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Weekly Market Flash
US recession likely pushed out further

May 28, 2023

The week ended with fairly insignificant deviations for the major world equity indices—especially in the US. However, the undercurrents were notable, with macroeconomic themes and micro aspects coming together, amplifying the divergences that had already been in place since the beginning of the year, both geographically and sector-wise.

Highlights

- European growth is slowing down markedly, as evidenced by the technical recession (two consecutive negative quarters) in Germany. But there are no worrying signs on the labor market so far.

- In the US, the economy is continuing to confuse doubters with strong spending keeping inflation too high. The core PCE deflator stood at 4.7% compared to the 4.6% expected. The tone of the data during the week has been on the average good, with the housing market now seeming to re-accelerate.

- AI-related stocks exploded this week, driven by a very positive quarterly report from Nvidia, which further improved the outlook for the next 12 months. It is clear that the stock and the semiconductor sector is in the midst of a bubble.

- The US Treasury's cash balances declined significantly, reaching USD49.5 billion after Thursday's market close, down from USD76.5 billion the previous day and USD140 billion on May 12.

- Fitch placed the AAA rating of the US on "Rating Watch Negative". Moody's Investors Service highlighted the importance of a mid-June payment of interest on Treasuries, stating that missing it would result in a default and a downgrade from AAA to AA1.

- For corporate bonds, UBS strategists have provided estimates for potential losses. If interest payments by the US government were to be missed for a week, blue-chip spreads could increase to 215 bps.

"...there are no worrying signs on the labor market so far, and consequently one should not be too alarmed for the time being."

Markets & Macro | US recession likely pushed out further

Will we see another Fed hike in the near term?

At the economic level, the emerging dynamic is that European growth is slowing down markedly, as evidenced by the technical recession (two consecutive negative quarters) in Germany. Various regional indicators in other countries have also confirmed the weakness. That said, there are no worrying signs on the labor market so far, and consequently one should not be too alarmed for the time being.

“…in the absence of a deterioration in the labor market, there is no point in betting against the US consumer.”

Figure 1: Year-to-Date Performance of Major Indices

Equity Indices	Last Value	Week	Ytd
MSCI World	2,796.86	-1.47%	8.63%
Nasdaq	12,907.89	0.09%	23.79%
S&P 500	4,201.35	-1.09%	10.17%
S&P Equal Weighted	5,672.66	-2.32%	-0.42%
DJ Industrial	33,064.70	-2.28%	0.62%
Nikkei	30,916.31	0.74%	19.72%
Eurostoxx	4,346.20	-2.01%	17.50%
Swiss SMI	11,462.74	-0.98%	10.01%
FTSE 100	7,642.84	-2.18%	4.38%
Canada	19,928.85	-2.55%	4.06%
Shenzen	3,850.95	-2.63%	-0.36%
Hong Kong	18,746.92	-4.65%	-4.36%
MSCI EM	964.01	-1.38%	1.67%

Equity Sectors	Last Value	Week	Ytd
S&P value	152.07	-2.17%	5.33%
S&P Growth	66.79	-0.15%	14.51%
S&P Defensives	1,520.39	-2.52%	-0.59%
ARK Fund	39.37	-1.89%	26.02%
Fangs	7,070.88	1.30%	59.08%
S&P Banks	77.55	-0.57%	-21.95%
Euro Stoxx Banks	78.75	-0.51%	12.37%
S&P Energy	78.75	0.06%	-9.05%
Gold Miners	30.30	-5.08%	5.70%

Commodities	Last Value	Week	Ytd
BBG Commodities	99.89	-1.66%	-11.45%
BBG Agriculture	65.12	-0.73%	-5.38%
Gold	1,940.10	-1.91%	6.36%
Silver	23.07	-3.30%	-3.71%
BBG Brent Crude TR	982.48	0.54%	-7.48%
BBG WTI Crude Oil TR	176.22	-0.05%	-7.88%

