

Weekly Market View

Where are the risks?

→ Markets are still under-pricing risk. The US S&P500 volatility index had fallen last week to a one-and-a-half-year-low, just above 15, before rebounding to 20.

→ Three events and datapoints over the past week have brought risks back to the fore: (i) the failure of First Republic Bank; (ii) the Fed's pushback against market expectations of rate cuts from as early as July; and (iii) US Treasury Secretary Yellen's warning that the government could run out of cash as soon as 1 June.

→ In this report, we focus on the US debt ceiling risk and highlight the various scenarios that could unfold over the coming weeks and their implications for investors.

→ Overall, the backdrop calls for defensive positioning in markets at this time. We highlight some assets which have delivered strong returns during previous US debt ceiling battles.



How should investors position for US technical default risk?

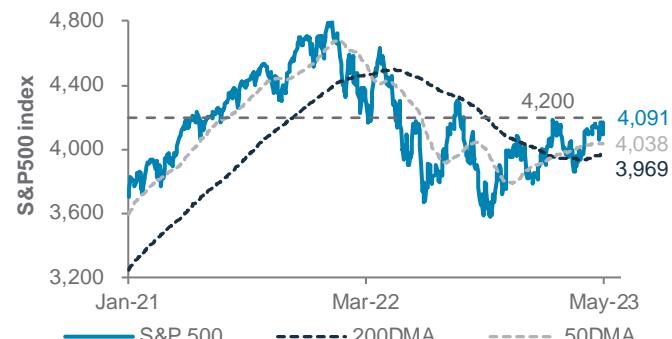
Do you expect the year-to-date outperformance of US equities over Chinese equities to reverse soon?

How have macro data and monetary policy evolved over the past week?

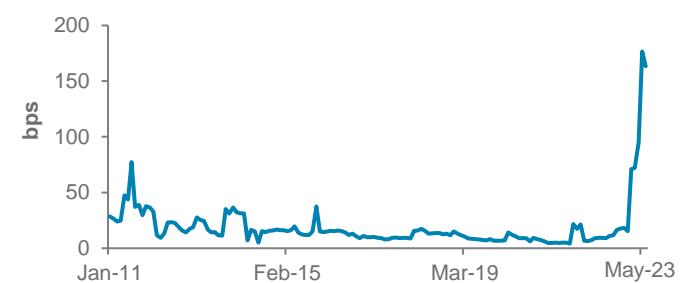
Charts of the week: Significant hurdles

The S&P500 index has failed to break above the 4,200-resistance since August; a US technical default is a near-term risk

S&P500 index, with 50- and 200-day moving averages



US one-year Credit Default Swap rates*



Source: Bloomberg, Standard Chartered; *used to hedge against debt defaults – higher level generally implies greater worry about a default

Editorial

Where are the risks?

Markets are still under-pricing risk. The US S&P500 volatility index (VIX) had fallen last week to a one-and-a-half-year-low, just above 15, before rebounding to 20. **Three events/datapoints over the past week have brought risks back to the fore:**

First, the failure of First Republic Bank, the third large US regional lender to go bust in three months, reminded investors of the damage done to smaller banks from the surge in interest rates in the past year. US small lenders, particularly vulnerable from their exposure to commercial real estate, are likely to curb lending further, likely causing a **credit-crunch** this year. The Fed's quarterly Senior Loan Officers' Survey on 8 May is likely to show further tightening of bank lending standards, adding to the ongoing cyclical tightening, slowing growth further.

Second, the Fed's pushback against expectations of rate cuts this year while the job market remains tight, and inflation elevated. Whether the Fed can cut rates early as growth slows matters significantly for investors. If the **Fed is hamstrung** by inflation remaining well above target and still-rising wage pressures, it is unlikely to cut rates as early as the market is expecting (July). This week's data showed two of the broadest and most reliable measures of US wage costs, the Employment Cost Index and Unit Labour Cost, both accelerated in Q1 (to 1.2% q/q and 6.3% q/q) amid a decline in productivity.

