October 2023

Risk Radar Report

Summary

- Strong economic data in the US, combined with increased Treasury issuance, have led to a significant move higher in long-term yields. Unless we see a meaningful turn in hard economic data, and signs that inflation is on a sustained path toward the Federal Reserve's target, yields could well have further room to run

- China is currently facing both cyclical and structural challenges to its economic growth. While aware of the risks, we see the possibility of an acceleration in stimulus that could benefit global liquidity conditions at a time they remain depressed

- Rising oil prices have concerned market participants around the Fed's inflation fight. The real risk is whether this becomes more sustained, shifting inflation expectations higher. Higher oil prices also risk hurting the demand picture as the consumer gets tested heading into Q4

Rising US yields and a resilient consumer

The 10-year US Treasury yield has shifted meaningfully higher in the past few months as the growth outlook continues to surprise. We've seen the inverted yield curve bear steepen by over 60bps in under six weeks, with 10-year yields rising considerably more than 2-year yields. We believe this has been driven by a confluence of factors, with robust economic data and accelerated Treasury issuance being the key drivers. We'll be paying close attention to the upcoming Treasury refunding announcement in November. If government spending continues to be primarily financed through large coupon issuance, this could exert further upward pressure on the longer end of the yield curve, likely resulting in a more pronounced sell-off in risk assets.

Rising US yields

Over the summer, we saw the US consumer continue to show remarkable strength. This was confirmed last week with a 4.9% GDP growth figure for Q3, the largest quarterly increase since Q4 2021. It's worth noting that the surge in consumer spending during the summer can be attributed, in part, to temporary factors. We expect the consumer to be challenged over the coming months with rising energy prices, and the resumption of student loan repayments gradually exerting downward pressure on discretionary spending.

Labour market data has been softer recently, with demand and supply dynamics gradually coming into balance. Workers are finding it increasingly difficult to transition to more lucrative roles, evident in declining quits rates. The Fed will be encouraged as this helps mitigate upward wage pressures, but more work is needed to achieve a healthier equilibrium in the labour market. Any sustained material weakness could serve as a catalyst to send yields lower. However, for markets to grow concerned, we would need to see significant negative surprises in forthcoming jobs data.

With resilient economic data being met with accelerated treasury issuance, we see upside risk to longer-dated yields, posing continued threats to long-duration assets. Hence, our high-yield credit fund remains predominantly invested in low-duration corporates, despite an awareness that the time to increase duration risk is getting closer.

China growth concerns

We are closely monitoring the ongoing challenges in China, marked by growing concerns surrounding the real estate sector and a slow pickup in domestic consumption. China's approach to their post-COVID recovery has been notably different from the widespread stimulus measures adopted across the west. Combined with underlying structural issues, this has resulted in a recovery that has fallen short of expectations. We have seen stimulus efforts pick up recently, but it's clear more comprehensive measures are needed to stimulate not only consumption and investment, but crucially, private sector confidence.

We are also paying attention to the persistent weakness in the Chinese yuan and Japanese yen, as these developments have far-reaching implications for global liquidity. Weakness in the yen will not help China, as this invariably shifts foreign demand for goods and services away from China and into Japan. China finds itself in a delicate balancing act regarding its currency. On one hand, they want to avoid excessive strengthening against the dollar, which would hamper their exports. On the other, they will be watchful of more weakness spurring further capital flows and increased food and energy costs. In theory, increased monetary and fiscal stimulus could lead to further devaluation of the yuan. However, it's worth considering that more aggressive expansionary policy could bolster investor confidence on future growth prospects, providing some support for the currency.

Although the issues in China are more idiosyncratic, the implications are being felt across the global economy, particularly when it comes to the growth of money supply. Over the past two decades, China has played a pivotal role in driving global money trends, with money supply growth in China and the rest of the world being closely linked. With the US, UK, and Europe still in the process of maintaining restrictive monetary policy, the more China refrains from over-stimulating, the more sluggish global money supply growth will be.

Global M1 money supply growth

Source: ***Simon White, Bloomberg***

This ultimately poses headwinds for short-term liquidity conditions, which have hampered assets such as Bitcoin over the past few months due to their sensitivity to these liquidity dynamics. Although Bitcoin has several positive catalysts, such as the 2024 halving and pending spot ETF approval, were we to see more meaningful stimulus from China and a clear sign that other major central banks are done hiking, improvement in money supply growth would prompt us to be even more bullish. Given its significance in driving global liquidity growth, we remain vigilant in monitoring China's policy response and the money supply growth rate.

