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CREDIT RATING AGENCY

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ECONOMIC DIGEST

GLOBAL MACROECONOMIC DEVELOPMENTS

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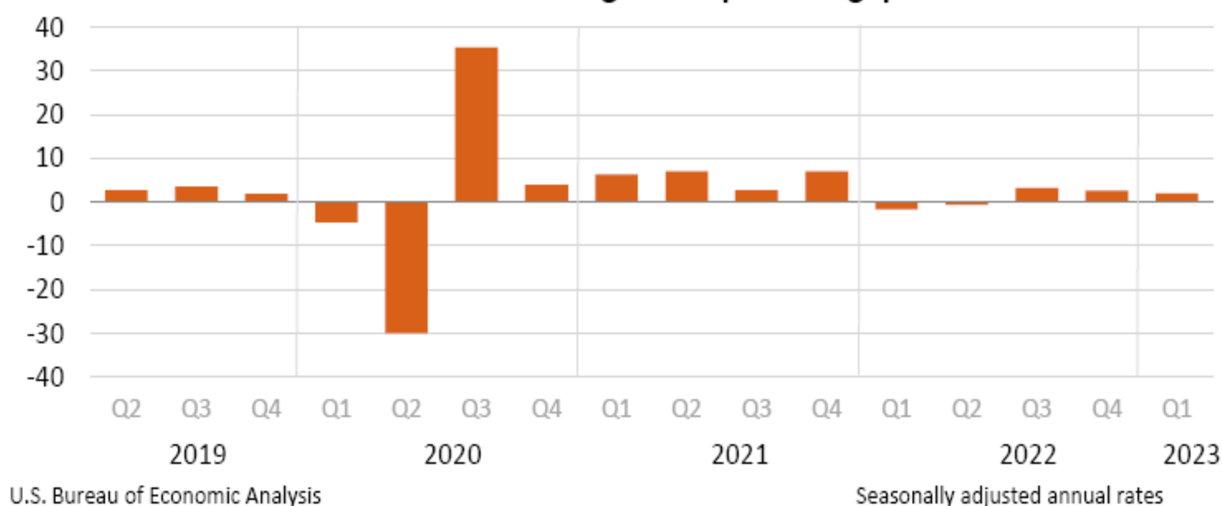
Introduction

The American economy today is confronted with challenges at multiple levels. With the geopolitical and economic disruptions in the last few years, the business ecosystem has changed significantly. Businesses face tumultuous times. According to the "third" estimate released by the Bureau of Economic Analysis, real gross domestic product (GDP) increased at an annual rate of 2.0% in the first quarter of 2023 (table 1). In the fourth quarter, real GDP increased 2.6 %.

The consumer price inflation in the United States declined to 4.0 % in May 2023, the lowest since March 2021. This decline was largely attributable to a decline in energy prices. In addition, the core rate, which excludes volatile items such as food and energy, has slowed to 5.3 %, the lowest since November 2021. The softening of the inflationary spiral supported the case for the Federal Reserve to consider pausing its current cycle of monetary tightening.

The unemployment rate in the US increased to 3.7 % in May 2023, the highest since October 2022 The jobless rate, however, remained historically low and suggested the labor market remained tight. The number of unemployed people increased by 440 thousand to 6.10 million and employment levels declined by 310 thousand to 160.72 million. The labor force participation rate was unchanged at 62.6%, remaining at its highest level since March 2020. source: U.S. Bureau of Labor Statistics