Finally, US Treasury Secretary Yellen's warning that the government could exhaust all emergency measures and run out of cash as early as 1 June. We believe the risk of a temporary debt default is non-negligible, even if it means delaying repayment on some short-term bills by a few days, while the parties negotiate. US politics has become more polarised over the past decade, making negotiations harder vs. past debt ceiling fights. A small caucus among the Republicans in the Congress has an outsized hold on the party. They are insisting on sharp spending cuts as a price for approving a deal.

The bigger concern would be any sharp spending cuts as part of emergency measures adopted by the government to avoid a default or as part of a long-term deal with Republicans. It is still likely the two sides will cobble together a last-minute deal to lift the debt ceiling for now, only for the issue to come back in the 2024 election year (see page 4 for more scenarios).

Then there is the **effect on markets** if a deal is struck. The **Treasury will likely need to boost borrowing** to replenish its reserves once the debt ceiling is raised, **draining market liquidity**. In this event, the Fed is likely to halt its quantitative tightening programme earlier than planned, providing relief to markets, though this may not be enough to trigger rate cuts.

Investment implications: The above backdrop calls for defensive positioning in markets at least until the Fed capitulates and cuts interest rates. Hence, we reiterate our **defensive asset allocation**, Overweight Developed Market government bonds and Gold, and a regional preference for Asia ex-Japan. In Asia, Asia USD bonds and China stocks are preferred, given China's positive data surprises and earnings, ongoing consumer recovery, and attractive valuation.

History of US debt ceiling battles (2011 and 2013) suggest the following positioning for the near term: **Underweight stocks and 1-3-month bills, Overweight longer-term government bonds and gold, hedge through safe-haven currencies (CHF, JPY).** US stocks are particularly vulnerable following the rally since March. **The S&P500 index has failed to break above 4,200 resistance** since August last year. However, some positioning indicators suggest investors are defensively positioned, which could limit significant downside.

At the end of March, we **downgraded US financials** to Underweight; we see further **scope to reduce exposure** to this sector, given rising risk of recession, leading to loan losses.

— Rajat Bhattacharya

The weekly macro balance sheet

Our weekly net assessment: On balance, we see the past week's data and policy as negative for risk assets in the near term

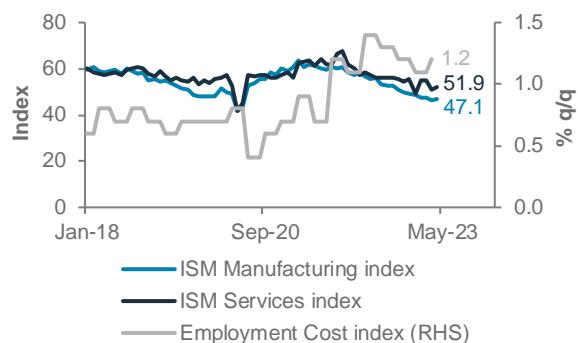
(+ factors: Fed's hint of a rate pause, recovering US manufacturing and strong Euro area job market

(-) factors: Elevated US inflation and wage pressures, US debt ceiling risk; weaker Euro area GDP; continued ECB policy tightening

