compromise. The recently elected House speaker, Kevin McCarthy is already on the record as saying "You couldn’t just keep increasing it. Let’s sit down and change our behavior for the good of America. Because what we’re going to do is bankrupt this country and bankrupt these entitlements if we don’t change their behavior today." A valid sentiment, but not one to be negotiated with a bazooka to the temple of the global economy.

We have to assume that it's unlikely the politicians will joust to the point of default, but it is a possibility. If this happened, what might it mean for investors? Most fundamentally, it would destroy investor confidence in the US and blow out its cost of borrowing. As well as US bonds, US equities and the dollar would likely be deeply impaired and the dollar would lose its status as the world's dominant reserve currency. The US economy would become swamped with increasingly high interest costs and would struggle to finance itself. Unemployment would rise and a severe US recession would be a certainty. The tumultuous impact would extend globally to some extent, but be greatest in the US. Other countries or regions might even benefit from the US's decline, experiencing inflows heretofore States-bound. US investors would likely seek refuge in real, as opposed to financial, assets, high-quality international equities and the government bonds of countries perceived to be more fiscally responsible than the US.

Failure to agree an increase in the debt ceiling is unlikely, mainly because of these grave conequences. However, in a nod to the Republican argument, the US is living well beyond its means and has been for years. The massive post-GFC and post-pandemic spending to stimulate the economy has not been paid for by way of higher taxes or lower public spending; indeed, quite the opposite. The US has simply printed more and more paper and will need to do so indefinitely. On the one hand, it is argued (including by Republicans, not just by right-leaning non-US economists) that this can't go on forever. To paraphrase the enonomist Herbert Stein who came up with 'Stein's law', "trends that can't continue won't". On the other hand, there are so many interests vested in the health of the US economy and its financial sustainability, there won't be many volunteers, domestically or internationally, waiting to pull the rug from under it.

Pic of the Week: Bear rating

Evidently we were deep into bear market territory for most asset classes by the end of last year. However, despite the more encouraging bounce-back we've seen so far in 2023, caution is warranted. Bear markets tend to last from between 1 to well over 3 years, depending on the nature of the bear market, whether its cyclical, structural or event-driven. It's arguable that the current bear market is a combination of two of these: cyclical and event-driven. Before the 2022 fall in asset prices there were few signs of widespread imbalances or extremely compressed levels of risk premia. Private-sector balance sheets were generally healthy, banks not highly leveraged and aggregate households and corporates relatively healthy. Valuations were high, especially for growth equities, at the end of 2021, but due to low real interest (and, thus, discount) rates not due to compressed risk premia. History suggests that once a cyclical or event-driven bear market sees indices falling by -20%, a turn may be nigh. While we may have reached that dubious milestone, history also suggests that US equity values don't trough until a pause or cut in Fed rates or the start of a recession.



Source: BNY Mellon Investment Management, Macrobond. Data as of 11/01/2023.

Newswire

...on Monday
Credit Suisse announces plans to cut 10% of investment bankers.

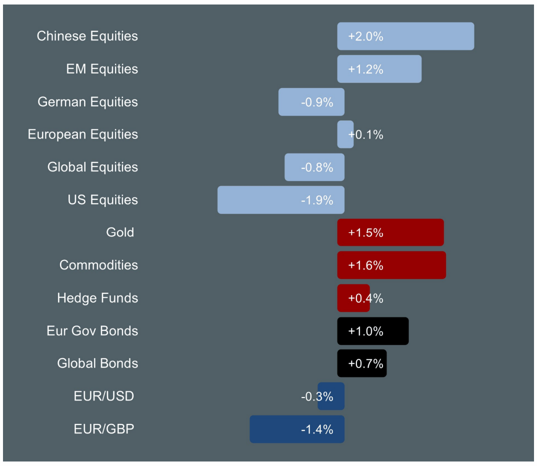
...on Tuesday
German investor sentiment improves for the first time since the Ukraine war began.

...on Wednesday
Microsoft adds to the trend of tech layoffs, announcing 10,000 job cuts.

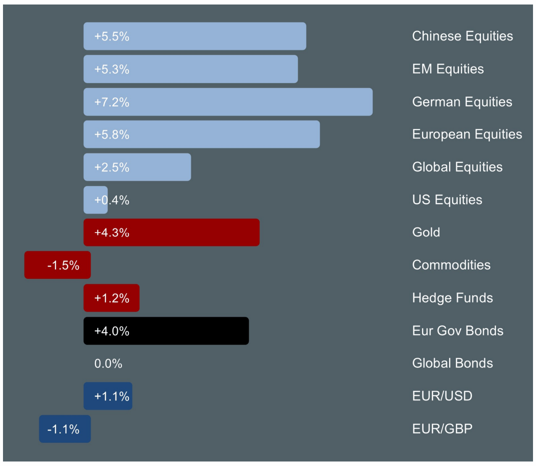
...on Thursday
US jobless claims unexpectedly fall.

Market View

Last 7 days (€)



Year to date (€)



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