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Markets in a Minute

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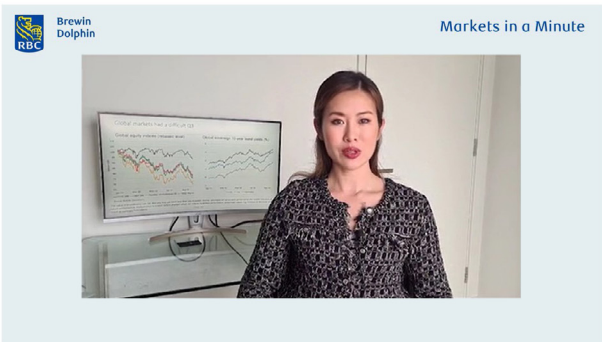
Janet Mui, Head of Market Analysis, takes a closer look at the U.S. earnings season, the strength of the technology sector and its positive impact on markets. Plus, she reviews fresh U.S. economic data and what this may mean for interest rate cuts.



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Earnings season continues…

The U.S. first quarter earnings season reached its zenith last week. Almost half of the companies had reported, and analysts will now start to question what share of them have beaten profit forecasts. Regular readers will know this is an almost irrelevant number, which tends to be pretty consistent at around 80%. Indeed, for the current quarter it stands at just under 81% for now. Similarly, sales surprises tend to be fairly consistent at around 50% (this quarter, it's 56% for now).

The tone of reports has been mixed, with nuances seeming to reflect the characteristics of individual companies rather than clear macroeconomic trends. Overall consumption continues to support earnings in the U.S.; the question is how long that can continue for.

Did GDP growth disappoint?

A slight shock came with the first quarter gross domestic product (GDP) numbers from the U.S., which were significantly below the average forecaster's estimate. However, further reading shows that U.S. demand remains pretty robust, with final demand growing by over 3% (annualised) during the quarter.

The drag came from two sources. One source is unsold stock held by companies, known as inventories. Growing inventories imply backlogs of unsold goods piling up in warehouses, which suggests companies need to slow production to let sales catch up. In this instance where inventories are declining, the opposite is true, which is encouraging.

The other drag on GDP was net trade. When net trade is a drag on GDP, this is because imports grow relative to exports.

However, GDP are quite lagged data, so the more timely measure comes from purchasing managers indices (PMIs). The contrast here was striking. In the U.S., manufacturing activity appears to be slowing in April. It seems too early for the current upturn to be petering out, especially if inventories contracted last quarter. At the same time, even services activity, which had been the brightest spot globally, seemed to slow in the U.S.

Again, this could be mere noise because outside the U.S. the consumer recovery continues to gather pace.

Is the UK government on borrowed time?

UK public finances for March were released last week, and they made disappointing reading. Borrowing was considerably higher (£6.6bn) than the Office for Budget Responsibility predicted the previous month. This is both an economic and political setback because in an election year, it was widely assumed the government was planning to cram in one further "fiscal event" before calling an election. The schedule always looked tight for that, as the most anticipated date for an election seems to be mid-September, although there are some reasons to be sceptical about that.

One compelling reason is that an established preference exists to not have elections coinciding amongst members of the so-called Five Eyes intelligence collaboration alliance (driven by the U.S. and UK and incorporating Canada, Australia and New Zealand). The perception is that a change of power in these countries can complicate their responses to signals intelligence.

The UK and U.S. electoral systems tend to mean complete changes in the executive government, rather than the evolving coalitions seen in other countries, which heightens the risk.

The U.S. election will take place on 5 November, although recent elections suggest the scope for a disputed result may be higher than has historically been the case. This is partly mitigated by the fact that the incoming president is not scheduled to take power for more than 70 days while a transition is planned.

Aside from the timing being tight, these latest data suggest UK finances are also getting tight. There will be little point in holding a fiscal event if there is no scope for further tax cuts. If forecasts are excessively optimistic, the risk is that fiscal policy might need to be tightened, a politically unpalatable prospect both parties are hoping to postpone until after the election.

What can be done?

The implication in the UK is that either taxes will rise, or spending will be cut after the election. However, certain areas of expenditure are protected (e.g., the NHS, schools, aid and childcare) meaning much steeper cuts of around 2-3% in real terms for areas like further education, courts and prisons. Even these forecasts likely understate the money needed to flow into the NHS or for this week's pledge to increase defence spending to 2.5% of GDP by 2030.

Polling still indicates that any long-dated commitments would likely have to be delivered by a new government, but making the commitment now forces the opposition to either match the pledge (and tie its own hands for the future) or risk losing votes.

The challenge the UK faces is that it has relatively high debt already, which was assumed at a time of low interest rates. Over time, that debt will be refinanced at higher interest rates and as it does so, it will absorb a growing share of national income – currently estimated at 3.2%.

The Bank of England (BoE) is the owner of £700m worth of UK government bonds. As the BoE is owned by the public sector, when it buys government bonds, it is arguably cancelling the debt. However, although it is widely understood that the BoE buys these assets with printed money, which sounds costless, they are actually purchased in return for bank reserves, which suffer the BoE rate of interest. Unusually, that rate is currently above the government bond yield, so the debt has become more expensive since being acquired, because interest rates have risen.

By the end of this week, most of the excitement of earnings season will be starting to wind down. But it is at this stage we start to see the upgraded estimates from analysts feeding into consensus numbers. It's also a big week for economic news, with hopes for another quarter of a million new jobs to have been created during April.

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