	Positive for risk assets	Negative for risk assets
Macro data	<ul style="list-style-type: none"> US manufacturing sector confidence (ISM) rose more than expected to 47.1; new orders PMI rose to 45.7 US service sector confidence (ISM) rose more than expected to 51.9, with the new orders component jumping to 56.1 US private sector (ADP) employment rose more than expected by 296,000 Euro area unemployment rate dropped unexpectedly to 6.5% 	<ul style="list-style-type: none"> US PCE deflator rose more than expected to 4.2% y/y; Employment Cost Index (1.2% q/q) and Unit Labour cost accelerated in Q1 US job openings dropped to the lowest since April 2021 Euro area Q1 GDP slowed more than expected (1.3%) ECB's Lending Survey showed banks curbed credit more than expected China manufacturing PMI dropped more than expected to 49.2 in April
	Our assessment: Negative – Elevated US inflation, slowing US job openings, weaker-than-expected Euro area growth outlook, China's contracting manufacturing sector	
Policy developments	<ul style="list-style-type: none"> The Fed signalled a likely pause after raising rates by 25bps as expected to 5.25%, but pushed back against market expectations of rate cuts this year 	<ul style="list-style-type: none"> The ECB signalled more rate rises after hiking the deposit rate 25bps to 3.25% The RBA unexpectedly raised cash rate by 25bps to 3.85% and signalled further tightening
	Our assessment: Neutral – Further ECB and RBA tightening vs. Fed hint of a rate pause	
Other developments	<ul style="list-style-type: none"> US Foreign Secretary Blinken hinted at a China trip this year to restart regular dialogue 	<ul style="list-style-type: none"> First Republic became the third large US regional lender to fail in 3 months President Biden called for a Congressional meeting on 9 May to address the US debt ceiling issue after Treasury Secretary Yellen warned the US could run out of cash by 1 June
	Our assessment: Negative – US debt default risk	

US service sector business confidence remains robust and wage growth accelerated in Q1; this explains the Fed's pushback against rate cut bets

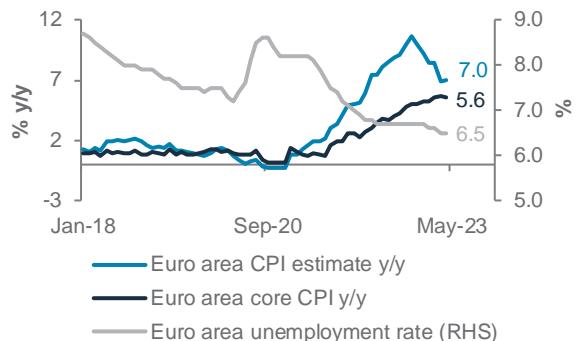
ISM Manufacturing and services PMI; Employment Cost Index



Source: Bloomberg; Standard Chartered

The ECB is likely to hike rates further as long as the Euro area job market remains tight and inflation elevated

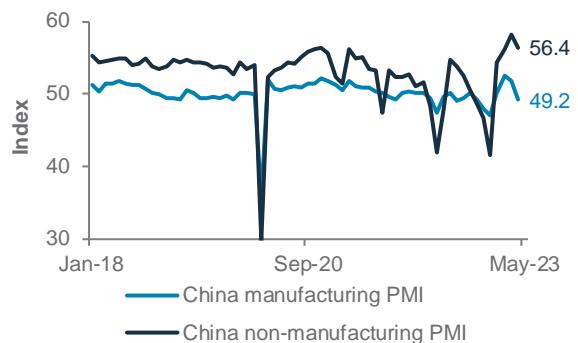
Euro area inflation and unemployment rate



Source: Bloomberg, Standard Chartered

China's service sector confidence slowed, but remains at an elevated level; manufacturing sector confidence slump reflected contraction in activity

China manufacturing and non-manufacturing PMIs



Source: Bloomberg, Standard Chartered

Top client questions

Q How should investors position for US technical default risk?

Concerns about US debt ceiling negotiations and the possibility of a US technical default have come into market focus over the past two weeks. The rapid rise in concerns has been driven by two factors:

1. Weaker-than-expected tax collection in the April tax season means that initial estimates of the so called "X-date" – when the US Treasury can no longer pay its bills – has been brought forward from the earlier estimates of August 2023
2. US Treasury Secretary Yellen warned earlier this week that the X-date could be reached as early as 1 June, further heightening the concerns.