FX	Last Value	Week	Ytd
DXY Index	1,247.99	0.68%	0.11%
EUR/CHF	0.9712	-0.09%	-1.85%
GBP Index	640.22	-0.34%	2.79%
EM FX Index	1,676.01	-0.16%	0.93%
USD/JPY	140.67	1.95%	7.28%
USD/CNY	7.07	0.78%	2.44%
Bitcoin	26,808.40	-0.12%	62.09%

Bond Indices	Last Value	Week	Ytd
US Inv Grade	106.19	-0.67%	2.05%
US High Yield	73.92	-0.74%	2.40%
Euro Corps	231.45	-0.06%	1.66%
JPM Europe Govies	9,645.82	-0.24%	4.51%
US Treasuries	2,216.98	-0.95%	1.31%
China Aggregate	256.40	-0.37%	0.44%
EMBI Global	776.81	-0.40%	1.11%
EMBI Local	130.00	-0.56%	5.10%

Source: Bloomberg, as at May 26, 2023. Performance figures in indices' local currencies.

In the US, on the other hand, the economy is continuing to confuse doubters (including us), with strong spending keeping inflation too high. In fact, the tone of the data during the week has been on the average good, with the housing market now seeming to re-accelerate, in defiance of the rate hikes. In our view, the inversion of the curve (read by all as an early indicator of recession) weighed heavily in this dynamic. The fact that long-term rates are being compressed downward, without following central bank policy, is supporting the cost of mortgages, and therefore real estate activity. It's a similar situation for consumption, which continues to show that in the absence of a deterioration in the labor market, there is no point in betting against the US consumer. In May, the core PCE grew by 0.5% in real terms compared to the previous month, almost doubling expectations. As a result, US GDP appears to be accelerating from Q1 (1.4% quarter-on-quarter), up over 2% in real terms.

“Against this backdrop, it is possible that Fed hawks may prevail at the next meeting in June.”

Against this backdrop, it is possible that Federal Reserve (Fed) hawks may prevail at the next meeting in June. If (as is highly likely) a solution to the debt ceiling is announced between Monday and Tuesday, and the labor market data to be released on Friday is strong (of around +200,000), the way for a further hike would be cleared. The market currently assigns a 60% probability that this will happen. After all, inflation as expressed by the core PCE deflator (printed on Friday) stood at 4.7% compared to the 4.6% expected.

Our view: All these factors push forward the arrival of the infamous recession in the US. The economy still seems too strong, and the excess savings accumulated during the pandemic are not yet finished (it is estimated that there are still around USD1 trillion in savings, and they are being spent to the tune of USD100 billion per month). Real rates (the difference between Fed rates and inflation) then are still slightly negative, so we have to wait for either a further rise in rates or a fall in inflation for credit conditions to be really tight.

In terms of equities, as mentioned above, there is no shortage of interesting and somewhat surprising dynamics. AI-related stocks exploded this week (Figure 2), driven by a very positive quarterly report from Nvidia, which further improved the outlook for the next 12 months. It is clear that the stock and the semiconductor sector is in the midst of a bubble—Nvidia's price-to-sales ratio has surpassed that achieved by Tesla at the time of the pandemic, and its 1-year performance is 133%. However, it is difficult to say how much longer the speculative wave can last, and what the trigger for its downsizing might be, since rates have already risen in recent months and are unlikely to rise much further.

