MARKET BULLETIN

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Armistice or peace?

Politicians in America are increasingly struggling to come to agreements on Capitol Hill. Global investors, however, do seem to agree that the biggest risk to the world's largest economy in 2013 is no longer America's investment bankers, who were the pariahs of 2007, but its elected representatives. After three weeks of political drama in Washington, the US Congress agreed an armistice, even if they were unable to declare peace. With pressure mounting from US business and overseas creditors such as China, Democrats and Republicans last Wednesday found a way to end the government shutdown, extend the debt ceiling and start negotiations on a new budget.

The consensus among fund managers and investors is that the alternative outcome would have been self-defeating: no one believed Congress would undermine the status of the world's reserve currency with a politically driven default. As expected by markets, the US pulled back from the brink at the last minute. The US government has been funded until mid-January and the debt ceiling will not be hit again until February. Budget renegotiations will begin immediately to find a longer-term settlement by mid-December. Fund manager PIMCO's chief executive Mohamed El-Erian said: "Instead of decisively emerging from a damaging phase of political dysfunction, Congress appears still stuck in what game theorists would call a repeated game with suboptimal outcomes."

El-Erian's critique of last week's deal chimes with the widely held view that Congress has "kicked the can down the road", and global markets will have to brace themselves for the possibility of a repeat performance of the high drama in early 2014. But the political fallout that Republicans are undergoing in the aftermath of the 16-day shutdown could dampen their combative zeal. The need for credibility may be stimulus enough for reason to again take a grip on Capitol Hill. The hope in global markets, as fund manager Schroders' chief economist Keith Wade observed, is that Sir Winston Churchill's maxim will hold again: "Americans will always do the right thing, but only after having exhausted all the alternatives."

But the underlying problem that divides many Democrats and Republicans has not gone away. The political polarisation in Washington reflects an uncomfortable fact that is likely to split opinion in America until, at the very least, its economic recovery is in full swing – its wealth has been diminished in the aftermath of the collapse of Lehman Brothers and the global financial crisis. The US Federal Reserve's quantitative easing (QE) programme has upheld asset values and allowed the economy time to recover. But in straitened times public spending in the US, as on this side of the Atlantic, will continue to be the major focus of political debate and conflict into 2014 and beyond.

In the meantime, global markets reacted positively to the armistice in Washington. US equities had held up well during the political rollercoaster ride to 17 October, when the S&P 500 index gained 1.4% in anticipation of the deal that evening and reached an all-time high of 1,733 points. This was followed by a 0.7% rise on the Thursday with the index closing the week at a new record high of 1,744 points. The relief rally left the US index 2.4% stronger at the end of the five-day period – which was also its best performance for three months. Other factors that lifted the US index included strong corporate earnings, with good performances from utilities and consumer staples, and speculation that the Fed would have to maintain QE measures longer than expected and into 2014 due to the Congress stand-off.

Equity markets outside the US also responded positively to the developments in Washington and the expectation that the $85 billion-a-month bond-purchase scheme will remain unchanged until Fed vice chair

Janet Yellen takes over from Ben Bernanke at the beginning of 2014 to head the US central bank. The FTSEurofirst 300 index rose 0.8% to a five-year high on Friday, giving it a weekly gain of 2.1% to 1,278 points. European luxury goods stocks also took a lift from improved Chinese growth of 7.8% in the third quarter from a year earlier, up from 7.5% in the second quarter.

In London, the FTSE 100 closed the week up 2.1% to 6,623 points, with international mining stocks lifted by the encouraging Chinese economic growth data. The Nikkei 225 Stock Average index in Tokyo dipped 0.2% on Friday, which ended seven consecutive days of trading day rises and its longest streak of gains for seven months. The Japanese index closed the week at 14,562 points. Japanese markets viewed the US Congress's dance with default as a warning shot that underlined how vulnerable its economic revival plans could be to any adverse developments in the political fighting on Capitol Hill.

Pacific perspective

Expectations that the Fed will maintain its QE programme into 2014 left the US ten-year government bond yield at a two-month low of 2.58%, which was ten basis points lower over the week. The US dollar also dipped to an eight-month low as the political tensions in Washington cast some temporary doubts over its status as the global reserve currency of choice.

