Weekly Update

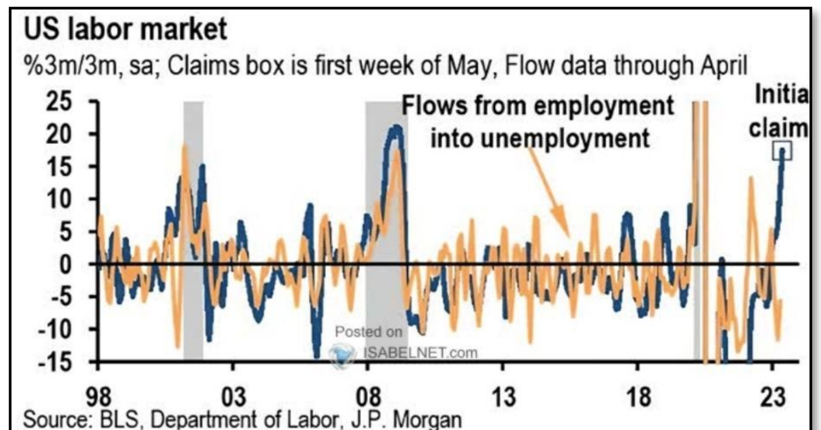
Musings

If you don't like to lose money and it affects your judgment, don't buy things that can go down a great deal.

Walter Schloss

Last week in the markets

Markets remained relatively range-bound last week, with a continuation of the battle between strong big tech and weak cyclical risk-on sectors.



On economic data, the number of Americans filing for unemployment benefits rose by 22 thousand to 264 thousand on the week ending May 6th, the most since October 2021, and well above market expectations of 245 thousand. This is at odds with the strong jobs data that we saw last week and presumably suggests a turning point in the employment situation.

U.S. Debt Ceiling

As we had forecast a few weeks ago, the drama around the U.S. debt ceiling is now reaching its final act.

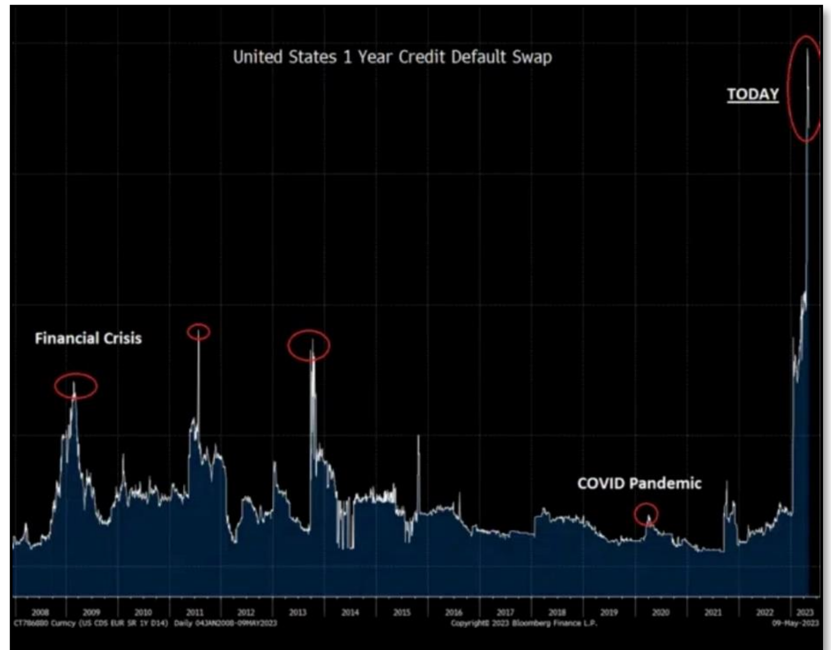
Treasury Secretary Janet L. Yellen has said the agency may only be able to sustain operations until June 1 before running out of money if the government can't borrow more. That specific deadline — known as the "X-date" — depends on tax revenue and spending, which can fluctuate dramatically from week to week.

Broad consensus is that cool heads will eventually prevail, and Congress will do a deal or find some kind of way to avoid a default. However, in the currently polarized environment, it is in the interests of both parties to appear willing to countenance a default for as long as possible, as this maximizes the likelihood of extracting concessions should the other side blink first.

As always, this is a dangerous game.

Prices for US credit default swaps — derivatives that provide a kind of insurance against non-payment of debt — have picked up markedly albeit with only tiny volumes changing hands compared with the vast size of the market.

The current level of the 1-year CDS is orders of magnitude higher than anything this century.



