Election surprise sends UK into a tailspin

News Analysis

Growth dynamics remain constructive despite a setback in oil prices, while in UK, Brexit negotiations begin amidst a chaotic political backdrop.

by
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June 2017

Falling oil prices cast their shadow over markets during the past week, with crude dropping to a low of US$42/barrel due to ongoing inventory concerns. This trend continued to push government yields lower, notwithstanding an amount of hawkish rhetoric coming from central banks, with William Dudley in the US and Andrew Haldane in the UK both pointing to rate hikes in the second half of 2017. Spreads in the energy sector were marked wider and emerging markets saw some pressure – though to put this in context, moves were pretty negligible compared to those seen in late 2015 and early 2016. This relatively muted reaction partly results from the fact that break-even costs in shale continue to fall and producers' balance sheets are in a much stronger position than they were the last time prices dropped. However, moves are also explained by the fact that the current decline in prices is viewed as much more of a supply issue than a demand issue, with global growth continuing to look broadly robust. Reflecting this, US equities printed another all-time high on Monday this week and away from energy, corporate credit continued to trade robustly, with Euro CDS indices reaching new tights for the year.

With summer weather seemingly dampening volatility and little data of note, away from the moves in oil prices, it is tempting to observe that there is little of substance currently going on. In Europe, political risk appears to continue to diminish for the time being and in the UK, it seems as if markets are very sanguine notwithstanding rife divisions with the Bank of England, a lack of a government deal between the Conservatives and the DUP and a lame duck Prime Minister whose days seem surely numbered.

As we look ahead, a further drop in oil prices could be a factor elevating market stress in the weeks ahead. However, as long as the general growth dynamic remains constructive, we believe that sentiment in global risk assets should remain largely supportive. In this regard, we would argue against those purporting the view that a flattening of global yield curves suggests that such a slowdown is now imminent. In the past, curve flattening has occurred in tightening cycles as policy restraint starts to bite – yet in the current environment, we believe that any flattening of the curve is very much a function of low-flation rather growth disappointment. With oil base effects turning negative if prices remain at these levels during the second half of the year, CPI prints may be set to remain benign in the months ahead. Indeed, inasmuch as lower oil prices benefit consumers, we do believe that lower inflation could go hand in hand with faster consumption and therefore stronger growth and, therefore, trying to read signals with respect to the economy based on the curve shape may well be misleading at this time.

Meanwhile away from the headlines, we would observe that in the US, discussions on Capitol Hill with respect to healthcare plans and budget proposals are ongoing and given how low expectations are with respect to the Administration getting anything done, there is still plenty of scope for positive newsflow to surprise markets before the summer recess at the end of July. Indeed it was also interesting to see that the Republicans retained their Congressional seat in Georgia, with Democrats lamenting that 'our brand is worse than Trump'. Perhaps it is the case that bond market participants are becoming too pessimistic on the broader outlook at the moment, wanting to point the finger at the Federal Reserve for being too hawkish as the Committee's view diverges materially from market expectations. In contrast, equity market participants seem to retain a more constructive frame of mind, and this remains more logical in our view with the Atlanta Fed GDP forecast for Q2 continuing to track at 2.9% and data momentum in the US surprise index looking like it has reached a near term bottom and is now is now set to rise.

Elsewhere, we would note that on the first anniversary of the historic referendum the Leave to EU, the UK macro and political backdrop seems to be going from bad to worse. This week, formal Brexit negotiations commenced and with 20 months left on the clock it seems unclear what the UK government will be able to deliver. With a record low approval rating, we believe that Theresa May is very unlikely to be Prime Minister when negotiations conclude and we continue to see the risk that a further general election will be required in the coming 12 months, in order to establish a government with a workable majority. For now, it seems the only factor stopping a leadership challenge within the Tory party is the threat of internal civil war, coupled with the thought that the Prime Minister job is not really one that anyone wants at this juncture. Maybe Prince Harry's comments were more widely applicable when he voiced the thought that 'nobody in the family really wants to be King or Queen'. That said, it is certainly possible to think of one pretender to the throne in waiting…

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