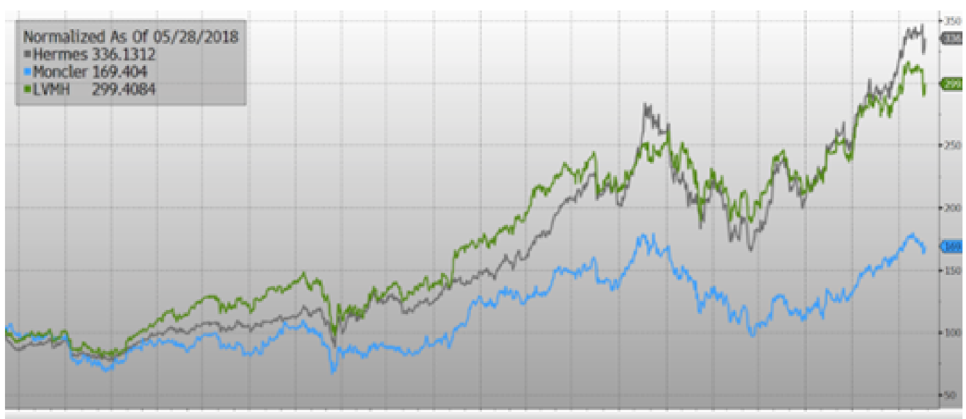
Figure 2: AI-related Stocks Explode

“The gap between Europe and the US is closing (in favor of the US currently).”

Source: Bloomberg, as at May 26, 2023.

The US market, excluding the big technology stocks, is actually struggling a lot and showing signs of weakness: the S&P 500 index is up by more than 10% year-to-date, the S&P Equal Weighted index is down by -0.3%. In practice, it is only technology stocks (the Nasdaq index is over 23% year-to-date) that support the market. The gap between Europe and the US is closing (in favor of the US currently). We no longer see the indiscriminate flows that daily assailed European equities at the beginning of the year, and, as can be seen from Figure 3, even European luxury stocks, the market's best representative, have started to correct in the last two weeks. It is more than likely that the disappointing performance of the Chinese economy and market (both the Shenzhen and Hong Kong indexes went negative this week) had an influence on the sector, as these names had been bought as a proxy for the Chinese reopening.

Figure 3: European Luxury Stocks Start to Correct



Source: Bloomberg, as at May 26, 2023.

“We no longer see the indiscrim-inate flows that daily assailed European equities at the beginning of the year…”

Fixed Income | A credit tightening versus a credit crunch

High yield spreads could widen up to 175 bps in the third quarter.

The US Treasury's cash balances declined significantly, reaching USD49.5 billion after Thursday's market close, down from USD76.5 billion the previous day and USD140 billion on May 12. This highlights the urgency to resolve the debt ceiling issue, as evidenced by the fact that yields on US T-bills near the X-date (June 1) are trading with a 6% handle. The debate over the debt ceiling in the US also coincided with higher-than-expected UK inflation numbers.

“US futures have increased the probability of a rate hike in June to 54%...”

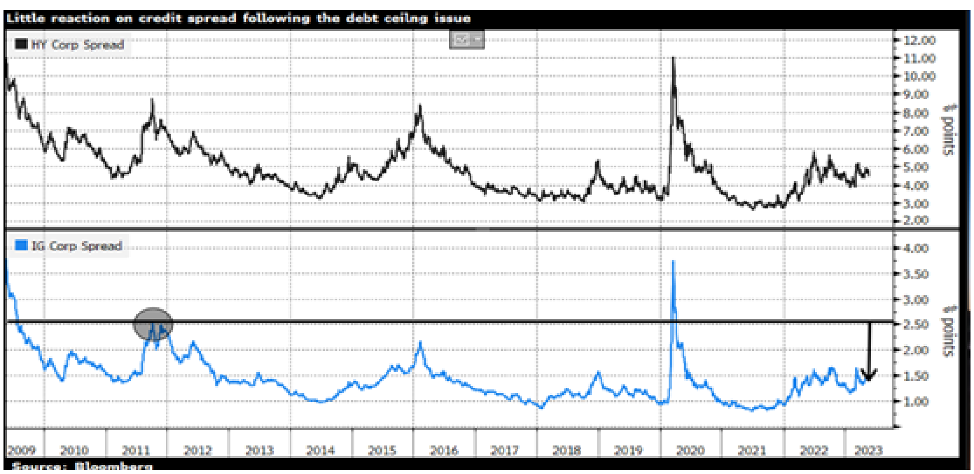
While it was just the UK that had a strong inflation print, investors responded by dialing up the chances of rate hikes more broadly. US futures have increased the probability of a rate hike in June to 54%, signaling a notable departure from the previous view, which suggested no further hikes and expectations of a rate cut. As markets priced in more rate hikes, sovereign bonds sold off across the board once again. In the US, yields on 10-year Treasuries, which were up 7.6 basis points (bps), hit a post-SVB high of 3.81%. In Europe, where the next two European Central Bank hikes are still fully priced and the market pricing of rates cuts is “overly optimistic”, yields on 10-year Bunds moved to 2.52% (up 10 bps), BTPS to 4.40% (up 15 bps) and UK Gilt to 4.37% (clear underperformer with an increase of 40 bps during the week).

