11 December 2020

More attractive risk premium for US government debt

Economic momentum slows. Weakened employment and consumption. Priority to growth. Unavoidable continuation of deficit monetisation. Rising earnings for equities.

Key points

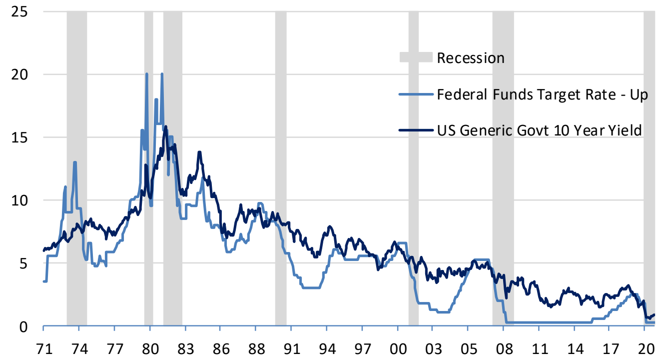
- GDP momentum expected to slow sharply in Q4
- Employment remains fragile and could penalise consumption.
- The four priorities of the new US president
- Rising government deficit and risks of structural depreciation of the US dollar
- Post-Covid debt financing implies further monetisation of new issuance
- The Fed can only stay the course
- The rise in long-term rates increases the relative attractiveness of the bond market
- Exceptional rebound in corporate profits

GDP momentum expected to slow sharply in Q4

Economic results for Q3 were finally better than expected. The +33.1% increase in GDP (annualised) was slightly higher than the consensus estimates, thus compensating for the -31.4% collapse (adjusted data) on an annualised basis in Q2. In the health context of the third quarter in the US, which saw an increase in the number of Covid-19 cases and deaths, this result is rather surprising.

Personal consumption contributed significantly to this strong result, with an increase of +25.27% compared with the -24.01% drop in the previous quarter. However, it has not yet completely erased the drop in Q1 and is down -2.9% year-on-year, similarly to real GDP, down -2.9% yoy.

US recessions, long-term yields, and Fed funds



Sources: Bloomberg, BearBull Global Investments Group Limited

However, despite this particularly encouraging rebound, measured before the American elections, several factors have since then suggested a clear slowdown in economic momentum at the end of 2020.

Annual GDP growth of around +5% is now expected, which is likely to be supported by a continued recovery in household consumption, real estate and inventory rebuilding. However, health risks are still very present and may still have a negative impact on the economy at the end of the year.

The US is not seeing any significant improvement in the situation, and new cases of Covid-19 continue to trend up significantly. While Europe is undergoing a second wave, in the US the situation never really improved. Thanksgiving clearly and unsurprisingly contributed to the deterioration in the health situation in the country, which is now reporting around 220,000 new cases per day.

In the coming weeks the pandemic will therefore slow the recovery, which will lack the stimulus and positive factors to strengthen.

Employment remains fragile and could penalise consumption

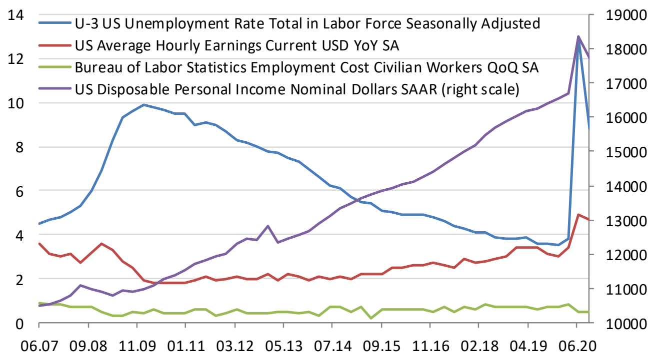
PMI leading indicators are still resolutely optimistic. The manufacturing PMI (56.7 in November) is at its highest level since September 2014, pointing to excellent prospects for the industrial sector, confirmed at least in part by the equally high level of the manufacturing ISM index, still close to its highs for the decade.

On the services side, the PMI was still rising in November (58.4) to reach a zone of solid expected growth, also confirmed by an ISM of 55.9. On the other hand, the prospects for employment have not improved. The trend remains uncertain, and job creation in November (307,000), the lowest since July, was well below expectations (440,000), mainly due to the low level of hiring by large companies.

The deceleration in job creation is actually quite worrying. It also reveals varying regional situations, which will be negatively affected by the continuing pandemic and by the expiry of the CARES Act programme, whose extension does not seem foreseeable before the end of the year.

The temporary PUA and PUEC unemployment insurance programmes will terminate at the end of December, affecting more than 10 million Americans, who will see a net decline in their purchasing power from 2021 onwards.

