RBC BlueBay
Asset Management

Market Commentary

Euro carnage

A summer of sport will be a welcome distraction from politics!

14 June 2024 (London): A relatively benign US CPI report helped yields to rally over the past week, with hopes that a renewed downtrend in inflation may help open the door to future rate cuts. Although the Fed's dot plot played down hopes for monetary easing in 2024, moving from a central projection of three cuts this year back to just one cut, Powell's comments reiterate the sense that a first move in September remains possible, should data over the summer continue to moderate.

In this context, the FOMC will remain in a data-dependent mode for the time being. Recent economic data have been mixed, with some patches of weakness and other readings showing ongoing strength. However, we are inclined to reflect that interest rates staying much higher for longer, than had previously been anticipated, are now starting to weigh a bit more on overall activity.

For the time being, it looks as if we may be heading towards a relatively soft landing in economic terms, and this continues to support equities and credit. Yet we would note that if this premise holds, then it is unlikely that rates will decline by too much in the course of the year ahead.

We have just had two consecutive, better inflation prints, yet inflationary risks have not disappeared. Moreover, easing cycles in the mid-1990s may serve as a guide not to expect more than 75bps in total cuts, unless the economy slows into recession.

From this standpoint, we continue to have a relatively constructive view on 2-year Treasuries, but don't see much value further out the curve, given the extent of inversion in yields.

Moreover, we continue to think that ongoing fiscal easing and elevated deficits will put growing pressure on long dated yields over time, as investors demand an increased term premium for longer dated securities.

On this basis, we continue to think the biggest opportunity in US rates remains a curve steepening trade, rather than an outright directional one, for the time being.

Last weekend's EU elections confirmed a shift towards parties of the hard right across much of the continent, as the polls had largely projected. Relatively speaking, Germany's AfD performed well at 16%, outscoring Scholz's socialists, notwithstanding a series of scandals that have rocked the party. However, the absolute share of the vote is not far from prior historic levels and there is not much of a sense of the AfD gaining ground.

Meanwhile, green parties across the EU stood out as the biggest losers, with voters clearly rejecting an agenda which has pushed for a rapid move towards net zero emissions, at a material cost to everyday consumers. Although we doubt that the direction of travel in Europe has changed with respect to the climate agenda, it seems right to think that progress towards targets may come at a more moderate pace in the quarters to come, with protest groups such as the farmers lobby having the upper hand for the time being.

Yet, the big political shock came not from the results of the EU elections themselves, but rather the reaction of President Macron in France on the back of this. A decision to call snap French parliamentary elections, three years earlier than had been expected, took everyone by surprise. This came on the back of his party being trounced by Le Pen's National Rally, which recorded an impressive 31.5% of French votes.

In terms of Macron's calculus, it appears that he has thought that either he can rally a coalition to stop Le Pen, and so reaffirm his mandate and halt the momentum of National Rally in its tracks, or alternatively, should the far right prevail, then he hopes they will make a mess of their time in office and thus stymie Le Pen's presidential run in 2027.

However, this has a bit of a sense of a gamble by Macron, and the coming weeks will determine if this move pays off or not. Indeed, it is possible to reflect how politicians such as David Cameron in the UK might be able to tell a thing or two about how such gambles have a habit of blowing up in your face.

The reality is that Macron is currently very unpopular with voters, with his party polling at 13.5%. He will hope that in a 2nd round run-off there will be enough motivated to band together to stop Le Pen, but we may think that he is naïve in this hope. There was a sense in the past that the far right needed to be stopped, but it is less clear that this is how citizens feel in 2024.

Moreover, if National Rally attains office and there is a period of uncomfortable co-habitation, then there is an example just across the Alps of Georgia Meloni being able to demonstrate how a right-wing party can do a reasonable job in office. This could thus only cement Le Pen's credibility, if this is the case.

Either way, this move has added a risk premia into French assets, which has been translated across all other EU assets. Macron has been a driving force towards greater EU integration and so his weakness detracts from this agenda too.

Consequently, we think that France 10-year OAT spreads can trade around 70bps versus bunds in the run-up to the elections at the end of the month, with a move to 85bps or more on the back of a win for Le Pen and National Rally. We have maintained a bearish stance on OATs for some time, based on a combination of fiscal and political risks, and we continue to favour relative value away from France.

This week, we have also adopted a modest long duration stance in German bunds, just in case we witness more of a flight to quality trade within the Eurozone, at a time when many investors have tended to be positioned net long of spread risk across sovereigns and corporates.

Today's BoJ meeting saw Ueda make limited changes to monetary policy, with JGB yields lower over the week on the back of this. A decision to defer JGB bond purchases until the end of July appears to suggest that cash rates won't reach 0.25% until September. The BoJ continues to be very conservative in terms of removing monetary accommodation, notwithstanding this fuelling a weaker Yen and driving up inflationary pressures.

In the short term, renewed hopes for lower US rates may help limit additional yen weakness. However, with the Yen above 157, it won't take much for a renewed test of 160, which prompted intervention the last time this was reached.

Elsewhere, political developments have been a major driver of moves in emerging markets in Mexico, South Africa and Brazil. In Mexico, ongoing concerns about the implementation of the AMLO agenda have kept assets under pressure, with yields higher and the peso weaker.

We think that there may be some overshooting at this point, but many investors have enjoyed the carry in Mexico for some time, meaning that there is some capitulation as losses mount and as volatility increases.

Populist comments from policymakers in Brazil have also weighed on sentiment. Meanwhile, South African assets have been staging a recovery on hopes that a government featuring the ANC and the DA (either in coalition or on a confidence-and-supply basis) may deliver a constructive path forwards.

Looking ahead

Next week, we will continue to look at the pattern in economic data to confirm, or refute, hopes for a September Fed ease. However, with another Fed meeting and plenty of time to pass before we get to the

September FOMC, we think that this is likely to constrain price action in yields on both the top side and down side, in the absence of a much clearer picture coming from the economy.

Although the weather in the UK may suggest otherwise, we are now heading towards summer and a period when newsflow and activity may moderate. However, politics remains very much in focus across Europe, with upcoming elections in the UK and France, and certainly it feels like there is plenty shifting in the landscape.

It is notable how the UK is shifting to the left as the rest of Europe moves to the right. However, it isn't the first or last time we've seen the UK dancing to its own tune. Meanwhile, we can be happy to have the Euro football championship to distract us.

As a passionate England supporter, I can only hope our promising team performs to its potential, and if we make it to another final, that I don't end up confronted by hooligans and featuring on another Netflix documentary! Hopefully, a happier summer and better weather awaits….

Notes to Editors
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