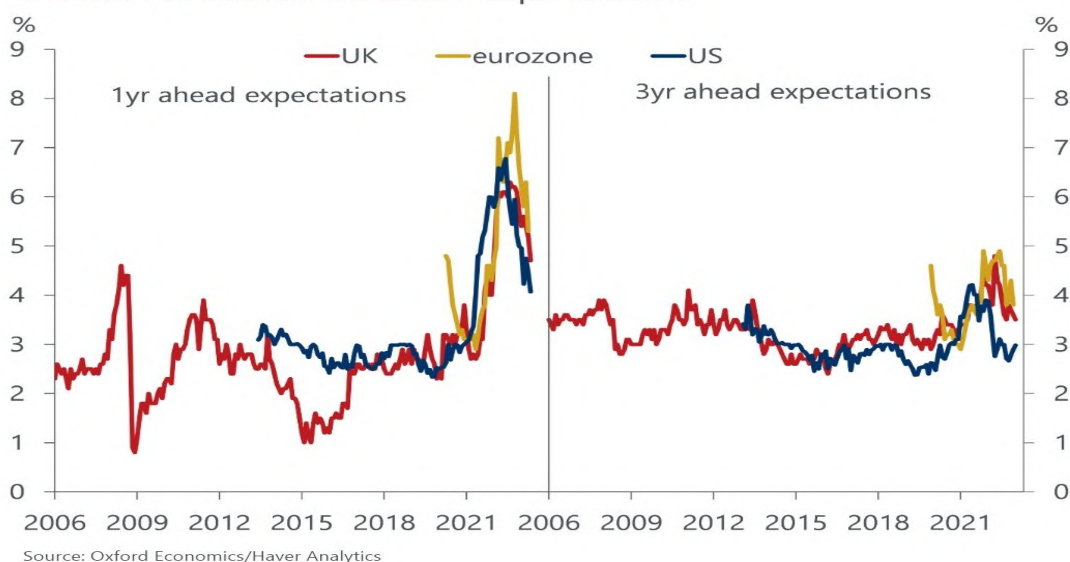


According to the CME FedWatch Tool, the chance of a Fed policy rate (federal funds rate) hike towards 5.25-5.50 (i.e. of a 25 bps hike) has increased to 76.9% (almost 77%) from the previous 71.9% (almost 72%) in the forthcoming policy. (Fed Chair Jerome Powell said: "inflation pressures continue to run high, and the process of getting inflation back down to 2% has a long way to go.").

Some argues that UK and Japan (Ueda)'s inflation problem is supply-side, so Central Banks (CBs) can do little about it. At the best CBs can influence the inflation expectations going forward with "effective" communications (Roughly speaking, a continuous hike in policy rate may give the signal a CB is committed to lower inflation rate towards their target. Now, suppose in subsequent quarter, inflation shows a downward trend, then it provides some assurance to the larger audience that we are in right track. But suppose in next quarter inflation increases. It may, however, increase for a variety of reasons. If at some instance, it shows durable disinflation, that means policy rate hike is probably working at a lag impact (at least one may get comfort thinking this).

More importantly, the belief the monetary policy signal is aligned with what market behaviour has a significant bearing on the conduct of the monetary policy. The difference between the expectation and the actual outcome can be justified by the ever-increasing volatility in the so-called "VUCA" world. [so, the "process of getting inflation back down to 2% has a long way to go' simply means, the lag impact of the Fed policy rate hike would be realised after a reasonably calculated period, and by influencing inflation expectations aligned according to this announcement. Currently, by re-iterating this phrase, Fed is trying to deliver that they will remain "hawkish" so that inflation should show the "durable disinflation path"].

Nevertheless, there is a lot of uncertainty regarding the time span and future path regarding this. To borrow from Oxford Economics (Chief Global Economist"Innes McFee") and "The Fed's Long-Term Inflation Problem" by the YahooFinance: "having a long-term 2% inflation target would require the Fed to bring inflation numbers well below 2% to average out the recent inflation."



Source: Oxford Economics.

According to Gita Gopinath, central banks now face a challenging "trilemma" (and not just the traditional "dilemma")--that is, reducing inflation without significantly damaging growth and while also avoiding financial instability.

In US, the mortgage applications are down from the peak by at least fifty per cent thus it is expected that prices should decline, but given the moderate supply, the prices are “holding up.” (ING). But from US Census we get upward trends in May’23 for most of the macro-variables (https://www.census.gov/economic-indicators/#home_sales), while quarterly profits of manufacturers are down.

In the US, the differential between 10-year treasury yield and 2-year bond has narrowed marginally to 0.97% that widens more than 1%. Nevertheless, the inversion argument is still strong. A survey shows that 80% of investors expect the US treasury curve to remain inverted into next year. The US manufacturing data upsets, with a sharp decline of PMI to 46.3 in June’23 compared to 48.4 in May’23 (forecast was 48.5).