Unemployment, income, labour costs & wages



Sources: Bloomberg, BearBull Global Investments Group Limited

The strong performance of consumption has been bolstered by this significant government support, particularly during the summer, but the disappearance of these measures will affect households' disposable income and their propensity to consume. These measures will likely be renewed, but pending the forthcoming economic stimulus plan, sentiment is expected to deteriorate further.

Following the recent positive momentum on the labour market, the next few weeks could again see a decline in employment and a further rise in the jobless rate, which is currently below 7%. While workers sidelined during the initial shock are clearly returning to the job market, this return is gradual and still far from universal.

The risks of disappointing growth at the end of the year seem significant in such a context. A new stimulus plan now seems urgent to sustain employment and consumption, but it is unlikely to come into play before the new president takes office in January 2021.

The four priorities of the new US president

Joe Biden's stated priorities seem to focus on four important areas. Managing the pandemic and economic recovery are at the forefront, as are racial equality and climate issues. On the latter, there is no doubt that the new president will make a 180-degree turn on environmental regulations after four years of Trump deregulation. Biden's economic policy will be very "Keynesian".

It will undoubtedly have a clear impact on economic momentum but will also have a direct influence on the indebtedness of the US and on the growth of the budget deficit. The health crisis has already had a major effect on government finances in 2020, and these will be even more affected by the policies pursued by the Democratic president over the next four years.

Economic recovery will be achieved by increasing public spending in several directions: increases in spending on education and health and major investments in infrastructure (USD 1,300 billion) and the energy transition (USD 1,700 billion).

Government spending will increase, and rising government deficits will likely weigh on the dollar. Joe Biden's strategy does not have the same slogan as Donald Trump's ("America First"), but it will pursue the goal of ensuring that the future is "made in all of America" by American workers.

The mobilisation of the American people's talent and innovative capacity must be able to count on the support and power of the federal government. Support will be legislative and financial, but it could still be limited if the Democrats do not manage to win the senatorial seats needed to secure a majority in the Senate in the second round of Senate elections in January.

Fiscal austerity will clearly not be part of the stimulus package. The aim is no longer to slow the progression of debt and provide a solution to the transfer of debt to future generations but rather to safeguard the economic system and avoid social collapse and the impoverishment of part of the population.

The increase in public spending to implement the economic stimulus package, including support for the US population, could reach USD 7 trillion. The actions of President-elect Joe Biden will therefore quickly have a significant initial impact on government spending and on US debt.

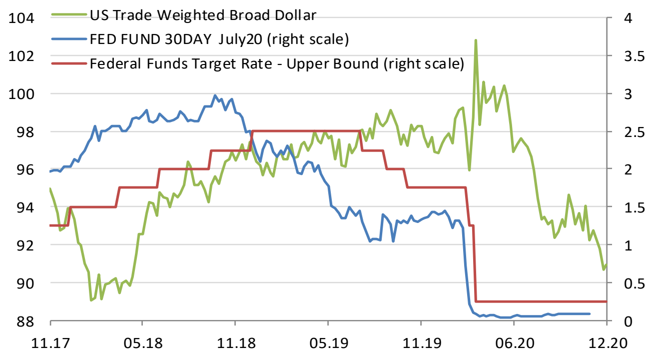
He will first promote growth by expanding government spending before attempting to rebalance the government's budget through higher taxes.

Rising government deficit and risks of structural depreciation of the US dollar

An increase in the US public deficit could have significant consequences in terms of financing the public debt if the Federal Reserve does not continue its policy of debt monetisation.

An unintended consequence of the health crisis was the extraordinary increase in the household savings rate, which jumped from 11% to nearly 20%. The risks of insufficient domestic savings to finance deficits have diminished but remain significant.

Fed funds, key rates & trade-weighted dollar



Sources: Bloomberg, BearBull Global Investments Group Limited

Financing is currently provided by purchases of US government debt by the Fed, European investors and capital inflows from emerging countries.

It is not certain that in a European context characterised by a need to finance Europe's own stimulus plans, Europeans will continue to buy US debt.

Capital flows from emerging countries could also decrease. If the Fed maintains its policy of low key rates, it will have to continue its purchases of Treasury securities and finance future deficits, a potentially risky strategy for the dollar.

The increase in the yield differential with the euro and the franc, which is now 1%, is however favourable to the dollar.

Post-Covid debt financing implies further monetisation of new issuance

Given the scale of the health crisis, the emergency measures taken by the authorities were very quickly accompanied by offsetting financial compensation, which immediately increased budget deficits.

