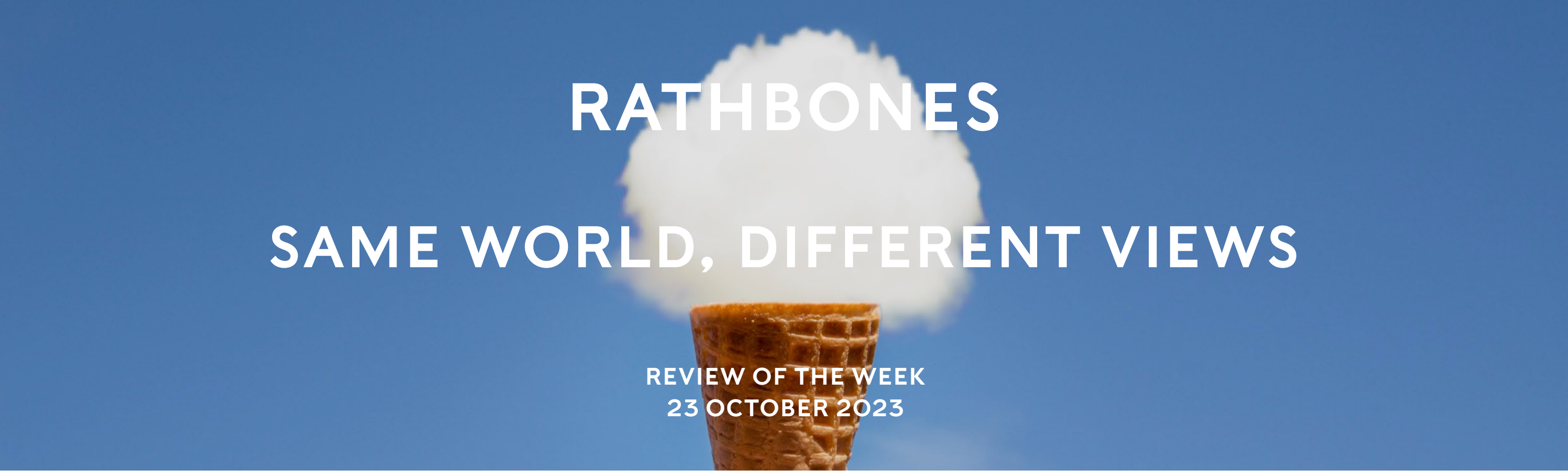

RATHBONES

SAME WORLD, DIFFERENT VIEWS

REVIEW OF THE WEEK
23 OCTOBER 2023

THE US HOUSE OF REPRESENTATIVES IS STRUGGLING TO AGREE ON A NEW SPEAKER AS THE US TICKS TOWARD A SHUTDOWN OF GOVERNMENT. STRANGELY, STOCKS SEEM MORE PERTURBED BY STRONG ECONOMIC GROWTH.

"Chaos doesn't scare me." Strange words from a conservative. Avoiding mayhem by sticking to the devil you know is the string that runs through the conservative tradition. But we're in a strange time.

Chaos-lover Matt Gaetz is a Florida Congressman whose motion to dismiss fellow Republican and erstwhile Speaker of the House of Representatives Kevin McCarthy set the American legislature adrift for the past 20 days with no end in sight. It was the first time in the Republic's 247-year history that the House has dismissed its Speaker. Gaetz and a group of 20-odd far-right Republicans voted against McCarthy – as did the full Democratic caucus, naturally – putting his boss out of a job and leaving the country scratching its head about what happens next.

On paper the Republicans have a nine-seat majority, so in theory it should be easy for them to decide on a replacement and outvote the Democrats. Yet in reality there is no single Republican party and therefore no consensus on who should take the job. The latest front-runner, Jim Jordan, called it off after it became clear that, the more he negotiated with his colleagues, the further he was getting from the simple majority he sought.

With no Speaker, there can be no House business. That means no ability to agree further support for allies abroad, such as Ukraine and Israel, or – more pressingly – to ensure the federal government can run. On 17 November a slap-dash, kick-the-can agreement to keep the government operational will end. If there's no Speaker by that date, there can be no last-minute decision to ensure the nation can function as normal.

We've been here before, of course. We've had 10 government shutdowns of more than five days in the last 50 years, most recently in 2013 (16 days) and in 2018/19 (35 days), although this one was only a partial shutdown as financial acts permitting 75% of government discretionary spending had already been passed. No such bills have been passed this time round, so this would be a full government shutdown. This could affect the US economy through four main channels: (i) the loss of government worker output, (ii) delays in government spending, (iii)government employees spending less than they otherwise would (most government employees do not get paid when they are furloughed but receive backpay when the government reopens), and (iv) higher borrowing costs as investors demand a higher 'risk premium' for investing in the US.