Citing the Bloomberg article “Hedging Failure Hammers Private Equity as Debt Costs Skyrocket”, 20 June 2023), Jefferies Greed and Fear (G&F) has emphasised that many private equity companies opted against hedging interest rate exposure on the floating rate they took on for leveraged buyouts, subsequently until August’23 nearly 75% of the floating rate debt in America was not hedged.

This explains why credit risk in this cycle in America is not primarily with households but with corporates. As regards corporate debt, there are three clear areas of exposure where credit has been extended to lower quality (in credit terms) companies. They are leveraged loans, which total about US$1.4tn, private credit funds which total nearly US$1.5tn and high-yield bonds which total about US$1.7tn.

The Financial Times reported recently that there were 18 debt defaults in the US loan market totalling US$21bn in the first five months of this year (see Financial Times article: “US junk loan defaults surge as higher interest rates start to bite”, 13 June 2023). This is bigger than the total value for the whole of 2021 and 2022 combined.

Issues in commercial real estate in US is also brewing. Besides a decline of around 30% of values, there are other serious problems as around USD 1.3 trillion commercial real estate loans would be due by the end of 2025. Borrowers might need to refinance their old loans via fresh borrowing which could be a pain point as many lenders could be cautious taking lessons from their past experiences. Hope for the best, but if this" best" would fail to take place, then banks could be at edge in a similar manner like SVB and First bank crises.[1] The drop in PMI in June'23 in Eurozone indicates some softening in economic activity including Germany and France.

The Bank of England's Monetary Policy Committee voted 7-2 to raise its interest rate by 50 bps to 5.0%, which revealed a stronger "hawkish" stance compared to market participants who expected a 25 bps hike. The BoE Governor, Andrew Bailey, said that "inflation is still too high and we've got to deal with it.". Annual headline inflation remained stuck at 8.7%.

Earlier, the larger expectation was that the Bank of England is about to deliver another 25 bps rate hike, raising rates to 4.75%. The UK inflation data came in hotter than expected, with the Core CPI hitting the highest rate since March 1992. The next policy is on 3 August'2023.

The one-year gilt yield is approaching towards 5.5%[2] thus likely to attract foreign investments which can be expected supporting the pound. Nevertheless, Brexit and cost of living related uncertainty are causing investors to sell risky assets, thus pushing GBP downwards. On the other hand, 10-year UK bond yield is down at 4.34%[3] showing somewhat an inverted yield curve. GDP in the UK for Q1 remained steady at a 0.1% quarterly expansion since Q4 2022, where the final Q1 report would come out by 30 June 2023.[4]

The Bank of Japan's 1Q23 Tankan survey shows that Japanese companies' five-year inflation expectations rose from 1.1% in 3Q21 to 2.1% in 1Q23 while one-year inflation expectations are up from 0.7% to 2.8% over the same period. According to the monetary policy minutes of the Bank of Japan (BOJ): "The year-on-year rate of increase in the consumer price index (CPI, all items less fresh food) was slower than a while ago, mainly due to the effects of pushing down energy prices from the government's economic measures, but it had been at around 3 percent recently owing to the effects of a pass-through to consumer prices of cost increases led by a rise in import prices. Inflation expectations were more or less unchanged after rising. With regard to the outlook, the year-on-year rate of increase in the CPI (all items less fresh food) was expected to decelerate toward the middle of fiscal 2023, with a waning of the effects of the pass-through to consumer prices of cost increases led by the rise in import prices."
It seems that the wage price spiral is happening to some extent, that this year's spring wage round saw the biggest wage increase amongst large companies in 30 years. While some companies have started raising wages, others are trying to keep same without layoffs.[5] The female workers participation rate has increased, with seniors remaining in the workforce.[6]

