US Exceptionalism: The Default Setting or Defaults Setting In?

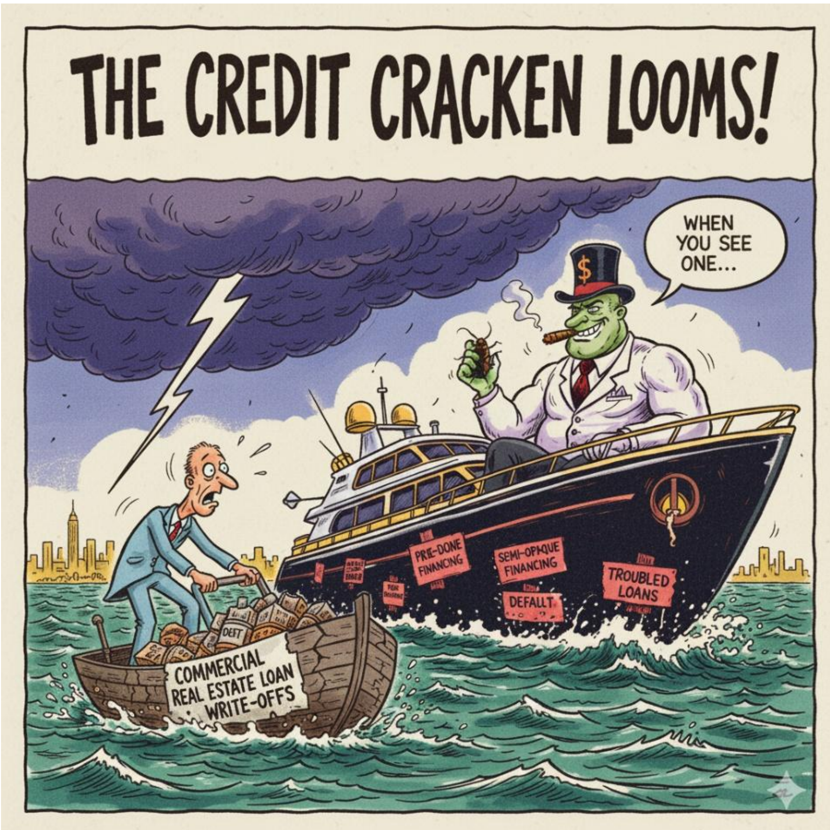
UK Gilt yields have been falling as Chancellor Rachel Reeves reaffirmed her intent to remain fiscally conservative and hinted at greater taxes on the wealthy although has ruled out an outright wealth tax.

The economy certainly doesn't look like it will come to the Labour government's rescue any time soon with another month of stagnant economic growth, unemployment creeping higher and wage growth slowing.

The labour market picture was made ever more worrying by the Bank of England's Decision Maker Panel survey which indicated that businesses were cutting jobs at the fastest pace since 2021 in the three months to August, with firms reporting an annual employment growth rate of -0.5%.

This decline in employment is partially attributed to the increase in employer National Insurance contributions implemented in the previous budget, with half of firms reporting they were lowering employment as a response.

After a strong reporting season for larger US banks, global bond yields continued to tumble into the weekend after regional banks reported some commercial real estate loan write-offs and legal action against borrowers for alleged fraud. The scale of these events is relatively small and are alone unlikely to have any systemic repercussions, but they have temporarily shot sentiment and spurred some profit taking.



They follow the recent bankruptcies of major US autoparts supplier, First Brands Group, and subprime auto lender and used car retailer, Tricolor, which have raised questions over lax lending standards and due diligence efficacy, particularly with respect to semi-opaque off-balance-sheet financing and even more opaque private credit lending.

Private credit is concerning by the very nature of its opacity which means that no one really knows how bad things might be under the surface, except maybe for those who would benefit from concealing this information.

Jamie Dimon, CEO of J.P. Morgan, captures the prevailing sentiment, "…when you see one cockroach, there's probably more."

In the wake of the global financial crisis, regulations pushed larger US banks out of private credit lending thereby reducing its potential impact on the financial system, instead putting the risk directly in the hands of investors.

While regional banks also de-risked, they have not retreated to the same extent, creating a long tail of ever smaller banks to act as a shock absorber for the US financial system, allowing the Federal Reserve to step in and respond appropriately to deteriorating circumstances.

Of late, Fitch, the credit rating agency, have warned that private credit's pervasiveness could amplify a systemic shock and highlight several characteristics that are associated with the run up of asset bubbles, but are also willing to go on record that they do not consider private credit a systemic risk.

The Federal Reserve's 2025 stress tests have concluded the same - private credit does not amount to a systemic risk that could bring down the banking system in a severe shock.

This all comes at a time when market sentiment was riding high and asset prices were looking optimistic, but a confluence of other factors this week have left investors decidedly skittish.