Back to the debt ceiling issue, Fitch placed the AAA rating of the US on "Rating Watch Negative". Moody's Investors Service highlighted the importance of a mid-June payment of interest on Treasuries, stating that missing it would result in a default and a downgrade from AAA to AA1. If downgraded, Moody's would continue to review the rating for further downgrades until Congress addresses the debt-limit legislation. S&P, on the other hand, maintained a rating of AA+ with a "stable" long-term outlook, while in 2011, S&P faced criticism for downgrading the US from AAA after a similar brush with default, causing a selloff in risk assets but boosting demand for Treasuries as safe havens.

For corporate bonds, UBS strategists have provided estimates for potential losses. If interest payments by the US government were to be missed for a week, blue-chip spreads could increase to 215 bps, while a month-long lapse could result in risk premiums reaching 280 bps, which is double the current levels. In the high yield market, spreads could surge to 850 bps, a level not seen since the early stages of the pandemic. In reality, for the moment, the debt ceiling debate is not significantly impacting investors in the credit market. High grade corporate bond spreads in the US are expected to decrease this week, indicating improved market conditions. The cost of insuring against defaults in the credit derivatives market for a portfolio of high yield companies has also declined. However, prices for CCC-rated junk bonds remain above the average for the year and recent months.

“In reality, for the moment, the debt ceiling debate is not significantly impacting investors in the credit market.”

Figure 4: HY and IG Corporate Credit Spreads



Source: Bloomberg, as at May 26, 2023.

Despite these positive developments, companies across the credit spectrum are still experiencing higher financing costs. In the first quarter, US companies experienced a significant rise in interest costs, averaging nearly 20% higher compared to the same period the previous year. For instance, Oracle Corp. reported a rise in interest spending from USD667 million to USD908 million year-over-year. This situation is even more challenging for junk-rated companies, which often have limited cash reserves and fewer options to mitigate the impact. Carnival Corp., a cruise operator heavily affected by the pandemic, saw its interest expenses increase from USD368 million to USD539 million in the first quarter. The company expects to reduce its debt over time and alleviate interest costs with free cash flow.

Again, UBS predicts that credit spreads in the high yield market will widen in the coming months, but they believe that the overall market is experiencing credit tightening rather than a credit crunch. Indicators of distress include private defaults, loan downgrades, and lower loan recovery rates. UBS maintains its forecast for significant spread widening in the third quarter up to 175 bps, reaching approximately 625 bps.

"We prefer to stay up in credit quality and prefer investment grade corporates..."

Our view: It is well known that the ability of companies to manage higher interest expenses varies based on the strength of their balance sheets, with higher-rated companies finding it relatively easier compared to lower-rated ones. Therefore, our view remains unchanged and cautious. We prefer to stay up in credit quality and prefer investment grade corporates, which in the case of recession should experience less spread widening. For the moment we are avoiding the lowest-rated bonds (especially below BB-) and we are wary of subordinated credit that tends to be more correlated to equity markets, which would likely decline in a recessionary environment.

Week Ahead | Key events to watch for

- Once the debt ceiling issue is resolved, the market will return to focus on macro dynamics. This week brings important data, such as the **ISM in the US (manufacturing and services), as well as the May labor market report** and the Conference Board's consumer confidence.

- **In Europe, labor market inflation** in the major economies will be published.

- **China's PMI and Japan's leading economic indicators** will be among the main data releases in Asia.

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