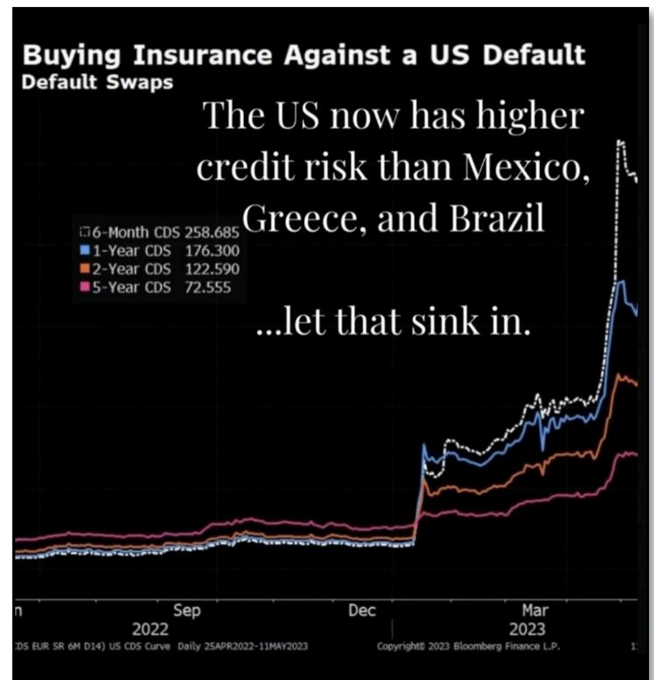
What could go wrong?

What could happen should the unthinkable, aka a default by the U.S. Government, occur?

Since there is no precedent, we can only try to put the pieces of the puzzle together using current knowledge, some references from the past and some expert assessments.

READERS SHOULD NOTE THAT THIS IS NOT A FORECAST, BUT AN ATTEMPT TO UNDERSTAND THE POSSIBILITIES SHOULD THE CONSENSUS NOT PLAY OUT.

The shock of a missed payment would ripple across the financial system — stocks, bonds, mutual funds, derivatives — before spilling out into the broader economy.



U.S. stock markets would crash.

Stocks would likely plummet.

The last time the U.S. government neared default was in 2011, when the X-date was less than a week away during a standoff between President Barack Obama and Republicans in Congress. Major indexes fell by roughly 20 percent.

U.S. borrowing costs would soar.

One estimate by the Brookings Institute, a D.C.-based think tank, found that breaching the debt limit could increase federal borrowing costs by $750 billion over the next decade.

This means the $46 trillion bond market would also tremble, as the values of existing Treasury bonds collapse due to higher yields on new ones.

Problems will spill over into the real economy and tip it into a sudden recession.

Federal workers will not receive salaries. Social Security and Medicare would miss payments. A banking sector already wary of making new loans could tighten up further.

A 2013 report by the Treasury Department found the 2011 debt ceiling standoff caused a $2.4 trillion decline in total household wealth. The broader economy, the White House Council of Economic Advisers said, could contract by as much as 6 percent, like the 2008 Great Recession.

Economic problems would spread worldwide.

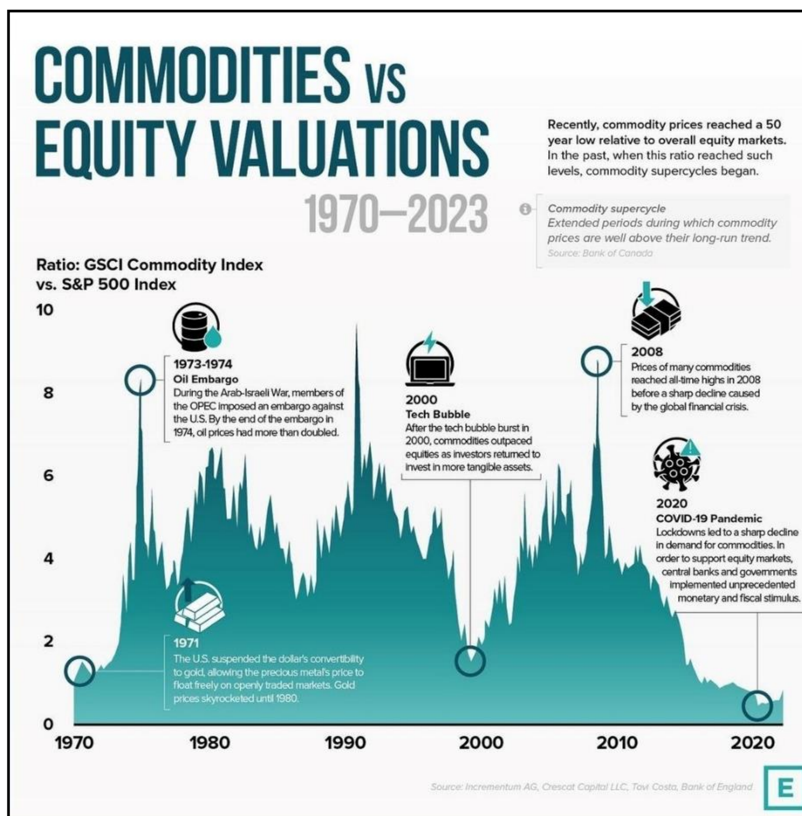
According to the Council on Foreign Relations, more than half of the world's foreign currency reserves are held in U.S. dollars. These will see a drop in value, and appetite for new investment will likely drop. Countries with high external borrowings will face challenges.

If lawmakers only narrowly miss the deadline, perhaps by hours or even a few days, worst-case outcomes will probably be avoided.

Risks rise dramatically should the standoff persist.

Chart of the week

In recent years, commodity prices have reached a 50-year low relative to overall equity markets (S&P 500). Historically, lows in the ratio of commodities to equities have corresponded with the beginning of new commodity super cycles.



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