Last Friday, cryptocurrencies experienced their largest single day liquidation event ever resulting in a dramatic crash for some of the more obscure digital coins. This was largely attributed to President Trump's announcement of higher tariffs on Chinese imports but was followed by a buy-the-dip response to the subsequent sell-off in equity markets resulting in the largest options trading day ever.

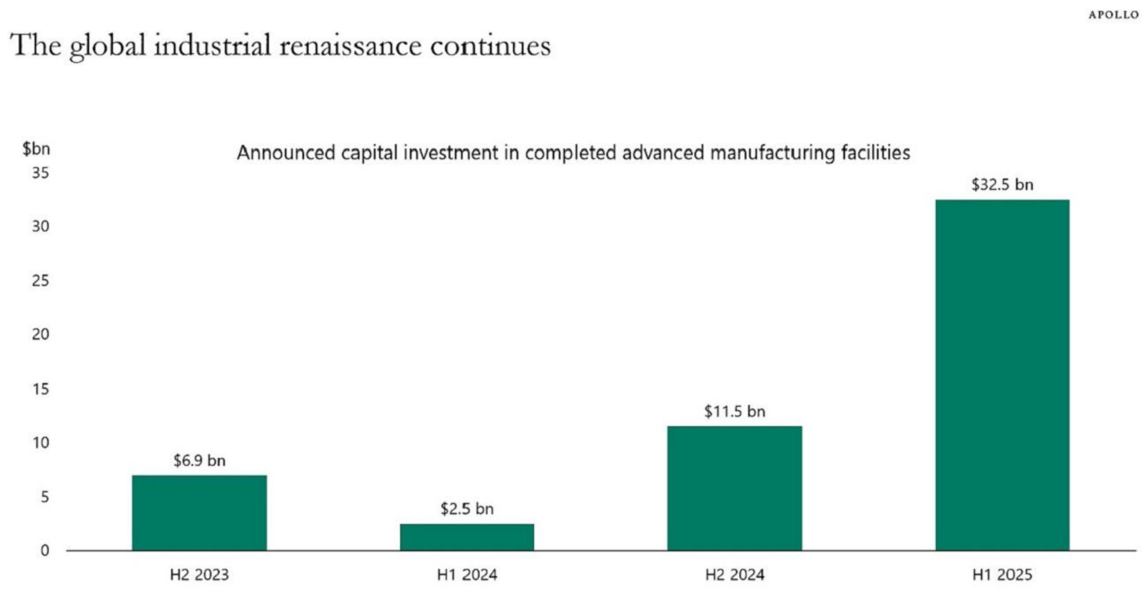
Quantum computing stocks have been on a tear, despite being far from commercially viable scale for solving general business problems. This adds to the froth in equity markets. The volume of stock being traded in the two largest quantum computing stocks was as high as Google's in value terms for a brief period, which suggests there's a lot of hype, and potentially pump-and-dump manipulation.

It probably hasn't helped that one of Paypal's cryptocurrency partners managed to mint $300 trillion stablecoins in error. The event highlights that the stablecoin's dollar peg is guaranteed by PayPal and its independent third-party attestation reports, rather than being intrinsically tied to the minting of a stablecoin. It is this pinpoint reserve verification counterparty risk that will become the key risk of such devices in future but in situations like this the error is easily reversed.

With Trump now set to meet with Putin and discuss ending the Ukraine war, profits are also being trimmed from defence stocks.

To round off these events financial stress indicators have been flickering in response to the events at US regional banks, but the drawdown of the Federal Reserve's Reverse Repo facility, which was inflated to buffer the financial system in the years following the pandemic, means that small money supply/demand shocks are more likely to transmit into pressure on overnight rates, tighter funding spreads, and volatility. So, their re-emergence was to be expected.

These events put a damper on a story which continues to otherwise be rather optimistic and was building back favour towards US exceptionalism.



The interrelationship between US corporates and the federal government is driving a capital expansion in the US like no other period in history. The manufacturing cycle is gaining traction with nearly 200 factory completions since mid-2023 and a $590 billion pipeline led by $5 billion-plus megaprojects, advanced manufacturing is set to be a durable growth engine for the US economy.

Where are markets up to?

The rolling 12 month % cumulative returns in local currency from various indices is shown in the following chart:

Where are the portfolios up to?

The portfolio performance, net of fees, to close of business on Thursday is as follows:

	1 week	1 month	3 months	12 months
Cautious	-0.38%	+2.10%	+5.10%	+6.56%
Balanced	-0.90%	+2.37%	+6.42%	+8.38%
Adventurous	-1.16%	+2.55%	+7.02%	+9.17%

As ever, if you would like to discuss any aspect of your portfolio, please do not hesitate to contact us on service@blythefinancial.com.