RBC BlueBay
Asset Management

Market Commentary

Drown and out

Where's your umbrella, Rishi?!

24 May 2024 (London): In a relatively quiet week, US Treasuries were fairly rangebound, in the absence of any additional catalyst to drive price action. Fed speakers and FOMC minutes sounded some caution with respect to recent improvements in inflation data, affirming the need for several more months of better price data, before discussions of rate cuts can really come back onto the agenda.

At the same time, with further Fed hikes seemingly ruled out of the equation, it strikes us that fair value for 2-year Treasuries should sit between 4.75-5.00%. Having maintained a short duration bias, globally speaking, we have recently been inclined to add duration towards the top of this range. At this point, we have adopted a broadly flat stance on global duration at the current time, with a focus more on curve trades and relative value.

In assessing yield curves, we continue to argue for more steepness over time. A narrative of tax cuts (in the US) or additional fiscal spending (in the EU) mean that fiscal deficits are unlikely to improve any time soon. This should witness more term premium being priced, as investors demand increased compensation for owning longer duration assets.

Meanwhile, curve inversion means there is little pressure on policymakers to more away from fiscal profligacy. Moreover, the valuation of longer-dated bonds only makes sense if cash rates fall materially from prevailing levels, yet if rate cuts are delivered, then it stands to reason that it will be the front end of the yield curve which takes the lead, in any market rally.

On a relative value basis, we have held to a short duration stance in Japan and the UK, preferring opportunities on the long side in Mexico, South Africa, Brazil and Iceland. JGBs exhibit lower volatility than other markets, certainly compared to those in the emerging market space.

Consequently, aggregate duration remains short, reflecting differing position sizes. Thematically, however, we have now adopted a stance where absolute moves higher or lower in US Treasury yields should have limited direct impact across strategy returns.

In Japan, yields have continued to edge higher over the past week, with 10-year maturities breaching 1.00% for the first time since 2012. There are suggestions that the government in Japan may soon announce a formal end to the era of deflation and, if this is the case, this could be a prelude to a further BoJ policy adjustment at its June meeting.

In the first instance, we think that this will comprise a further reduction in JGB purchases by the central bank. As previously shared, we think that balance sheet expansion by the BoJ is no longer warranted, and at a time when other central banks are shrinking their balance sheets, this has been a factor undermining the yen. Thereafter, we look for interest rate increases to 0.25% in July and 0.50% at the October policy meetings. In this case, we think that 10-year JGBs can reach 1.25-1.5% by the Fall.

In the UK, political developments dominated the newsflow, with Prime Minister Sunak announcing a General Election for 4th July. With the Conservative party a long way behind in the polls, there is a sense that a

Labour government is a foregone conclusion and the only real question to be debated will be the size of the Labour majority and the extent of Tory losses.

In some ways, the limited scope for a surprising outcome has led to a muted market reaction to the election announcement. However, we are inclined to think that a very large Labour win with a majority of 200 seats could be perceived negatively, if this means that Starmer struggles to exert his control over some of the more extreme members of his party. A desire to deliver a platform of 'Change' might be stymied by a lack of fiscal headroom, yet frustration to act in a hurry could easily expose these fiscal risks.

Meanwhile, gilt yields rose this week, underperforming other markets in the wake of a higher-than-expected April CPI release. It had been widely flagged that the annual inflation rate would drop in April, as last year's hike in utility bills was reversed out of the data. Yet, with service price inflation at 5.9%, core prices continue to increase at a much higher rate than the BoE 2% inflation target.

On this basis it seems difficult to see the BoE cutting rates at its June MPC meeting. Just prior to this meeting, we will have seen the May CPI release and a further reduction in headline inflation may be witnessed. However, thereafter, UK inflation is set to trend higher again in the second half of the year. In that case, it remains very possible that the Bank won't be able to deliver any rate cuts in 2024.

The BoE finds itself under building political pressure to deliver rate cuts, in order to help its political masters. At a time when there is growing scrutiny over BoE actions – in light of catastrophic QE losses being realised as the BoE sells gilts at a steep loss under its QT plans – the independence of the institution is now being called into question.

