RBC BlueBay
Asset Management

Market Commentary

Robots on the rise, politicians in decline

Is this the next wave of AI?

7 June 2024 (London): A softer ISM release and weaker JOLTS data on US jobs openings helped drive Treasury yields lower over the past week. With longer dated bonds leading the rally, this has seen US yields reverse market moves in the second half of May. Consequently, futures contracts now discount a 75% probability of a Fed cut by September.

Some anecdotal evidence appears to be suggesting a softening in economic activity, led by the consumer, and in light of this, the Atlanta Fed Nowcast of Q2 growth has dropped from around 3.5% to 1.8% over the past couple of weeks. However, other indicators remain upbeat. The labour market report, released later today, should show payrolls growing at a healthy pace. Meanwhile the ISM services survey was robustand the S&P stands at record highs, thanks to the ongoing surge in the Nvidia stock price.

Moreover, any path to rate cuts will be contingent on inflation. Notwithstanding one improved CPI print, any policy easing will depend on a renewed downtrend in prices over the next few months and it feels premature to try to take this for granted. From this point of view, any further rally in rates needs to be contingent on a benign May CPI report in the middle of next week.

Consequently, if yields dip further in advance of this, it could be that the balance of risks favours reducing overall duration exposure. That said, we continue to see 2-year Treasuries close to fair value in a range between 4.75%-5.0%, in the absence of additional information.

In the Eurozone, Lagarde delivered a well telegraphed reduction in interest rates of 25bps, taking the Euro deposit rate to 3.75%. This was the first reduction in interest rates since 2019 and there is scope for rates to fall further during the second half of the year. However, the enthusiasm to cut rates on the part of the ECB will be dependent on incoming data, as well as being influenced by actions taken by the Fed across the Atlantic.

The direction of fiscal policy may also weigh on the ECB's decisions. In this respect, by the September ECB meeting, it should be more apparent what the new direction of travel in the new European Parliament should look like. For now, we see bunds as close to fair value levels and we struggle to have much conviction for the time being on Eurozone fixed income assets.

We remain sceptical that the UK will be following the Eurozone and cutting rates soon. The next Bank of England meeting is still a couple of weeks away and prior to this we will see the May CPI release. However, we continue to view the inflation trajectory in the UK as more problematic than elsewhere.

In this context, we look for the October OFGEM energy price cap to record a -4% yoy change, compared to estimates close to -20% yoy currently embedded in Bank of England thinking. Although oil prices have been moderating of late, we continue to see UK inflation rising over the summer and through the second half of the year.

Meanwhile, the entry of Nigel Farage heading Reform UK has added interest to a General Election which has always seemed like being something of a coronation procession for Labour, under Keir Starmer.

If Reform builds momentum, it is not inconceivable to think it could match or overtake the Tories in the polls, reflecting underlying disenchantment with the established political class. Were this to occur, then the implosion of the Conservative party could easily accelerate as the party turns on itself, even before the election takes place. In this possible scenario, the idea of a reconstruction of the political landscape after the election becomes more likely.

In that case, it might strike us that Farage could be positioned to take over as Conservative party leader, given how few other Tory incumbents may be left in Westminster as credible alternative candidates.

Next week's Bank of Japan meeting will be closely watched. Over the past few weeks, speculation has increased that Ueda would announce a material reduction in bond purchases, in order to help stymie pressure on the yen. However, more dovish comments in the past few days have called this into question.

We continue to think that it is wrong for the BoJ to be actively growing its balance sheet under QE, at a time when other central banks are going in the opposite direction. However, there has been a hope in the BoJ that the US economy would cool and rates would fall, reducing pressure on the BoJ to rush any policy steps. Yet domestic data continues to point to building inflation pressure and an upward shift in inflationary expectations.

A move lower in US yields in the past week has helped take a little pressure off the yen, but should this be reversed, then the Japanese currency will be vulnerable if Ueda sounds too dovish next week. Were the BoJ to stop buying 10-year bonds, then we think that yields should be a bit above 1.25%, when comparing the valuation for longer dated 30-year bonds, which traded as high as 2.25% in the past week.

