RBC BlueBay
Asset Management

Market Commentary

Age concern

Time is not on Biden's side

5 July 2024 (London) – Long dated US yields rose at the start of the week, as concern around Biden's plummeting poll ratings, in the wake of the recent presidential debate, led investors to price in a Trump victory and a Republican clean sweep, with a probability exceeding 80%.

Such an outcome would be fiscally expansive, with Trump committed to further tax cuts. As this scenario came into view, so the US yield curve bear steepened, on concerns that debt worries would lead investors to demand an increased term premia to hold longer dated assets.

Meanwhile, some ongoing softening in economic activity has been supporting the shorter end of the yield curve, with the market continuing to discount a probability around 70% for a first Federal Reserve rate cut in September. In this context, business confidence surveys have indicated a moderation in demand and a number of labour market indicators have also softened somewhat.

Later today, the upcoming payrolls report will be closely watched, as always. For now, there is nothing in the data which appears to suggest recessionary developments. Therefore, risk assets have been supported by a narrative that a gentle moderation in economic activity can open the door to lower interest rates, without too many adverse consequences.

Next week's US CPI data will also be very important in assessing implications for future monetary policy. In this respect, market estimates have CPI dropping to 3.1% y-o-y in June, which would be welcomed by the FOMC, if these estimates prove accurate. However, there will be two further CPI prints for July and August, prior to the September FOMC meeting.

Moreover, we think that the recent downshift in CPI may stall during Q3, with inflation remaining stuck around 3%. In this context, we could see the Fed cut rates in September, if activity data continue to trend a bit weaker, but this is not a foregone conclusion.

From this standpoint, market pricing of a September easing, which stands around 70%, appears broadly appropriate in our view. In the short term, we would be surprised to see this implied probability rise much above 80% or decline much below 60%. In this way, the front end of the yield curve can be somewhat anchored as we move into quieter summer markets – barring a much more material data surprise.

Meanwhile, with pressure for Biden to step down coming from within an increasingly desperate Democratic Party, the past few days have seen a flurry of speculation, and then denial that the president is considering his withdrawal from the race. Procedurally, it may be difficult for the Dems to oust Biden at their upcoming convention, given his resounding win across the Primaries, unless he volunteers his resignation himself. Without doubt, there is now intense pressure on Biden to demonstrate his capabilities to a sceptical audience, and it is easy to see this pressure continuing to build to a point, where he finds this hard to tolerate. The incontrovertible reality is that all of us lucky enough to live into our 80s will come to learn that our levels of mental sharpness and acuity will be in decline at that point. For some of us, that decline will be steeper than it is for others. Yet with the president unable to turn back the clock and grow any younger, it will be incredibly hard for him to shake the perception amongst voters that he is simply not fit to hold the highest office in the country for another four years.

Should Biden depart, Kamala Harris is the easiest alternative selection for the Democrats already on the ticket. However, conventional wisdom in Washington has tended to cast doubt on her abilities, and it is questionable whether the party will quickly be able to unite around a credible alternative candidate to replace POTUS.

Yet such is the visceral fear of another Trump presidency that desperate Democrats may be forced to put aside their differences, and there is still plenty of time ahead of a November vote to potentially turn things around. From that point of view, recent developments may actually start to make a Trump victory and a clean Republican sweep look less likely. In that context, it has been noticeable that Trump, himself, has refrained from piling in on Biden when he is already weakened, knowing that a replacement candidate could throw the race wide open once more.

Subsequently, bear steepening at the start of the week has turned around in the second half of the week. Yet, we continue to think the trade to a steeper curve over the medium term is the right thing. In the same way that we always thought that an extended period of negative interest rates made little sense, we would also observe that it is anomalous for yield curves to remain inverted, for anything other than relatively short periods of time.

We are now approaching the second anniversary since US 2-30's curve went to a negative slope, and we would be very confident that this relationship won't persist for too much longer. Although we project only modest monetary easing in the coming 12 months, we expect further pressure on longer dated yields, as fiscal concerns continue to build beneath the surface.

Also, with investors in fixed income being burned by the negative carry from owning duration, so the appetite to own longer dated bonds is declining, just as government supply continues to go in the other direction.

