BELVÉDÈRE
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DANCING ON THE CEILING

MARKET INSIGHTS

DANCING ON THE CEILING

"Dancing On The Ceiling", a song by Lionel Richie from 1986, is all about having fun and partying. However, the dancing on the ceiling that we are about to address here is no fun at all and might in fact outright spoil the party for markets. We are talking about the debt ceiling in the US, which is currently set at USD 31.4 trillion and has been recently reached. This means that the US government is not allowed to take on any new debt and may be running into insolvency. The Treasury Department has taken emergency measures, which should at least buy the government some time, possibly up to early June.

A proper remedy would be for Congress to raise or suspend the debt ceiling. This is usually just a matter of routine. Not only because Congress has done this often enough in the past – to be precise, 78 times, according to NBC's count – but also because Congress is the very body that passes the budget and thus also defines the deficit amount and greenlights the necessary borrowing. By raising the debt ceiling, Congress is therefore only allowing to come to pass what it has decided itself.

However, this year raising the US debt ceiling may turn out to be anything but a matter of routine. The ruling Democrats and the Republicans, who won back the majority in the House of Representatives in last year's midterm elections, are too deeply divided. Moreover – and this is at least as ominous – there are groups within the Republican Party who are willing to go to extreme lengths and use their voting power as leverage for sweeping concessions.

The incipient friction in the US Congress could also have an impact on markets. Were the US to become unable to take on any new debt, in a first phase, persisting investor demand would effectively push the price of US government bonds up and, in turn, interest rates down. So far, no harm done. However, should the US government go into the next phase and actually default on its payment obligations, this might lead to some severe market disruptions. And not only in the US, where the world's largest, most liquid and safest market for bonds would be in trouble and the US dollar would come under massive pressure. It would become a global systemic risk, as it might easily drag down other markets and asset classes.

Notwithstanding all this, it seems quite unlikely that the US should actually default on its payment obligations for an extended period of time. That said, it is not at all unrealistic to assume that Congress will take up to the very deadline (or even a little longer) to reach an agreement. And that in itself has the potential to unsettle the markets. This became evident in 2011, for instance, when a similar constellation – a Republican Congress blocking a Democratic government – sent the markets into a downward spin and prompted rating agencies to downgrade the quality of US debt. This might happen again in 2023. Investors would be well advised to keep a vigilant eye on the "dance on the (debt) ceiling".

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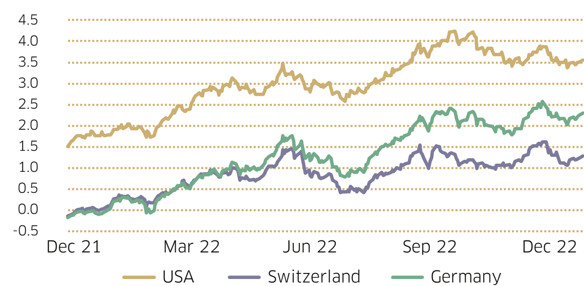
INTEREST RATES

A month ago, we claimed here: "At the long end of the yield curve, there should be significantly less movement this year than in 2022. We do not expect last year's highs to be substantially and sustainably exceeded." Of course, it is too early to furnish a proper verification of this statement. Nevertheless, as far as the peaks are concerned, this has so far been borne out. Long-term interest rates have softened at the outset of the year. To call this "significantly less movement" would be a wild understatement – the decline was distinct and unexpectedly substantial. At the same time, credit spreads have also declined significantly. All in all, easing concerns about the economy and inflation seem to be priced in. We are much rather about to see interest rates take a reverse course, which has already started happening these past few days.

Central banks will stay their course of tightening cycles. The European Central Bank and the US Federal Reserve will probably have taken the first step already this week (after our editorial deadline) and might follow up with one or two additional moves by the middle of the year. The Swiss National Bank is likely to follow suit in March. Markets are still anticipating key interest rate cuts in the US already in the second half of the year. However, in the absence of a more palpable weakness in growth – i.e. a proper recession – or other disruptive factors, such as turbulence around the debt ceiling (see editorial), we still consider this quite unlikely.