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[1] (Bloomberg Businessweek, 26 June 2023).
[2] https://uk.investing.com/rates-bonds/uk-1-year-bond-yield?utm_source=google&utm_medium=cpc&utm_campaign=18451347319&utm_content=624644787284&utm_term=dsa-1546555491574_&GL_Ad_ID=624644787284&GL_Campaign_ID=18451347319&ISP=1&ppu=1&gclid=CjwKCAjwhdWkBhBZEiwA1ibLmBCGwqDpYrrJaHWwFUkUXZb6WoH4a64ibNuVeJmb4By_7UwdDKBoZBoCW8kQAvD_BwE
[3] https://uk.investing.com/rates-bonds/uk-10-year-bond-yield?utm_source=google&utm_medium=cpc&utm_campaign=18451347319&utm_content=624644787284&utm_term=dsa-1546555491574_&GL_Ad_ID=624644787284&GL_Campaign_ID=18451347319&ISP=1&ppu=1&gclid=CjwKCAjwhdWkBhBZEiwA1ibLmJK4bZMydjzQR4hUsL7dYso0N5rcEc_v0LjpMIznYdD5iR-gpaEjfRoCdiwQAvD_BwE
[4] (FX Street).
[5] According to G&F "The Japanese Trade Union Confederation (Rengo) reported in its sixth preliminary survey of 4,475 affiliated unions on 5 June that companies have concluded their annual wage talks with average wage hikes of 3.66%, the largest increase since 1993, including a 2.14% increase in base pay."

The BoJ expressed concern regarding China as "Members agreed that the Chinese economy had picked up, as moves toward normalization of economic activity had been seen. Some members expressed the view that, although pent-up demand was expected to be seen for the time being, mainly for services consumption, the outlook for the Chinese economy was highly uncertain as it entailed both upside and downside risks. The uncertainties were mainly due to structural problems, including the prolonged high youth unemployment rate, debt problems in the real estate sector, and a decrease in foreign investment to China reflecting geopolitical risks. One of these members said that, if private consumption in China was weak, this could also exert downward pressure on Japan's exports through the impact on the "silicon cycle."

The Bank of Japan (BoJ) may tweak its yield curve policy in October'23. USD/JPY was trading at 144.03. Japanese Finance Minister Shunichi Suzuki announced that Japanese authorities would intervene if yen weakening becomes excessive.

Chines exports have declined by 7.5%, while China's central bank has cut its main benchmark lending rates; the one year loan prime rate (LPR) is reduced by 10 bps from 3.65% to 3.55%. The one-year medium term lending facility (MLF) is lowered, and other rates are showing somewhat downward trends (5Y LPR, 1Y LPR, 7-days reverse repo). The stringent Covid lockdown squeezed the growth, weakened sentiment, issues with property sector, etc; posed deeper distresses, that needs a holistic address through further fiscal and monetary supports. Chinese Yuan has been reduced, for issues related to this see ("PBoC eases RMB, triggering a debate in the process" (27 June 2023) Asiatimes).[7] The Goldman Sachs has lowered the GDP forecast from 6% to 5.4% for the whole year.[8]

The USD/CNY remains all-round against CNY, the CNY is worst performing currency though expecting to recover. The Covid restrictions, FPI outflow, weakening economic data, widening USD/CNY yield differential[9] have played roles in downplaying the USD/CNY movement. Further, Fed hawkishness and at the same time monetary easing by the PBoC has tilted the foreign portfolio investors sentiments. The Chinese government has to ensure domestic economic stability by targeted stimulus and appropriate monetary policy measures, addressing property and debt issues, with some stable and credible announcements.

In 2024, possibly we wait for a scenario when Fed achieves its 2% inflation target with recession (one may debate about "soft/medium/hard" landing) and huge unemployment. What are the other disruptions that we must overcome meanwhile? There are other bigger factors, US -China relation, Russia's war situation, attacking dollar-hegemony by Russia, China and other players and side-effects of these, global debt scenario and negotiation issues, oil sector developments, global trade situation, disruptions by AIs especially in fintech space among others.[10]

[6] Also see, "Wages Are Finally Rising In Japan, As Inflation Eats Away At Consumer Gains" (19 June 2023) The Outlook India,
[7] https://asiatimes.com/2023/06/pboc-eases-rmb-triggering-a-debate-in-the-process/
[8] https://www.cnbc.com/2023/06/19/goldman-sachs-cuts-chinas-growth-outlook.html
[9] https://en.macromicro.me/charts/18341/cn-10-year-yield-spread-between-cn-and-us--vs-cnh
[10] The Deutsche Bank report "The Age of Disorder" (8 September 2020) is an exceptional one, that lists as follows (a)Why we are coming to the end of an era (b) A cold war between US and China (c) A make-or-break decade for Europe? (d) Will even higher debt levels herald in an MMT world? (e) Should we 'dis' inflation? (f) Inequality-getting worse before it gets better?