RBC BlueBay
Asset Management

Market Commentary

Orange may be the colour of the moment, but at least England overcame the Dutch at the Euros!

It's tanning season….

Key points:

- The Fed seems content that slow progress is being made in bringing inflation back towards target.
- While a September rate cut is likely, it's not a forgone conclusion.
- French elections delivered a surprise outcome, with a coalition keeping Le Pen's National Rally from power.
- Broadly speaking, we still look for easier fiscal policy across the EU as a whole.
- Politics in the UK appear set for more of a period of calm and stability under Labour.

12 July 2024 (London): US yields rallied in the wake of June CPI data, with headline and core inflation declining to 3.0% and 3.3%, respectively. Broadly speaking, we sense that the Fed will be content at further progress towards bringing inflation back towards its 2% target.

Nevertheless, we expect the upcoming July FOMC meeting to be a non-event, with much greater focus on whether September may mark the juncture when the Fed decides to start to ease its policy stance. Yet, with futures markets indicating a cut as almost fully priced, it is worth noting that we will have seen a further two CPI inflation releases by the time we get to the September FOMC.

Looking at base effects during Q3, we think it is unlikely that the annual CPI rates will decline much further in the coming two months and so in September, inflation will still remain higher than Powell and colleagues would like to see.

However, given the lags in monetary policy, the most likely outcome remains for a September cut, with broader indicators of economic activity pointing to some moderation. Yet, given the risk of possible upside inflation disappointment, a September ease is not a completely forgone conclusion, and we have seen over the past year when markets have made a mistake in seeking to front-run rate cut expectations too much.

Looking beyond September, we think markets may currently price more monetary easing than is warranted in the following 12 months, given prospects for additional fiscal easing, which can support economic activity. Notwithstanding the large deficit, until bond markets start demanding more of a term premium, fiscal restraint seems unlikely to materialise.

Given that current baseline Fed projections for the coming year actually expect fiscal tightening, with prior (temporary) tax cuts not being automatically rolled, then one can understand that a revision in this trajectory would also have implications for the Fed's implied path.

In this context, we think that if a recession is averted, as may seem currently realistic, then terminal US rates in the cycle may lie above 4%, with inflation also settling in a range around 3%. Consequently, should yields rally materially on the back of a first rate cut, then it could be time to return to a short duration stance. Yet, for now, the only real conviction we maintain is with respect to US yield curve steepening.

Last weekend's French elections delivered a surprise outcome, with the left wing NFP coalition winning the most seats, with a total of 188 in the National Assembly. Le Pen's National Rally (RN) still won the most seats of any single party and recorded 37% of the vote, well ahead of the 26% total for NFP. However, tactical voting designed to keep the far rightfrom power meant that earlier hopes from the RN of an absolute majority fell well short.

Indeed, the 142 seats won by RN saw it place behind Macron's Ensemble centrists, who recorded 161 in the final outcome. Yet, any satisfaction on the part of centrists, in ensuring that a 'cordon sanitaire' stopped the success of RN, is tempered in the knowledge that much of the fiscal and social agenda on the hard left is potentially just as toxic as the agenda on the hard right.

Looking ahead, France seems set for a period of Parliamentary paralysis. It is difficult to see a constructive path towards a coalition government, with more moderate socialists unlikely to partner with centrists, as this will probably lead to widespread disaffection from their voter base.

Consequently, a minority government appears the most likely outcome, though it may be a few weeks until the picture becomes clearer. Little gets done in France in August, and Paris will also be focussed on hosting the Olympics. Yet, with a budget needing to be drafted in the fall, an outcome will need to be agreed by September. Further Parliamentary elections are not possible for another 12 months and although there may be discussions of a technocratic government being installed, the reality is that in other countries where this has been agreed, this outcome has only come together after a period of turmoil and stress.

In summary, political paralysis can help contain moves in spreads for the time being. Presidential elections in 2027 remain a long way off and we should understand that a lot can happen in three weeks in politics, let alone three years.

Yet, our sense is that the French political backdrop looks a lot worse today than it did before the election was called by Macron, one month ago. Macron is materially weakened, and we can see support continuing to drift to the far right. This seems particularly likely if Le Pen can follow the Meloniplaybook and sound somewhat reasonable, whilst those such as Mélenchon on the hard left make unrealistic demands.

Consequently, we see an effective floor on OAT spreads at 60bps versus bunds, and any strength in French assets could be an opportunity to add shorts, on a relative basis. Certainly, it strikes us that OATs can trade wide relative to Spanish bonos going forward, and therefore past notions around what constitutes the periphery and the semi core of the Eurozone are now well out of date.