The longer a shutdown continues, the greater the likelihood of lasting economic damage from all channels, but our previous analysis has never found a lasting impact on financial markets. This may change if a full shutdown lasts for more than three weeks or so – not what we expect, but not an insignificant risk.

The US has stepped up its sales of Treasury bonds as its need for cash rises with higher interest rates and the splurge of spending that has helped propel its economy out of the pandemic downturn. The number of people turning up to buy US government bonds at the regular auctions hasn't quite kept pace with the increase in bonds being sold. That means the bond prices are slipping lower, increasing their yield. There's been no real sign of panic about the political shenanigans, however. For now, it seems that continued strength in the US economy is persuading bondholders that the central bank will keep interest rates higher for longer, which demands a readjustment on the yield investors expect for holding US Treasuries for several years or more. But they are still assuming the House will get its act together – and soon. When a solution for the Speaker logjam does come it will be sudden. Whether it will be the right side of 17 November is anyone's guess.

We have often noted that US consumer confidence surveys don't seem to reflect reality – or the economic atmosphere, at least. The long-running University of Michigan Consumer Confidence Survey has been weirdly depressed for the past three years, despite strong growth in GDP, spending and wages.

Yet split out the survey's answers by party affiliation and you get some idea of what's going on. During Donald Trump's five years as President,Republicans were outlandishly excited about their economic situation and the future. Democratic voters saw a completely different country: they were roughly 40%more miserable. Since President Joe Biden took office, that has reversed: Democrats are generally happy (albeit not as rapturous as

Republicans under Trump), but Republicans are persistently catatonic. The increased politicisation of consumer confidence has compromised this previously reliable leading indicator.

More broadly, many economic indicators are produced by the government. They are also a casualty of a government shutdown. In normal times, a little less statistical noise is no bad thing. But a prolonged shutdown at a time when the Federal Reserve is, by its own admission, more "data-dependent" than usual, also increases the risk of a monetary-policy mistake (if one hasn't been made already!).

Economy Up, Stocks Down

It was a tough week for stocks. All major markets fell between 2% and 3%. It was a tough six months for stocks, in the round. Most markets are down over that time (in sterling terms).

But scanning across the performance of countries, industries and individual companies, a certain pattern emerges. The closer you get to China – or the more business is done with China – the worse the performance. China's economy has looked ropey for a year or more, and continues to get worse. Country Garden, a huge and struggling Chinese property developer missed a final deadline for making a £15.4 million interest payment on its bonds, putting it in imminent risk of default. Putting that in context, Country Garden has $200 billion in debts, $11bn of which are dollar-denominated bonds to overseas investors.

As China continues to struggle, the US is still booming. American third-quarter GDP growth will be released on Thursday and it's expected to soar to an annualised 4.2% from 2.1% in the previous quarter. A broad-based uptick in virtually every type of activity is behind the punchy acceleration. US Federal Reserve (Fed) Chair Jay Powell has said that he doesn't expect the momentum to last, so investors aren't factoring in further hikes in rates. But they have tempered forecasts of rate cuts in the foreseeable future.

We agree. There're a whole lot of factors that should restrain the US in coming quarters. Most prominent are higher rates, more expensive petrol and costlier essentials. There's also a big generational divide. If you're an older person with swathes of savings, a house with a mortgage taken out in the good old sub-4% days, the increased cost of everything may rankle. Yet it may not rankle enough to stop you living your best life today, to use the kids' phrase. The same can't be said for younger people who are paying huge rents. Or looking to buy homes which are more expensive than they have ever been at rates that haven't been seen since 2001. Another squeeze has begun in the past couple of months: a hiatus on repayment of student debt has ended. Many Americans will start to see more of their money diverted away from fun and towards bills, which usually crimps spending and cools the economy.

Here in the UK, Moody's dropped the negative outlook it slapped on the government after the mini-budget debacle of a year ago. But while the government is on a sounder footing, the economy is wobbling a bit. Retail sales fell sharply by 0.9% in September, they were forecast to drop just 0.2%. Warmer weather may have caused a sharper drop in clothing sales and that might recover a touch in coming months, but the clear trend is negative. In particular, consumers cut back on big-ticket purchases, which tends to happen when they are concerned about the future.

Inflation should continue to cool and average wages are now rising again in real terms will help in the fourth quarter, but we're sceptical that this will fully offset the large hit to disposable income that's still passing through to households from higher borrowing costs. Consumer confidence is shot: the survey delivered the largest monthly fall since December 1994 in October – and was pretty weak to begin with in September!

If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing **review@rathbones.com**. We'd love to hear from you.