RBC BlueBay
Asset Management

Market Commentary

Turd World War

Geopolitics continue to represent something of a wild card

31 May 2024 (London): Yields moved higher over the past week, as $44bn of US Treasury supply met mediocre demand. With prospects for rate cuts very much on the back burner, yields below cash rates appear to offer no compelling reason to buy duration for now. Upcoming data releases may change this picture if economic activity weakens, or if inflation prints come in softer. However, for the time being, the economy continues to appear relatively robust.

This is evidenced by projections for 3.5% GDP growth in Q2 from the Atlanta Nowcast model, and in an upturn in the US Citi Economic Surprise index, reversing a move lower towards the end of April and the start of May. At the Fed, Kashkari appeared to break ranks suggesting that he was more open to the notion of further rate hikes.

However, we continue to see the bar to higher rates as very high – especially ahead of the election. Of course, the Fed will always need to react to economic data. Yet, the overriding narrative is one where rates will just need to stay at higher levels for much longer, than had earlier been envisaged.

In this context, we have no clear directional view on US yields, but continue to look for curve steepening. Indeed, the US curve moved steeper between 2-year and 30-year maturities this week, with supply back in focus.

Ultimately, we think that the need to issue larger volumes of longer dated debt will drive an increase in the term premium. Over the past couple of quarters, there has been a material increase in short-dated Bill issuance, as the fiscal deficit continues to swell overall debt levels.

However, we think there will be a requirement to increase long dated bond issue sizes in quarters to come and this leaves us cautious in our assessment of long end yields. Conversely, with 2-year yields only 30bp below cash rates, we could see the shorter end of the curve performing relatively well, should data bring rate cuts back onto the agenda in the next few months.

In the Eurozone, the past week saw attention back on inflation data. Prints in Germany and Spain came out close to consensus at 2.8% and 3.8% respectively on the HICP measure. The ECB will most certainly cut rates by 25bps at its policy meeting next week. However, with inflation still at levels materially above the 2% policy objective and with signs of the Eurozone economy picking up a little momentum, so the case for further rate cuts is now called into question.

Elsewhere, the upcoming EU elections provide a focus of attention. Right wing parties are expected to do well and in aggregate the number of seats going to far-right parties could exceed the total for Von der Leyen’s FPP. However, these parties are more focused on national interests and haven’t represented a coherent bloc.

In recent days, Le Pen’s ID grouping has sought an alliance with the ECR dominated by Georgia Meloni and this could be facilitated by the ejection of the scandal ridden AFD party in Germany. But it is also possible

that Meloni will lend conditional support to Von der Leyen, seizing the chance to be something of a kingmaker in negotiations around the EU's top jobs.

This said, it appears that the position of Von der Leyen is weakening with the socialists and liberals who are part of her current coalition, reacting negatively to her overtures to Meloni. In this case, this opens the door to a new President of the European Commission.

Meanwhile, Mario Draghi is waiting in the wings and making little secret of his ambitions. Draghi is keen for the EU to embrace a more fiscally expansive agenda, rising to challenges around global security, climate change and the EU's international competitiveness. This may boost growth but is also potentially inflationary and is likely to push yields higher in the medium term if this is the direction of travel.

However, it is not entirely clear that the populous of the EU is on board with this idea. The far-right parties on the rise, tend to have a Eurosceptic agenda. They also tend to be more focussed on curbing immigration than tackling climate change. Consequently, assessing how the EU comes together will be a source of ongoing interest in the coming days.

In the UK, electioneering got underway with Sunak appearing to stumble before the campaign has properly got underway. With Tories pledging tax cuts and Labour planning to increase spending, this mostly hints at looser fiscal policy. However, it is not clear that there is much fiscal space to deliver on very much at the current time and from this perspective, fiscal and political risks may represent an ongoing risk for Gilt investors.

JGB yields rose over the past week, with deputy BOJ Governor Uchida sounding more upbeat in his assessment of economic prospects. With pressure remaining on the Yen, so it seems that the central bank is coming round to the idea that some further policy adjust is needed at its June MPC meeting.

Japanese service PPI inflation recorded a 10 year high in the latest month and we continue to see more evidence of inflationary pressures broadening out as the linkage between wage growth and price growth shows signs of accelerating. With 10-year JGB yields comfortably over 1%, we are now at levels last seen in 2011. However, we continue to believe that the sell-off has a lot further to go as Japan moves more clearly into an era of reflation and inflation.

We believe that the BOJ will announce a material reduction in Rinban JGB purchases in June and begin to wind down balance sheet expansion. We also remain hopeful for an official announcement regarding the attainment of inflation stable around 2%, as well as a narrative to emerge from the BOJ in terms of how they will normalise monetary policy over the coming quarters.

If we are correct with respect to R* in Japan being around 1.5%, then ultimately, we might think that 10-year JGB yields should rise to 2%. However, we are unlikely to see these levels until the end of 2025. That said, we still see the current move pushing 10-year rates above 1.25% and would observe that with 30-year JGBs already at 2.2%, so the 10-year part of the yield curve looks expensive relative to the longer dated maturities. This overvaluation can correct if the BOJ steps down its bond purchases.

In emerging markets, the outcome of election in South Africa left no conclusive winner, with the ANC polling <50%. In the coming days there may be uncertainty surrounding the make-up of a likely coalition. Any outcome involving the participation of Julius Malema and the EFF would be taken very negatively, though we only see this as a tail risk.

Largely speaking, we think that a market friendly outcome will prevail, though there may be a few days of uncertainty before this comes into view. Meanwhile, Mexico also goes to the polls this weekend.

Looking ahead

Once elections are behind us and investors focus on fundamentals, then we feel that with inflation around 4% in South Africa, Mexico and Brazil and bond yields in double digits, there is material value in several curves in local EM markets, even if we have a more circumspect view on EM FX.

Credit markets remain relatively quiet for the time being. Risk assets traded a bit weaker over the past few days as yields have risen. However, with the economic backdrop relatively robust, we don't see an obvious catalyst for spreads to widen, unless macro data on inflation is much worse than anticipated. Technicals remain favourable and we continue to reflect on a net contraction in corporate bond supply when trends are in the opposite direction in terms of government securities.

After a holiday shortened week with many away on mid-term holidays, so it feels like next week will mark more of a return to normality in markets. In this context, the payrolls data next Friday may be expected to be the highlight of the week.

Trump's conviction this week following his trial in New York has generated no shortage of headlines, but it is not clear that this will have a material impact on the election result. In a sense it might appear that voters have long made up their mind about Trump already and November's vote could hinge more on voter turnout in the swing states for Biden and Trump, respectively.

As we move towards the second half of the year, this will bring the US election into view. But for now, attention is more focused on Trump's trial in New York, which has generated no shortage of entertaining headlines, though appears unlikely to be decisive in swaying the election result.

Politics and policy promise to be an ongoing theme in markets during this year, with geopolitics continuing to represent something of a wild card. From this point of view, attention continues to be focussed on the conflicts in Ukraine and Gaza and any scope for spillover effects. Issues in the Baltic Sea recently raised tensions between NATO and Russia in the past week, whereas tension in Taiwan continues to bubble under the surface.

On a more light hearted note, it was interesting to see the conflict between North and South Korea take a new turn over the course of the past few days. The two states never signed a peace treaty after conflict ended in 1953 and so remain technically in a state of war.

That said the only munitions being sent across the border for the time being, appear to be balloons filled with trash and faeces. It isn't clear whether Pyongyang intended this to be the start of a new 'Turd World War', but it does show how pretty pathetic some of the global disputes really are. If only we could all grow up!

Notes to Editors

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