On a longer-term view, what is bad for France may be bad for the EU as a whole. However, in the shorter term, if paralysis characterises French politics for the time being, it is possible to see volatility drop over the summer.

On the back of this, it is understandable that investors may position for something of a summer of carry. Broadly speaking, we still look for easier fiscal policy across the EU as a whole, and the resultant abundance of government debt supply could see corporate spreads continue to outperform somewhat, as government collateral cheapens relative to other assets.

The ECB is expected to cut rates again in September, after keeping policy on hold this month. Yet, the extent to which inflation drops and rates can decline in the months ahead may be tempered by the broader fiscal and growth backdrop. On this basis, bund yields >100bps below cash rates don't appear to offer much value in absolute terms, and more opportunities may be found on a relative value basis.

In contrast to events across the English Channel, politics in the UK appear set for more of a period of calm and stability under Starmer. The Labour leader has begun to lay out his priorities in line with the election manifesto pledges. It will be interesting to see how much of their agenda can get done and how long a honeymoon period in office may last for. However, for the short term, it seems reasonable to think that voters and markets will be inclined to give them the benefit of the doubt.

Next week's CPI release appears the main catalyst, which could derail an August rate cut should it come above expectations. However, we are more bearish around inflation as we move later in the coming quarter,

and from this point of view, should the BoE move in the August window, it could easily prove to be the only rate cut they are able to deliver in 2024.

Pressure on the yen has seen the MoF intervene once more, in order to support the Japanese currency. Yet with intervention tending to have only a temporary impact on the exchange rate, so we see interest build towards the BoJ policy meeting at the end of this month. As it's a quarterly meeting, the BoJ will be updating its forecasts and with models updated for a weaker currency, this infers further upside risk to prior BoJ projections.

Our sense is that the discussions in Japanese policy circles are shifting. Ueda has been slow to act and is perceived as a policy dove in his tenure to date. Yet, we think that he will want to correct this narrative at some point. In this context, hiking interest rates to 0.25% in conjunction with announcing a schedule of reduced bond purchases, would signal a more material policy turn, which could see yields higher and the yen firm.

For now, the best risk/reward trade remains a short in JGB rates. However, once a policy shift starts to occur, the FX could become a more interesting channel to play a Japan reflation view. We would note that part of BoJ caution in letting yields rise over the past year is for fear of a disorderly market move as they back away from an extended period of Yield Curve Control. However, with the JGB curve positively sloped, so domestic assets could easily see increased asset allocation flows, onceyields are allowed to correct higher. In this context, although we remain confident that 10-year yields will breach 1.25% in the coming months, a move above 1.5% appears unlikely in our view, before the end of 2024.

Elsewhere, FX continues to be relatively muted, though the dollar has softened in the wake of the CPI report. It was previously notable that the dollar struggled to rally when newsflow out of France was at its most troubling. Consequently, the greenback has slipped somewhat in the past week. Yet there does not seem a lot of appetite to run a lot of FX risk across markets, with many investors seemingly struggling to capture much alpha in the space, over the past year or two.

Currently, we find ourselves skewed towards a weaker dollar, largely thanks to long EM FX positions which we have added on the back of idiosyncratic weakness during the course of June. Mexico and Brazil continue to recover from a lurch weaker last month, which forced out a lot of existing positions. Generally speaking, a lower volatility summer could favour carry and EM local as an asset class.

Looking ahead

With payrolls and CPI now out of the way, there seems little consequential US data to drive markets over the remainder of the month, and so attention will turn towards the FOMC meeting at the end of July. That said, we expect this meeting to be something of a non-event in policy terms, with much more of a focus falling on the September meeting.

We think that September represents the last juncture for the Fed to ease policy, prior to November's election. As mentioned previously, we think that Powell would ideally like to deliver a first cut, as long as data can support this. Therefore, if economic activity continues to show signs of moderation and CPI does not deliver further upside surprises, the market pricing on the September contract appears largely appropriate.

Otherwise, it seems that, for now, Biden remains determined to stay in the Presidential race. Indeed, in an attempt to come across as more youthful looking, it may appear that POTUS has taken a leaf out of Trump's playbook and headed to the tanning salon. Of course, it is possible that he has developed too much of a liking for Tango fizzy drinks….but there is something mildly surreal to witness the race for the White House being played out in hues of dayglo orange. Indeed, it seems that orange is the colour of the season. Just pleasing to see that this didn't stop the England football team, when it came to the Dutch :)

Notes to Editors

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