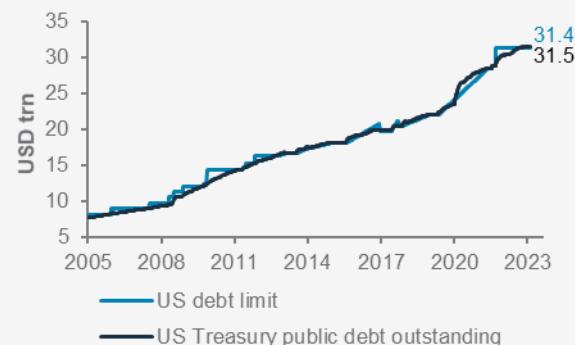
The risk of a technical US default has risen recently based on Credit Default Swap (CDS) market where investors can buy protection against a potential default. 1-year US CDS spreads are now higher than 2011 and 2013 debt ceiling deadlocks. However, once we factor in the CDS market technicalities, the market-implied probability of a US default is still lower than the peak seen in the 2011 and 2013. 1-year US CDS spreads currently imply approximately 4% probability of default, compared to over 6% probability indicated in July 2011.

Our base case remains that the US should avoid a technical default, though it is quite likely that the negotiations will go down to the wire before an agreement is reached. However, it is important for investors to understand the potential scenarios that could play out during the course of this process:

1. **Debt ceiling is raised before the X-date:** In an ideal scenario, Democrats and Republicans can reach an agreement on raising the debt limit in a timely manner, ahead of an X-date. However, given the increase in political polarisation in the US over the past decade, we would assign a low probability to this outcome. As an aside, we would also note the calculation of the X-date itself is an estimate involving several assumptions. The exact X-date can be difficult to predict precisely.
2. **No agreement till X-date, but US avoids default:** No agreement to raise debt ceiling by the X-date does not automatically imply a US default. Looking at the contingency plans formed in 2011, the US Treasury could prioritise debt and coupon payments and cut back/delay spending on healthcare, social security and payment to vendors, among other things, to avoid a default until an agreement is eventually reached. This would dent US growth and increase the risk of a US recession, especially if a final agreement involves long-term spending cuts.
3. **US defaults on government debt:** This is the least likely, but the most damaging outcome, in our opinion. However, the US Treasury does have a few tools at its disposal, such as rolling over debt by one day to delay this outcome.

US debt ceiling has been raised 78 times since 1960. The US hit its current debt ceiling on 19 Jan

US Treasury total public debt outstanding and US debt limit



Source: Bloomberg, Standard Chartered

Top client questions (cont'd)

From an investor perspective, the last two scenarios mentioned above are likely to be negative for risk assets. Any agreement to raise the US debt ceiling is also likely to come with some spending cuts, which would act as a drag on the economy and be negative for US equities. However, investors have a few options to add a defensive tilt to their portfolios:

- High-quality bonds:** Looking at the past debt ceiling showdowns, medium to long-term US government bond yields declined (prices rose). Increased risk-off sentiment should drive demand for safe-haven assets such as government bonds, though a key assumption here is that the US ultimately manages to avoid a technical default.
- Safe-haven currencies:** Increased safe haven demand, deteriorating US growth prospects and decline in US government bond yields should lead to a decline in the USD index (DXY). Safe-haven currencies such as the JPY and CHF are likely to be the key beneficiaries. We see a high likelihood of EUR strength as well, given the region's stronger economic prospects.
- Gold:** Although gold prices have rallied significantly over the past few months, a spike in debt default concerns could cause gold to test USD 2,200 /oz. We would look to add exposure to gold on dips below USD 2000/oz.

— **Abhilash Narayan, Senior Investment Strategist**

Q Do you expect the YTD outperformance of US equities over Chinese equities to reverse soon?

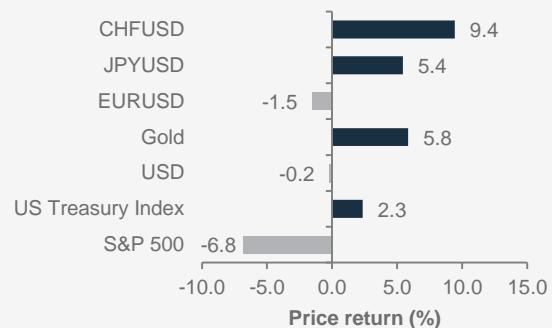
We believe US equities have already priced in much of the good news from earnings. Q1 earnings have been beating expectations, resulting in Q1 earnings expectations being revised up to -1.4%, from -5.1% at the start of April. However, on the macro front, the Fed did not agree with market pricing of rate cuts in H2 2023 at its latest FOMC meeting. Thus, US equities are likely to enter a stage of "good news is good" and "bad news is bad", where economic data is likely to dictate further direction. Potential US credit tightening, due to stress in regional banks, as well as the potential impact from the US government hitting the "debt ceiling", especially if it causes a short-term risk-off or creates fiscal contraction in the long term, are risks. All these are likely to prompt rotation into Chinese equities. In contrast to the US, Chinese economic data has been surprising positively (unlike the US where positive surprises are fading) and Chinese company earnings have been healthy.