Meanwhile, in Europe, all eyes have remained on France. It now appears unlikely that the National Rally will achieve an outright majority in Sunday's poll, despite being the biggest party in parliament. Macron might be happy that a 'cordon sanitaire' against the hard right has blocked Le Pen's path to power.

Yet this will be a pretty hollow victory, and as investors look towards the presidential vote in 2027, so Le Pen and her party look to emerge from this campaign further strengthened. Moreover, a government left in paralysis, as parties squabble in an unholy coalition, is likely to do nothing for the support of the incumbents. This could easily lead to rapid defections and a broken administration.

In that case, Macron will be blamed for a petulant decision to call an election that has led to political paralysis. Within the French system, another election is not permitted within 12 months and so there may not be too much to discuss for the time being. However, there is a real sense that the genie is now out of the bottle. Political risk in France has been unleashed and is unlikely to go away any time soon.

In the short term, we think there can continue to be some short covering in France, on the back of relief that the National Rally has not taken power. But with this taking 10-year spreads on French OATs from a wide of 80bps down to 65bps, we are not sure this move will have much further to run. We think that a return to the tights, at close to 50bps, is now unlikely and so any further rally in French assets, as investors close hedges once this weekend's vote is out of the way, is likely to prove an attractive entry opportunity to sell French assets.

On a medium-term view, we can easily see France trading wide relative to Spain, prompting some need to re-define what constitutes the EU periphery, if such a concept is really valid anymore. Longer term, we would also flag that with the wrong political and policy mix, there is nothing to stop France trading at similar levels to Italy, based on the current trajectory. French fiscal and political risk has often been overlooked, and without doubt France is coming from a much stronger starting point. However, it is naïve to take France's position at the heart of Europe for granted.

By contrast, the UK general election hardly set pulses racing. A large Starmer victory was long assured, with the only real uncertainty being the future for the Conservative Party. We think that in the short term, Starmer might benefit from a honeymoon period. Who knows, if only the England football team could stop misfiring, a victory at the Euro Championships could actually see a proper summer bounce!

With UK CPI around target, it is likely that the BoE will cut in August, having revealed a preference to do so. However, we think that the optimism around the UK may be short-lived. Fiscal worries can end up dogging the Labour government, frustrating their agenda and stymying the hopes of those who have voted for them.

Meanwhile, inflation will pick up in the autumn and we can see UK CPI back at 4% later in the year, limiting the scope for the BoE to deliver as many cuts as currently discounted. That said, we have closed short UK gilt positions in the past week (having already closed out shorts on the pound when the election was announced). Near-term optimism could see UK assets perform somewhat better, and we think there could be opportunities to return to a short stance on gilts at a more advantageous entry level.

Elsewhere, European credit markets have mirrored moves in French spreads. In EM, ongoing recovery in Mexican and Brazilian assets has benefitted local rates and FX.

In Japan, yields have continued to rise as the yen has fallen. The BoJ meeting will be a major focus later in the month, and for now we see the probability of a rate hike in conjunction with an already announced reduction in bond purchases, as underpriced by financial markets. Such a move could herald a more material change in the direction of Japanese monetary policy. In that context, this could yet serve as an inflection point for the yen, which has endured a wretched run over the course of the past year and more.

Looking ahead

There is plenty in terms of economic data, plus political intrigue, to keep us interested in the coming week. Looking beyond this, quieter summer months may be around the corner, though clearly there are plenty of uncertainties in the macro landscape, which could be a material driver of price action in the days ahead.

Returning to the debate around Biden, it remains pretty shocking to think the Democratic Party have allowed themselves to get into the position they are in today. After all, it has seemed pretty clear for some time that their man wasn't going to be up to the task of running for, nor completing, a second term in office.

Although polling data may have suggested that other potential candidates fail to poll much better against Trump than Biden does, the whole problem with Joe is that time is simply not on his side. One hopes that those advising him will encourage him to bow out gracefully, as it becomes clear that he is mortally wounded in this year's race for the White House.

By contrast, the idea of Biden over-exerting himself in desperation to prove his vigour could easily be a strategy which backfires badly. Meanwhile, if some youthful energy can be drawn into the race (on the assumption that Harris, if she runs, doesn't end up with Sanders as a running mate), one wonders how long it will be before the spotlight falls back onto Trump. After all, Biden has made him look like a spring chicken, which he most definitely is not!

Notes to Editors

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