Emerging markets have witnessed some volatility in the past week with election results in South Africa and Mexico throwing up surprises. With the ANC in South Africa doing much worse than many expected, this has led to horse trading around a potential coalition. A tie up with the DA Party would be seen as favourable by investors, with an alternative alliance with the more radical EFF representing a very negative result.

As the ANC struggles with its choices internally, there are different competing considerations at play, and the outlook is still uncertain. Ultimately, we remain hopeful that a constructive outcome will come to pass. With long dated yields at 11.5% and inflation at 4%, we see a lot of value in South African gilts, if this were to occur. Yet in the short term, we are happy to own bonds and hedge some of the risk through a short position in the rand, as we await greater clarity.

Meanwhile, the margin of victory for Claudia Sheinbaum in Mexico opens the door to a more fiscally expansive redistributionist agenda in the country. Although a Sheinbaum victory was widely expected, the fact that the Morena party has achieved the majority required to make constitutional changes has caught investors off guard. Subsequently, the peso fell by 4% at the start of the week, only to recover somewhat on reassurances that any changes made would mitigate the impact on the deficit or the broader Mexico macro picture.

Elsewhere, elections in India saw Modi's party win the most seats but left reliant on smaller coalition partner parties for a majority in Parliament.

The past week has been a reminder of how politics and policy can move markets and how political outcomes can sometimes be relatively difficult to model with a lot of accuracy ahead of the event, notwithstanding improvements in polling methodologies.

By contrast, credit markets remain relatively quiet with spreads relatively stable. New issuance continues to see strong demand, even with syndicate teams sure to squeeze any premium in pricing that has been on offer. That said, impetus to spread tightening seems to have lost momentum, as valuations run into a bit of a wall. Financials also saw a week of profit taking, following a recent run of strong relative performance.

Looking ahead

US election polls remain relatively close at a national level, though the momentum appears to be with Trump in the swing states with less than 6 months to go to polling day.

Meanwhile, a Wall Street Journal article casting doubt on the cognitive capabilities of Biden has continued to undermine the president's position, as voters question his capacity to see out a coming four-year term. Senator Shelley Moore Capito appeared to capture the mood, observing that a couple of years ago she found Biden to be as 'sharp as a tack'. When asked whether this characterisation would still apply, she noted that this was very open to question. Others have been far less respectful and polite in their comments. Moreover, it is hard to see how the president can do very much to really shift this overarching assessment, given that he isn't getting any younger any time soon.

With upcoming CPI reports, payrolls and the FOMC all ahead of us over the next few days, so the coming week promises to be an interesting one in financial markets. We have felt that price action would be constrained for a time longer, until it becomes more apparent whether inflation is trending lower once more and interest rate cuts should follow, or if the current level of monetary restraint may need to be maintained over the entire second half of the year.

It seems unlikely to us that the FOMC would move interest rates after September, in advance of the November election. Therefore, this means that the September FOMC outcome could be pivotal and data in the next couple of months should help to determine this outcome.

Keeping an open mind and being prepared to take a view if markets get ahead of themselves, in either direction, seems the right way forward to us from now. Notwithstanding higher Treasury yields in the year to date, rallying equities and credit markets mean that Financial Conditions indices sit at levels which are slightly easier than the average level that has prevailed, based on the last 10 or 20 years of data.

In this context, if stocks and credit continue to trade well over the summer, then this will continue to mitigate the need for Fed action.

Of course, a material part of the rise in stocks is solely a function of moves in the Nvidia price itself. It seems the AI boom is in full swing and as data centres continue to add capacity, it is conceivable that models will have consumed the entirety of the information available on the internet by the end of next year.

At that point, the desire to add capacity could slow, but until then it seems hard to stand in front of a steaming train. Moreover, with robots now investing, one wonders how AI is programmed to keep wanting to buy stocks in its very own self. For sure, there will be plenty of unintended consequences of this development, which will come to impact all of our lives in due course. Indeed, with US voters faced with choosing between an increasingly frail Biden and a convicted Trump, maybe a robot in the White House would be no bad thing….

Notes to Editors

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