Rising oil prices

Oil prices have continued their upward trajectory, as supply continues to tighten amidst further OPEC+ and Russian production cuts. Demand continues to hold up, despite the weaker-than-anticipated recovery in China.

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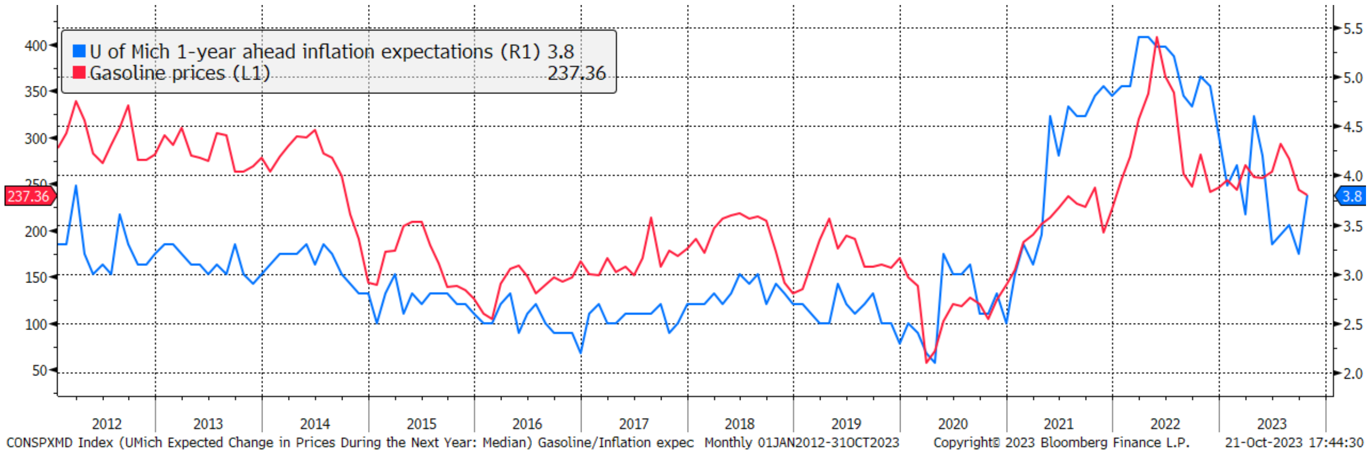
Gasoline prices moved into positive territory on a year-on-year basis in August and September, which will raise concerns around the Federal Reserve's inflation fight. At this stage, it's unlikely the Fed will be too worried with the more volatile components of the CPI basket such as energy prices. However, it's important not to dismiss the potential risks associated with significantly higher oil prices and their impact on bringing inflation down to target, both in the United States and in Europe.

A key risk associated with rising oil prices is that they can lead to unanchored inflation expectations. Consumers begin feeling the pinch at the pump, and it's things like food and energy that ultimately drive near-term inflation expectations higher regardless of their inherent volatility. What's more, rising oil prices lead to higher energy costs for firms, which will be passed on to consumers. This will exert upward pressure on non-energy inflation too. While we are currently not at price levels to warrant excessive concern, it remains a risk worth monitoring, especially considering recent developments in the Middle East.

Rising US gasoline prices and inflation expectations



Something to consider is that today's consumer is different from the one we've seen over the last few years. While household balance sheets remain robust, there are several factors presenting upcoming challenges for consumers. These include higher borrowing costs, the continued drawdown in excess savings, and the resumption of student loan repayments, which combined may pose significant headwinds to discretionary spending. We are already seeing evidence of this as reported by several US districts in the Beige Book, where consumers are becoming much more resistant to price increases. Firms may find it increasingly more difficult to exercise the same level of price-setting power they've been used to if consumers respond by being more selective with their spending.

The Fed will likely look at the recent rise in oil prices as transitory. However, if price increases were to be more sustained, this could compel it to adopt a more aggressive approach to curtail oil demand. This would then carry the risk of pushing the economy into a more significant downturn. Although the strong price action in the commodity has acted as a tailwind for our names in offshore oil & gas services, triple-digit oil would warrant caution as the demand outlook becomes more worrisome. We remain nimble to identify hedging opportunities were the fundamental demand and supply picture to change.

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