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A Month in the Markets

JUNE 2023

In this latest edition our Multi Asset Solutions Team look at the challenges investment markets faced in May. Debates among US lawmakers over whether to raise the debt ceiling – and in doing so potentially avoid a US debt default, which risks major economic damage – captured the attention of investors.[1]

Debt ceiling and debt default explained

The debt ceiling refers to the maximum amount of money that the US government is authorised to borrow to meet its financial obligations. It is a statutory limit set by Congress, beyond which the government cannot legally borrow funds. The debt ceiling exists to control and monitor the government's borrowing activities and prevent excessive debt accumulation.[2]

The risk of debt default occurs when a government is unable to fulfil its financial obligations on existing debts, such as interest payments, as they become due. A debt default would mean that the government fails to make timely payments on its outstanding Treasury bonds and other debt instruments.[2]

As the US government approaches the debt ceiling and there is uncertainty around its ability to raise it, investors worry about the possibility of a debt default by the US government. This would have severe consequences, both domestically and globally. It would erode confidence in the US government's ability to honour its financial commitments, leading to higher borrowing costs, decreased investment, and potential disruptions in financial markets.[3]

Market Overview

The world economy also showed signs of slowing this month as China's post-lockdown resurgence began to fade.[4] Japanese shares stood out, touching a 33-year high as a dip in the value of the yen increased the overseas earnings of firms.[5] An index of the largest 250 firms listed on the Tokyo Stock Exchange delivered its best monthly performance since November 2020[6], capping off an excellent month for the Japanese stock market.

In the US, enthusiasm about artificial intelligence propelled the Nasdaq Composite Index, which is weighted towards technology companies, to its best May performance in three years.[7] However, the technology sector proved to be an outlier as fears that debt ceiling negotiations could falter caused the Dow Jones Industrial Average, which offers a broader snapshot of the US economy, to lag behind.[8]

The UK's FTSE 100 Index, which contains some of the world's largest oil producers and mining companies, experienced its worst May performance in eight years amid worries that China's stalled economic recovery may dampen the demand for raw materials.[9] A cost-of-living crisis continues to punish UK consumers, while economists warned of the danger that the UK may still lapse into recession.[10]

A gauge of Chinese shares in Hong Kong tumbled more than 20% in May[11], while the yen weakened amid signs that the Chinese recovery is fading out.[12] Disappointing manufacturing data in the world's second-largest economy compounded investor concerns, with domestic demand proving slow.[13]

Eurozone shares fell to a two-month low at the end of the month as China's faltering recovery raised concerns that the demand for imported luxury products would fall.[13] European stock markets also wobbled in the run-up to a crucial vote on the US debt ceiling in late May, reflecting investor nerves.[15]

Yields on UK government bonds that mature in two years, the most sensitive to interest-rate changes, reached their highest levels in seven months as inflation proved more persistent than expected and investors consequently anticipated that the Bank of England (BoE) would keep interest rates higher for longer.[16] Bond yields move inversely to prices, meaning that prices fell.

In the US, yields on two-year government bonds also climbed as a gauge of inflation preferred by the Federal Reserve (Fed) rose more than expected.[17] Although they fell slightly towards the end of the month as progress was made on the debt ceiling issue[18], yields still ended the month higher than they had been at its start.[19]

Yields on 10-year German government bonds, which are often used as a general gauge for the Eurozone, ticked upwards through the month amid market uncertainty.[20] However, as US lawmakers reached a deal on the debt ceiling issue in late May they recovered somewhat.[21]

Gold prices experienced their first monthly decline in three months despite coming close to record highs earlier in May. A strengthening US dollar proved attractive to investors, lessening the demand for gold.[22]

UK and Europe

UK business confidence fell for the first time in three months in May as higher-than-expected inflation weighed on economic sentiment. However, while optimism waned, it remained in positive territory, indicating resilience in the economy.[23]

The International Monetary Fund altered its growth forecast for the UK this month, now believing that the economy will grow by 0.4% in 2023, as opposed to the 0.3% contraction it had anticipated in its April forecast. Its rationale for this shift was rooted in resilient demand, improved financial stability and falling energy prices.[24]

Data released in May showed that the economy expanded by 0.1% in the first quarter, despite unexpectedly contracting by 0.3% in March.[25]

Shop price inflation reached a three-month record amid calls for the government to introduce price caps[26], while data released earlier in the month showed that a key measure of inflation jumped to its highest level in 31 years.[27] The BoE's response was by now routine, with the central bank hiking interest rates for the 12th consecutive time.[28]

