RBC BlueBay
Asset Management

Market Commentary

Kane unable – bring on the Euros!

Markets are quiet, but footballing action is on the horizon….

10 May 2024 (London): Following a move lower in yields in the wake of some softer US data at the end of last week, yields have traded sideways over the past few days, in the absence of an additional catalyst to drive price action. A somewhat weaker reading for US payrolls and a softer ISM survey suggest the pace of economic activity could be moderating.

This picture was also supported by comments in the last round of corporate earnings releases, with anecdotal signs of some consumer weakness. However, any moderation is from a strong starting point, so there is little for investors to become too concerned about for the time being.

Moreover, this narrative supports the implicit desire being communicated by the Fed that they would like to start to lower rates if they can. Yet any policy moves will rest heavily on the evolution of inflation data over the next few months.

In light of this, we think that next week's US CPI release will be pretty pivotal in setting the tone and determining the course of coming price action. A benign reading would put rate cuts back in play and would be a positive catalyst for bonds and stocks.

However, another disappointing release could easily produce the opposite result. Although we may hope that core CPI records a 0.2% or 0.3% gain on the month, as seasonals in Q2 turn more supportive than they were in Q1, another 0.4% monthly gain would be problematic.

Such an outcome would suggest that recent higher readings are more than a temporary blip, and this would be a troubling outcome for the FOMC.

Part of the recent disappointment in inflation data has been related to higher imputed rents. There are reasons to expect gains in this space to moderate, though with the housing market relatively robust and ongoing shortages of supply exacerbated by immigration flows, it is unlikely that this will drop too far.

Elsewhere, insurance costs may be peaking. This is a sub-component which has been rising by as much as 20% lately and although a small weighting in total data, this impact has still been noticeable in aggregated data.

Meanwhile, with the prices paid component in ISM rising to levels last seen in 2022, it is clear that upside risks still remain in other components of inflation and, from that point of view, it is hard to have too much confidence in predicting the upcoming data ahead of its release.

In the interim, as we wait for these inflation data, the market backdrop has been relatively quiet. The Vix has dropped back below 13.5, helping credit spreads continue to edge tighter. Equity indices have been broadly rangebound, albeit there has been some interesting relative performance between stocks and sectors in recent weeks, with dispersion tending to increase.

The BoE kept UK rates on hold at 5.25% for the sixth consecutive meeting. This was in line with expectations, however, some market participants were looking for a more dovish spin from MPC members, owing to the idea of receding inflation persistence. Two members called for a cut to 5%, but the

majority continue to highlight elevated levels of services inflation and wage data, so caution continues to be warranted.

In that respect, the April CPI print later this month will be an important barometer in terms of the path of policy for the rest of the year. We would note, however, that UK investors have been wrong-footed countless times on inflation over the past two years, and so after a summer dip, we think data will then push higher again, limiting any material easing cycle.

In Europe, expectations of a 25bps rate cut from the ECB in June have continued to firm. Recent discussions with European policymakers continue to highlight that inflation in the region has been better behaved than is the case in the US. They have also been at pains to highlight the relatively stronger fiscal position across the continent, at a time when the US remains blasé with respect to its burgeoning deficit, even when the economy has been booming.

In Sweden, the Riksbank cut rates by 25bps to 3.75%, effectively frontrunning the ECB. The Swedish economy and housing market have been materially impacted by higher rates, thanks to a mortgage structure which is more floating rate in design. Certainly, when one thinks of the US mortgage structure whereby householders were able to hedge rates for 30 years when borrowing costs were at their lows, this is a significant factor in explaining why the policy has had such little traction, compared to cases such as Sweden and elsewhere.

Japan has returned after its Golden Week holidays, with the fallout from the latest BoJ meeting and subsequent MoF currency intervention continuing to reverberate. Political leaders have been holding Ueda to task for failing to account for currency moves in his policy decision making and analysis. This continues to speak to more policy change to come, supporting our conviction to remain short duration in JGBs.

Following intervention, the yen dropped from a high of 160 last week, to as low as 152 versus the dollar. However, as the MoF has stepped back, so the rate has returned around 156 and there is a degree of questioning in Tokyo about the MoF needing to waste FX reserves and burn some geopolitical goodwill, without having any tangible result to show for this. As we have noted previously, intervention may only be able to slow moves rather than drive a change in trends, unless it is also supported by changes in underlying monetary policy.

Looking ahead

We think a lot is riding on the upcoming inflation story, as mentioned earlier. Thinking on strategy positioning, if we see benign US data, then it may be interesting to add exposure in favoured positions where valuations continue to look cheap. This is more the case in a space like EM local rates in curves like Mexico, South Africa or Brazil, than in credit, it seems.

However, credit spreads continue to be supported by a positive technical in which there is a relative oversupply of government bonds relative to corporate paper, where net issuance in IG and HY is expected to modestly contract in the coming months.

Meanwhile, disappointing inflation may be the catalyst to move in a more defensive direction, adding to hedges and remaining careful with respect to overall strategy duration. For now, we have a moment of calm, which even seems reflected in some better weather. After a wet winter and a cold and damp spring, it is certainly nice to see some warmer weather arrive.

From a financial markets perspective though, it is not clear how long these conditions will last. In this case, being ready and prepared for all potential outcomes appears to be the current state of play. As Bayern Munich and Harry Kane found out this week, things can change quickly!

Notes to Editors
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