The S&P 500 index hit a triple-top this year, just below 4,200, which we believe is a major level of resistance. Technically, it could correct to 3,951 and to 3,856 support levels. On the other hand, the Hang Seng Index has seen strong support in the 19,000 to 19,500 zone, increasing potential to challenge the next resistance level at 20,865.

— **Daniel Lam, Head, Equity Strategy**

Classic safe-haven assets such as US government bonds, CHF and gold rose in the lead-up to the 2011 US debt ceiling showdown

Performance from 31 May 2011 to 2 August 2011



Source: Bloomberg, Standard Chartered

The Hang Seng Index is likely to find strong support in the 19,000 to 19,500 area

Hang Seng Index



Source: Bloomberg, Standard Chartered

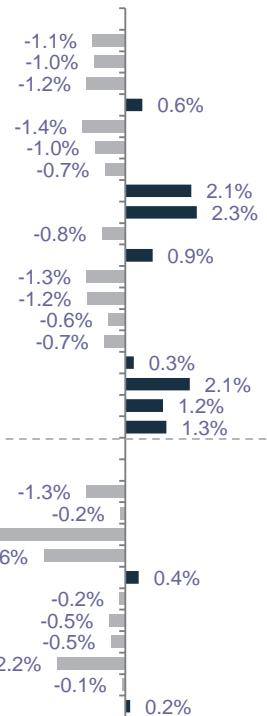
Market performance summary *

2023 YTD

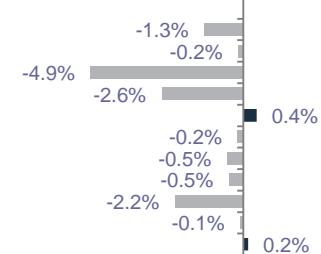
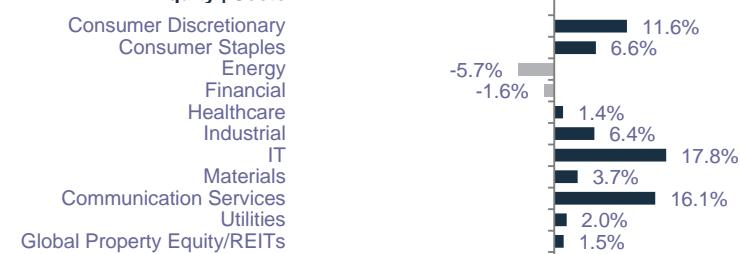
Equity | Country & Region



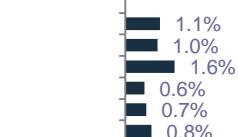
1 Week



Equity | Sector



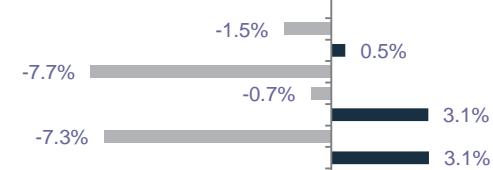
Bonds | Sovereign



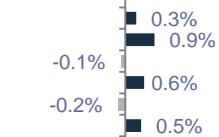
Bonds | Credit



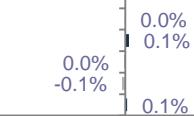
Commodity



FX (against USD)



Alternatives



Sources: MSCI, JP Morgan, Barclays Capital, Citigroup, Dow Jones, HFRX, FTSE, Bloomberg, Standard Chartered