Yet any attempt to rescind this, in order to push interest rates down for political purposes, is likely to be self-defeating as investors would surely attach a material risk premium to UK assets, were the government to pursue such a course (something that Donald Trump may also want to pay heed to).

At the same time, a mounting crisis around water utilities is also an important story to watch in terms of its political and policy implications in the UK. With Thames Water facing potential collapse, it seems that nationalisation is now on the cards. Under a Labour government, we think that Railtrack in the rail sector could be a template for how water could be structured as an industry in the not-too-distant future.

However, as society appreciates the chronic under-investment in pipes and new reservoirs, which have led to our polluted rivers and a country drowning in rain still facing the prospect of summer droughts, so it is clear that bills will need to rise, in order to fund this. With water companies already calling for price hikes between 24-91%, the inflationary implications are clear, as are the risks on the fiscal side.

On a broader point, it can also be seen that in a world where interest rates are staying higher for longer, then this is a toxic environment for business models dependant on high levels of leverage at cheap borrowing costs. This is particularly pertinent with respect to private assets, with many private equity assets subject to material write-downs in value, as elevated borrowing costs eat up free cashflow.

With many such assets in the UK having been gobbled up by PE, in the wake of Brexit, this is something which could be notable for asset owners in the UK. On this basis, it is perhaps understandable that many of the banks which have been courting the private asset space have been amongst the loudest voices arguing for rate cuts to be delivered.

Elsewhere, in the higher quality segment of the credit universe, conditions currently appear much more benign. May has witnessed relatively heavy new issuance of securities and this issuance should now slow over the coming several months. Through a period of supply, new issues have not offered much of a pricing concession and issuance has been easily absorbed.

Although we are reaching a point where valuations impose a constraint on spreads moving aggressively tighter, with volatility dropping, we might well witness a steady grind tighter, for the time being.

In emerging markets, there has been building interest ahead of upcoming elections at the end of next week, in both South Africa and Mexico. Ultimately, we think that market-supportive outcomes can prevail,

notwithstanding some short-term uncertainty. That said, we feel that in both markets, local currency bond yields are discounting too much potential bad news, at a time when FX in both nations appear to embed a much more sanguine view.

At a time when valuations on many assets offer limited opportunities, we think that EM local rates stand out as an area which remains structurally cheap. In this context, we think that as inflation declines in EM, there is an opportunity to add to risk in this space. Certainly, owning duration in these markets seems to appear much more rewarding than is the case in developed markets.

Looking ahead

In the coming week, there is relatively little in terms of economic data or central bank action to focus on. However, the gathering of G7 finance ministers and central bankers in Italy over the next few days may generate a number of headlines and, in this context, it is possible that Japanese policymakers may want to comment around policy and the yen, noting that the currency continues to struggle against its peers, with recent intervention seeming to have had little lasting impact.

Broad market conditions remain relatively benign for the time being, but in a world where rates are staying higher for longer, we continue to look for areas where pain may be starting to build. US regional banks and the property sector remain sources of vulnerability, but don't appear to pose a near-term threat to financial stability.

Elsewhere, the economic backdrop in the US remains relatively constructive and European data has also improved in 2024 relative to 2023. However, the longer that monetary policy remains at restrictive levels, the more likely it will be that vulnerabilities are exposed. Certainly, many business plans and models were not built with the prevailing level of rates in mind and, at some point, those who have gotten over their skis, will be found out.

Returning to UK politics, the timing of the election looks like it will be much more surprising than its result. It's hard not to pity poor Rishi, struggling to make himself heard, as he announced an election to the refrain of 'Things can only get wetter'. It seems that the Prime Minister decided that although the macro backdrop in the UK does not look great, things could easily get worse for him over the course of the summer.

With infighting within Tory ranks kicking off, even before the campaign gets underway, you do get a sense that Sunak is already desperate to put his time in Downing Street behind him and look to disappear on his holidays and find a bit of sun….

Notes to Editors
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