Rates coming down again
(yield 10-y government bonds, in %)



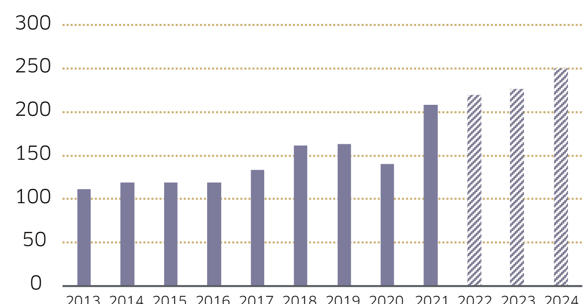
Source: Bloomberg, BAM

EQUITIES

Contrary to expectations, equity markets got off to a buoyant start in 2023. Europe's stock markets benefited from waning fears of a recession, lower energy prices and a brightening of sentiment in manufacturing, which is reflected for instance in the German ifo business climate index. US markets initially lagged behind the developments in Europe, but caught up in the second half of January. The continuing decline in inflation from 7.1% to 6.5% in December fuelled speculation that the US Federal Reserve might adopt a less restrictive monetary policy, which particularly benefited riskier stocks. The best example of this is Tesla, which has gained over 40% since the beginning of the year. In Asia, the surprising reopening of the economy in China gave a boost to stock markets.

Given this good performance, the question is now whether the equity markets' positive momentum is sustainable. Looking at the course the reporting season in the USA has taken so far, gives rise to doubts. The number of companies that have reported higher-than-expected earnings is below the long-term average and the extent of positive surprises is low at a mere 1.5%. The market is thus counting mainly on monetary policy, i.e. an interest rate cut in the second half of the year, which we consider unrealistic. Our outlook for the eurozone is somewhat brighter. Lower energy prices compared to last year, an easing of supply bottlenecks and the still comparatively low valuations, along with an improving economy, could secure a sustained price rally.

Earnings per share S&P 500



Source: Factset, BAM

ECONOMY

The gap in economic growth between the US and Europe seems to be narrowing somewhat. While US economic data is deteriorating from fairly high levels, we see corresponding improvements in Europe. To pick one example, the purchasing managers' indices in the US are in a downturn, whereas in Europe they are already swinging up again. In our view, there is a fair chance that Europe might run through a mild recession in the worst case, before an upswing sets in. And we see energy supply as a key driver. Energy saving efforts, alternative gas sources and the mild weather all combined have led to gas storage levels that are almost 20 percentage points above the 2015–2020 average.

Economic growth in China reached 2.9% year on year in the fourth quarter, thus exceeding expectations (1.6%). This was driven by private consumption and robust infrastructure investments. China is currently battling another wave of covid, which has probably already peaked, though. We expect to witness some pent-up demand for consumption and a bottoming out of the sorely battered real estate market in the spring. After a disappointing 2022, the government is likely to pull out all the stops to get the economy back on track.

Asset class	Appraisal	Commentary
Bonds		After the interest rate decline at the outset of the year, a rebound is to be expected. Central banks will continue the cycle of interest rate hikes for the first half of the year.
Government bonds		
Corporate bonds		
Equities		After the strong upward moves, the upside potential is getting exhausted. Notably stock markets in the US are relying too heavily on an interest rate cut in the second half of the year.
Switzerland		
Eurozone		
United Kingdom		
US		
Emerging markets		
Real Estate		Picked up from September lows, but still comparatively inexpensive. The distribution yield is still attractive compared to government bonds.
Switzerland		
Commodities		Following a considerable rise since November, the remaining upward scope for the gold price is narrow. A successful reopening in China could boost the oil price in the course of the year.
Oil		
Gold		

unattractive — attractive   Current asset class assessment

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