*Performance in USD terms unless otherwise stated, 2023 YTD performance from 31 December 2022 to 04 May 2023; 1-week period: 27 April 2023 to 04 May 2023

Our 12-month asset class views at a glance

Asset class	
Equities	▼
Euro area	◆
US	◆
UK	▼
Asia ex-Japan	▲
Japan	◆
Other EM	◆
Bonds (Credit)	◆
Asia USD	▲
Corp DM HY	▼
Govt EM USD	◆
Corp DM IG	◆
Bonds (Govt)	▲
Govt EM Local	◆
Govt DM IG	▲
Preferred Sectors	
US Healthcare	▲
US Staples	▲
US Utilities	▲
Europe Utilities	▲
China Discretionary	▲
China Comm. Services	▲
China Technology	▲
China Industrials	▲
Alternatives	◆
Gold	▲

Source: Standard Chartered Global Investment Committee

Legend: ▲ Most preferred | ▼ Less preferred | ◆ Core holding

Next support for the US S&P500 index is at 4,121

Technical indicators for key markets as of 04 May close

Index	Spot	1st support	1st resistance
S&P 500	4,061	4,025	4,133
STOXX 50	4,287	4,263	4,335
FTSE 100	7,703	7,647	7,815
Nikkei 225	29,158	28,957	29,258
Shanghai Comp	3,350	3,332	3,360
Hang Seng	19,949	19,782	20,032
MSCI Asia ex-Japan	632	628	634
MSCI EM	976	972	979
WTI (Spot)	72.5	70.1	77.3
Gold	2,050	2,005	2,073
UST 10y Yield	3.38	3.29	3.52

Source: Bloomberg, Standard Chartered

Note: These short-term technical levels are based on models and may differ from a more qualitative analysis provided in other pages

Economic and market calendar

	Event	Next week	Period	Expected	Prior
MON	GE	Industrial Production	Mar	–	0.6%
		WDA y/y			
	EC	Sentix Investor Confidence	May	–	-8.7
TUE	US	Fed Senior Loan Officers' Survey	Apr	–	–
	US	NFIB Small Business Optimism	Apr	89.7	90.1
	CH	Exports y/y	Apr	8.5%	14.8%
	CH	Money Supply M2 y/y	Apr	12.6%	12.7%
WED	CH	New Yuan Loans CNY	Apr	1350.0b	3890.0b
	US	CPI Ex Food and Energy y/y	Apr	5.4%	5.6%
	CH	CPI y/y	Apr	0.3%	0.7%
	CH	PPI y/y	Apr	-3.2%	-2.5%
THU	UK	Bank of England Bank Rate	11-May	4.5%	4.3%
	US	PPI Ex Food and Energy y/y	Apr	3.3%	3.4%
	UK	GDP q/q	1Q P	–	0.1%
	US	U. of Mich. Sentiment	May P	62.6	63.5

Source: Bloomberg, Standard Chartered

Prior data are for the preceding period unless otherwise indicated. Data are % change on previous period unless otherwise indicated
P - preliminary data, F - final data, sa - seasonally adjusted, y/y - year-on-year, m/m - month-on-month

Investor diversity remains healthy across asset classes

Our proprietary market diversity indicators as of 03 May

Level 1	Diversity	1-month trend	Fractal dimension
Global Bonds	●	↓	1.89
Global Equities	●	↓	1.82
Gold	●	→	1.54
Equity			
MSCI US	●	↑	1.99
MSCI Europe	●	↑	1.59
MSCI AC AxJ	○	↓	1.43
Fixed Income			
DM Corp Bond	●	↑	1.99
DM High Yield	●	→	1.89
EM USD	●	↓	1.77
EM Local	●	↑	1.59
Asia USD	●	↑	2.26
Commodities			
WTI Crude Oil	●	→	1.58

Source: Bloomberg, Standard Chartered; **Fractal dimensions below 1.25 indicate extremely low market diversity/high risk of a reversal**

Legend: ● High | ○ Low to mid | ○ Critically low

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