Despite the relief in global markets that America's elected representatives managed a last-minute deal, the showdown has rattled major Treasury holders, particularly China and Japan – and is the third round of fiscal wrangling they have had to witness from the other side of the Pacific since 2011. With last week's legislation looking like it will only postpone rather than solve the fiscal crisis, further deadlock could store up greater potential difficulties for international holders of bonds. Foreign investors account for $5.59 trillion of the $12 trillion in outstanding American government debt.

Any gradual retreat by sovereign wealth funds, reserve currency managers and central banks in the coming years from US Treasuries would probably come at a time when the Fed starts pulling back from its bond-buying programme that has kept Treasury yields low. Foreign investors could start to adopt a harder line on Treasuries. However, China and Japan, with their combined holdings of around $2.4 trillion, are unlikely to want to sell for fear of destabilising the market and increasing any potential losses.

Counting the cost

Fears of the US missing a payment last week on its debt also spurred the largest move out of money market funds in more than two years as investors pulled $70 billion from short-term capital markets. Bank of America Merrill Lynch (BofA) data shows that withdrawals in short-term securities, including US Treasuries and commercial bonds, in the five-day period to 16 October were at the same level reached in the previous debt limit crisis in August 2011.

BofA data also showed that investors moved $17 billion into stocks over the period, with nearly $10.6 billion going into the US market, assisting the S&P 500's record levels last week. Investors increased their allocation to eurozone equities to the highest in more than six years this month as they saw a stronger outlook for the region's economy. Meanwhile, global bond funds saw outflows of $3 billion. The US government shutdown also put a brake on the issue of corporate debt. US investment grade bond sales have amounted to $30.1 billion so far this month compared to a record $149 billion in September, according to Dealogic. But global corporate borrowers are starting to return to debt markets after the shutdown.

However, alongside further fiscal uncertainty over the coming months, the 16-day government shutdown is likely to come at a cost to the US economy. BlackRock chief executive Larry Fink last week warned that the debt ceiling crisis in Washington would have a negative impact on US corporate earnings and equities. "Whatever influence, if any, I have in Washington, I will try to make sure they understand this is extremely damaging to the economy," Fink told Bloomberg. "I think the fourth-quarter results will come in negative. This is as a result of the behaviour of Washington."

Standard & Poor's analysts estimated that the shutdown would cost the US economy around $24 billion, or about 0.6% off annualised GDP for the fourth quarter. Fund manager Majedie estimated the cost in the region of 0.5% off growth in the final quarter of 2013. "This episode contributes to our sense that leading indicators may soon start to fade, set against valuations and expectations that are increasingly elevated," added James de Uphaugh of Majedie.

The main impact of the delay for markets is that the Fed will need longer to assess the state of the economy when it considers whether or not to begin its tapering of the QE programme. "Economic data has been delayed, distorted and depressed by the shutdown and it will not be until early next year that we can get a clear picture of the fourth quarter," observed Wade of Schroders. "We would not expect bond purchase tapering to begin until March next year with the possibility it will be delayed until June."

Fund manager Artemis also predicted that there could now be a delay to the gradual unwinding of QE until March, and that the suspension of official statistics during the partial shutdown was "bullish for stocks" and reduced the likelihood of the Fed tapering this year. Fund manager EdgePoint's president Tye Bousada added that previous debt clashes in Washington had resulted over the long term in higher returns. "As long-term investors in businesses, we can be selective and view the volatility these events create as opportunities," Bousada said. "We don't believe the recent events in the US should be reason for concern for long-term investors."

The long haul

A long-term investment strategy is central to our approach to wealth creation – and it is the very perspective that the Prince of Wales last week called on the City of London and the wider pensions and insurance industry to adopt for the benefit of individual investors as well as collective society. The champion of long-term investment Warren Buffett, while unimpressed with the antics of Capitol Hill, remains upbeat about global equities – and believes investors have nothing to fear about a stock market bubble. And in a week in which investment bank Morgan Stanley reported a 50% jump in third-quarter revenues, the octogenarian investor Buffett is positive for Wall Street banks too – those one-time pariahs of the 2007–2008 financial crisis. "They are in the best shape I can remember," Buffett concluded.

BlackRock, EdgePoint, Majedie, PIMCO and Schroders are fund managers for St. James's Place.

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