Brewin Dolphin

The Weekly Round-up

Friday 28 April 2023

In his latest weekly round-up, Guy Foster, our Chief Strategist, discusses first quarter earnings results, the US debt ceiling bill, and the Bank of Japan's policy review.

It has been a mildly negative week for stocks this week. UK and US bonds were unchanged, but European and particularly Japanese (discussed later) bonds rallied.

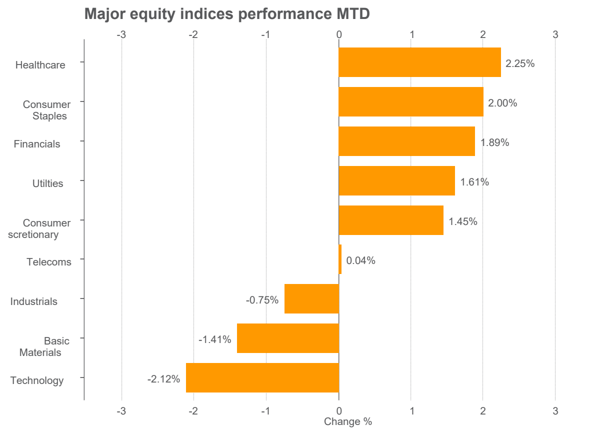
This comes in the week in which the first gross domestic product (GDP) estimates of 2023 were issued. The US posted a second straight quarter of slowing growth. It also appears that momentum within the quarter may have been ebbing, in a sign that rising interest rates are taking the wind out of the economy as hoped. Outside the US, the core of Europe is close to stagnation with German activity unchanged and France rising a paltry 0.2%. The periphery was stronger, with Spain and Italy expanding by 0.5% each.

First quarter earnings mixed, but generally resilient

This week saw US earnings season pass the halfway point. Certain sectors cluster their earnings reports at different times during earnings season. The first week tends to be dominated by financials, with the emphasis switching to technology in the second week. As it happens, these two sectors have defined the first quarter in terms of market performance and sector performance.

Huge optimism surrounded financials as the quarter began, but ultimately led to frustration. Banks were to benefit from high net interest margins, or so the theory went. As it turns out, the speed with which interest rates rose tripped up some smaller regional banks, prompting their depositors to place renewed focus on improving their returns and minimising risks. The latest weekly statistics suggest that deposits were flowing back out of banks in the second week of April. Investors, therefore, were relieved to find banks generally reporting strong earnings and meeting or exceeding analysts' forecasts. Having underperformed during the first quarter, they bounced back during April.

Defensive stocks such as healthcare and staples have also performed reasonably well this month. Expectations were less challenging and, in both cases, were largely surpassed. Consumers seem conditioned to expect price increases, which is making it easier for consumer staples companies to rebuild their margins faster than many feared. That's good news for shareholders, but it is a potentially ominous sign for the Federal Reserve if it could indicate that consumer price increases are more persistent.



Source: Refinitiv Datastream

Technology stocks lagged slightly, having been the best performer of the first quarter. The messages from earnings were generally pretty reassuring.

The debt ceiling looms…

Investors are becoming increasingly concerned about the US government's ability to honour its debt payment. Unless the Treasury is granted authority to raise the statutory limit on US government debt, it will run out of money this summer. The precise date is not known, but a disappointing influx of tax revenue on tax deadline day has brought the event horizon forwards. We will shortly get a revised estimate for when the government is expected to run out of money. The situation is complicated in numerous political ways. Democrats control the Senate and the White House, but Republicans control the House of Representatives. Reaching an agreement between these parties is extremely challenging.

Republicans are opposed to raising taxes and Democrats are opposed to cutting spending. Within the Republican-controlled House, many representatives won their districts by pledging not to authorise more spending. The Republicans' majority is extremely thin, so any lack of unity will inhibit their ability to pass legislation. A consequence of this is that the House speaker, Kevin McCarthy, who controls which legislation is voted on, is vulnerable to being dethroned at the whim of any member of the House. Doing so would pause any new legislation until a new speaker were elected, allowing minorities to be able to prevent legislation they don't like (such as authorising an increase in the debt ceiling). This was insisted upon by sceptical members of the speaker's own party to mitigate the risk that he might reach a compromise with the Democrats.

…and pressure intensifies

This week, McCarthy passed a plan through the House of Representatives which would see the debt ceiling increase to $1.5trn, enough to avoid further stresses until the end of March 2024. However, it comes at the cost of $4.8trn in budget cuts. This bill was immediately rejected by the Democrats, but it earns the speaker a right to join negotiations with the Democrats. Any concessions during those negotiations, though, would make passing a new deal far harder. The challenge is just beginning.

Markets have exhibited some stress over this. Yields available on one-month Treasury bills fell well below the yields available on three-month bills, reflecting the nervousness among investors that a default could occur over the summer. The cost of insuring US debt against default has been soaring. Some legal experts believe that the 14th amendment, which states that US government debt "shall not be questioned", implicitly authorises the government to override the debt ceiling. It is unclear though whether the government would be prepared to do so due to the legal and political risks that this strategy would bring.

A long hard think for Ueda

Japanese debt yields are currently constrained by the Bank of Japan's yield curve control policy. We anticipate that this policy will need to be dropped at some stage in the future as core inflation continues to climb. Inflation is putting upward pressure on interest rates and forcing the Bank of Japan to inject increasing amounts of money into the economy (to maintain the yield cap) at a time when it should arguably be tightening policy.

At the Bank of Japan's latest policy meeting, the first for incoming governor Kazuo Ueda, attention was focused on how policy might evolve. Scrapping the yield curve control policy would be very good for the yen, but bad for Japanese government bonds. It would benefit financial stocks, but other sectors would suffer from the stronger yen.

The decision was made to scrap forward guidance which had previously committed the Bank of Japan to maintain slightly negative interest rates. This would suggest that policy change is indeed afoot. However, yen bulls were left disappointed as Ueda announced a review of Bank of Japan policies which would take a year to complete.

That, together with renewed forecasts showing inflation returning to target under existing policy settings, saw a rally in Japanese government bonds and a fall in the yen. That came despite Ueda confirming that policy could be changed during the policy review period. That seems a likely outcome. We have discussed before how important it is that the Bank of Japan surprises the market when it does eventually abandon yield curve control. If the policy is telegraphed too clearly, speculators will be able to profit by shorting Japanese bonds, forcing the Bank of Japan to pour more money into an overheating economy.