A survey of Eurozone companies found that business output rose for a fifth successive month in May as growth in the services sector compensated for another contraction in manufacturing, indicating that the region's economy is likely to expand in the second quarter.[29]

The European Central Bank implemented an interest rate increase early in May, but this 0.25 percentage point rise marked a softening of the 0.5 and 0.75 percentage point hikes it had previously introduced. However, it warned that further action may be required to tame inflation.[30]

US

A survey released by the Fed at the end of May showed that the rate of hiring in the world's biggest economy is easing, lessening inflationary pressures.[31]

Unexpectedly strong economic data raised hopes that the US may dodge a recession, but strong consumer spending maintained upward pressure on prices, encouraging the Fed to continue raising interest rates.[32]

Inflation remains stubborn. Figures released in May showed the Fed's preferred gauge of inflation accelerated from 4.2% the previous month to 4.4% in April – more than double the central bank's 2% target.[33]

In the face of persistent inflation and uncertainty regarding the debt ceiling issue, US consumer confidence slipped to a six-month low in May.[34]

Asia Pacific

A contraction in China's business activity continued in May, the risk of a downward spiral in the manufacturing sector heaping pressure on policymakers to restore the momentum of the economic recovery. The revival in domestic consumer spending following the lifting of COVID-19 restrictions has also proven weaker than expected.[35]

While its global peers struggled with elevated inflation, China's economy may be at risk of deflation. Figures released in May indicated that consumer prices rose at their slowest pace in two years in April, indicating weak consumer demand.[36]

In Japan, figures published this month showed that factory output unexpectedly declined for the first time in three months in April as a global slowdown hurt the export-orientated economy. It marks a disappointing beginning to the second quarter, overshadowing the improved supply chains and signs of recovery that had characterised the first quarter.[37]

Bank of Japan Governor Kazuo Ueda told lawmakers towards the end of the month that the central bank will remain committed to ultra-low interest rates, given that the central bank expects inflation to ease to within its 2% target.[38]

Outlook

We believe the global economy is headed for a slowdown rather than a full-blown recession, which is defined as two consecutive quarters of negative growth.

The key will be how central banks respond to economic data. While headline inflation rates have eased, core inflation (which strips out volatile elements such as food and energy costs) has remained relatively persistent.

Speculation regarding whether central banks will continue hiking interest rates or pause will probably continue to drive volatility in stock and bond markets.

The gradual slowing of inflation should benefit bonds. However, we expect stock markets to be volatile and trade in narrow ranges.

We favour US government bonds over European bonds, as the outlook for European interest rates and UK inflation makes US bonds more attractive. US and UK bond yields are also very attractive at current rates.

As we enter June, the deal to avoid a debt default that might have upended the global economy was officially signed by Joe Biden on 3 June, suspending the US debt ceiling. This put an end to a months-long stalemate with Republican House Speaker Kevin McCarthy and should cool investor concerns that troubled markets during May.[39]

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All data as at 5 June 2023.

[1] Fortune, 16 May 2023
[2] Investopedia, 05 June 2023
[3] The Economist, 22 May 2023
[4] Bloomberg, 16 May 2023
[5] Reuters, 29 May 2023
[6] Dow Jones, 31 May 2023
[7] Reuters, 31 May 2023
[8] Morningstar, 31 May 2023
[9] Reuters, 31 May 2023
[10] The Guardian, 26 May 2023
[11] Bloomberg, 31 May 2023
[12] Reuters, 22 May 2023
[13] Reuters, 31 May 2023
[14] Reuters, 31 May 2023
[15] AFP, 29 May 2023
[16] Financial Times, 24 May 2023
[17] CNBC, 26 May 2023
[18] FXStreet, 31 May 2023
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[24] BBC, 24 May 2023
[25] CNBC, 12 May 2023
[26] Investment Week, 30 May 2023
[27] Bloomberg, 24 May 2023
[28] The Guardian, 11 May 2023
[29] S&P Global Flash Eurozone PMI, 23 May 2023
[30] Reuters, 4 May 2023
[31] Yahoo! Finance, 31 May 2023
[32] Reuters, 26 May 2023
[33] Associated Press, 26 May 2023
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[35] Associated Press, 30 May 2023
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[38] FXEmpire, 30 May 2023
[39] The Guardian, 04 June 2023