RBC BlueBay Asset Management

Market Commentary

New Year’s fireworks

2025 has started with a bang!

Key points:

- The UK 30-year gilt yield surpassed an incredible 5.40% this week, the highest level since the late 1990s.
- Stronger business sentiment and higher-than-expected inflation numbers from Germany saw a rapid re-pricing in ECB expectations.
- The resignation of Canadian Prime Minister, Justin Trudeau, has set the stage for a Spring election and a potential Conservative government.
- In emerging markets, Brazil remains a source of considerable volatility, with both the currency and rates market trading close to their weakest levels.

10 January 2025 (London) – Government bond yields continued their ascent higher into the new year, with US 10-year yields reaching 4.7%, a full percentage point higher since the Fed’s 50bps interest rate cut last September.

Weighing up the potential scenarios in the year ahead, we continue to think that yields on longer dated tenors could remain under upward pressure on the view that fiscal and inflationary concerns are unlikely to abate any time soon.

Multi-year bond levels were also breached in Japan and the UK, where 10-year yields reached their highs going as far back as 2011 and 2008, respectively.

The UK has been front and centre this week, with the rise in borrowing costs making front-page headlines, reminiscent of late 2022. The 30-year gilt yield surpassed an eye-watering 5.40%, the highest since the late 90s, and while some of the move can be attributed to external (US rates) and technical (supply) factors, as we have noted consistently in the past, structural forces continue to plague the UK economy.

Inflationary pressures remain persistent and elevated, while at the same time the growth backdrop, exacerbated by the recent budget, is deteriorating and straining government finances further.

Recent services PMIs highlighted that input cost inflation accelerated to an eight-month high, while a survey from the British Chamber of Commerce pointed towards a sharp slump in sentiment, with more than 50% of companies planning to raise prices over the coming months.

Moreover, households will face rises in energy costs, water bills and council tax in April, adding to the squeeze in consumer budgets.

Politically, the official growth forecast for 2025 (2%) is already looking ambitious and is likely to be re-rated lower in March, adding to spiralling deficit concerns. Higher borrowing costs are feeding back into a deteriorating fiscal profile, and there is a growing sense that the Labour government will break its own fiscal rules and be forced to renege on its promise not to raise taxes further, given the high sensitivity around additional borrowing and cuts to public spending. We remain bearish on UK assets as we continue to envisage a fiscal and political downward spiral.

In the US, the first week of the year has also seen more two-way action in FX and the US dollar, after a strong run post-election. Despite our expectation for the US economy to remain robust, heavy positioning on the long side, combined with noise on Trump tariff policies over the coming months, means that scaling back some of our long US dollar conviction is prudent.

On the policy front, we continue to see the Fed on hold in the first half of 2025. Financial conditions have tightened in recent weeks on the back of the stronger dollar, and there remains plenty of economic and political uncertainty in the year ahead. However, for the time being the US economy continues to exhibit solid growth momentum. In that respect, we eagerly await the December Jobs report later today as the first meaningful acid test of 2025.

In Eurozone fixed income, stronger business sentiment and higher-than-expected inflation numbers coming from Germany have seen a rapid re-pricing in ECB expectations in the first week of the year. Markets now expect the ECB to cut rates to 2% by Q3 this year, pushing back expectations that were calling for more front-loading of cuts.

Nevertheless, Europe faces many challenges, economically and politically, in the months ahead; we think that ongoing economic and monetary policy divergence with the US is likely to manifest more clearly in FX moves over the coming months and continue to look for a test of parity in the euro/US dollar exchange rate.

Little steer from the Bank of Japan over recent weeks is keeping investors guessing as to whether an interest rate hike is on the cards later this month. Incoming data on activity and wages remains robust and will likely meet updated forecasts on inflation, while the yen approaching 160 versus the USdollar will keep policymakers alert on the FX front.

Yet you could also argue that not much has changed since December's meeting - US policy under Trump is still just words and tweets, while further data on this year's Spring wage negotiations will likely come closer to March.

Arguably, the one outcome that Japan really needs to avoid is to allow too much of an inflationary overshoot to develop. If this needs to be addressed through monetary policy, the outcome could be very painful at a future point in time. We remain confident that the BoJ will hike to 0.50% in January with the more immediate impact a stronger yen. Structurally, 10-year JGB yields should climb as the BoJ purchases wind down, where we target 1.25%.

Elsewhere, Canadian prime minister Justin Trudeau resigned this week, opening up early elections in the Spring and the doorway for the Conservatives, led by Pierre Poilievre, to form the next government. From a macro perspective, this may lead to a much warmer stance from the Trump administration than Trudeau has seen to date, given some similarities – for example, we could well be in a situation soon where both the US and Canada are in sync regarding energy policy and concurrently focused on growing energy output, boosting exports, and reducing energy prices.

In emerging markets (EM), Brazil remains a source of considerable volatility. The central bank was forced into an aggressive intervention program last month, using up circa USD20 billion of reserves to prevent the negative spiral from accelerating. Thus far, the intervention has provided some stability to the FX market, but the currency continues to trade close to its weakest levels, as does the rates market.

With Trump winning the race for the White House, a strong dollar and a higher trajectory for US rates have also been hurting EM sentiment in local markets.

Investment Grade credit spreads are relatively unchanged so far this year. While we have seen the usual January new issue supply spike, investors have been lightly positioned ahead of this, helped by ongoing yield chasing flows into the asset class.

With spreads at tight levels, especially in the US, it will be interesting to see whether ongoing heavy supply, combined with rising underlying core government yields and US political noise, causes volatility to pick up in the weeks ahead.
In credit, we have continued to reduce positioning after a strong run, and indeed ahead of new year supply and potential Trump volatility in January, we have reduced credit beta exposure to the lowest level we have run in the past couple of years.

At this point, we feel that the opportunity cost from moving towards a short stance in credit now looks pretty modest, though we struggle to get too bearish at a time when we continue to have a relatively constructive view on the US economy.

In that context, we are happy being close to flat and using any potential widening as an opportunity to add at more attractive levels. Meanwhile, we have been speaking about an increased opportunity set in FX relative to rates and credit as we head into the new year, and this is broadly reflected in our overall positioning.

Looking ahead

We remain positive on the US dollar but to a lesser degree, and we are biased towards higher yields in the US and Japan. We would observe that investors still aren't paid much of a premium to own longer dated bonds relative to cash rates (with the exception of long dated JGBs), and so we think curve steepeners still have room to move higher.

We are also at a juncture where spreads are very tight, and we are cautious on the outlook for credit and risk in general. Meanwhile, economic uncertainty seems compounded by ongoing political and geopolitical uncertainty, at a time when Trump is about to take office.

While Elon Musk is firing political rockets and causing mayhem, much to the loathing of European politicians, UK policymakers' attention is rather focused on the firework display in the gilt market. Happy Year to all!

Notes to Editors
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