These have been largely financed by the Fed's asset purchases, with the corollary expansion of its balance sheet and the full monetisation of new issuance. In the exceptional context of 2020, the financing of these new liquidity needs was therefore provided primarily by the US central bank. The US Federal Reserve had thus increased the size of its assets by USD 3 trillion.

We estimate that in 2021 the Fed will not be able to adopt any other strategy than the one already implemented and will probably not stop adding new federal debt issues to its balance sheet any time soon. Long-term rates are therefore likely to remain under the influence of the Fed.

The Fed can only stay the course

For several months now, monetary policy has remained relatively stable, the key rates policy has remained unchanged, and asset purchases have been commensurate with financing requirements.

In the absence of any real acceleration in the US economic recovery, this situation should be considered the new normal. While on the short end of the yield curve the situation is unlikely to change for several quarters at least, the situation on longer maturities is a little more uncertain.

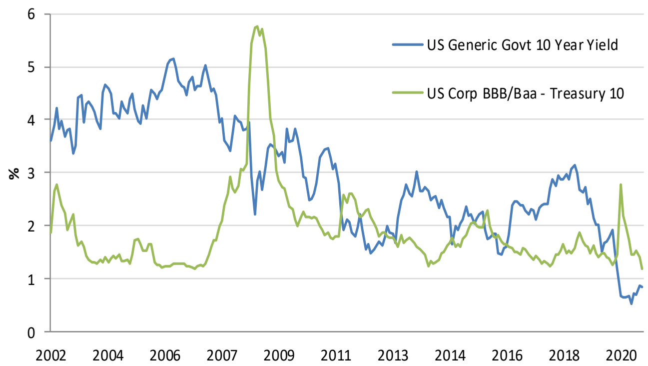
The evolution of long-term rates will essentially depend on the situation regarding financing needs, net new issuance and the Fed's capacity to absorb the latter.

The rise in long-term rates increases the relative attractiveness of the bond market

Over the past six months, US Treasury long-term rates have begun a gradual but significant rise. After reaching a low point of 0.54% in March, ten-year yields almost doubled in one week, rising to 0.985% before suffering further temporary weakness.

In recent months, the more positive economic outlook has again supported an adjustment in yields, which are again close to 1%. It is also important to note that risk premiums have fallen during this period, approaching historic lows and therefore no longer offering sufficient protection in our view.

Yields and risk premium



Sources: Bloomberg, BearBull Global Investments Group Limited

The yield differential with the 10-year German Bund and Swiss government bond, which had fallen to a low of 100 basis points, is now again above 150 bps.

Dollar rates have thus become more attractive to European and Swiss investors, even though yield spreads remain lower than they were at the beginning of the year. This adjustment could strengthen the interest of non-resident and domestic investors. These recent developments show that long-term rates may well tighten, even as the Fed continues its purchases.

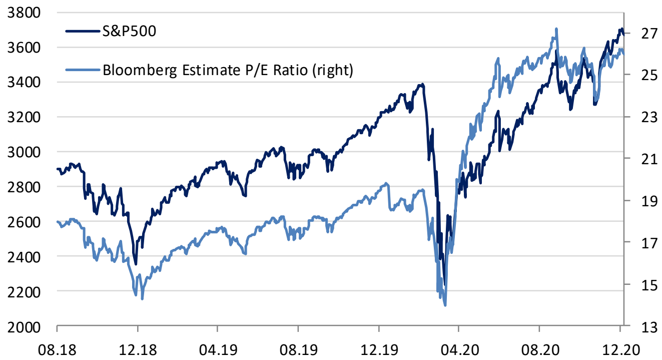
Without the Fed's intervention, it is likely that ten-year Treasury yields would already be close to 2% given the solid economic recovery expected in 2021, unlimited money creation and a possible rise in expected inflation. The November CPI index was only 0.2%, for a yoy inflation rate of +1.2%. The pressure on prices is obviously modest, but expectations are already at +2.8% for the next twelve months.

Exceptional rebound in corporate profits

After two quarters of declining profits of -10.3% and -12%, respectively, the latest GDP figures suggest that US companies saw their profits jump by +27.1% (annualised). The end of the drastic lockdown measures and the broader reopening of economic activity in the US has indeed allowed American companies to regain positive economic momentum and return to profits.

The yoy increase in corporate profits is approaching 500 billion. The resurgence of domestic demand and the cost reductions resulting from the massive layoffs in the first two quarters of the year have supported this earnings recovery. Gross domestic income also jumped by +25% after a -32.6% drop in the previous quarter. Valuation levels remain high, however, at 21x expected earnings for 2021, projected to rise.

S&P 500 & P/E



Sources: Bloomberg, BearBull Global Investments Group Limited

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