



Market Commentary

Trump ascendant

We are hopeful that calm heads can prevail

Key points:

- Expectations concerning the extent of rate cuts in the US remain excessive, given that we see the US economy avoiding recession and inflation remaining around 3%.
- The chances of Trump winning re-election look stronger than ever.
- Policymakers across Europe the Continent are in dismay at the notion of Trump's return. The threat of US tariffs weighs heavy.
- In Japan, the focus is more on prospective changes in monetary policy than fiscal.
- Beyond further political shocks, we expect markets to see reduced volatility, at least until important ECB and Fed meetings in September.

19 July 2024 (London): Treasury yields moved slightly lower over the past week, notwithstanding firm data on retail sales, which helped to lift the Atlanta Fed Nowcast projection of Q3 GDP to 2.7%, from a low of 1.5%, at the start of July. Comments from Fed Chair Powell acknowledged recent progress towards the Federal Reserve's mandate objectives, and this helped to sustain optimism surrounding future rate cuts.

Futures contracts now fully discount a move from the Fed in September and a few commentators have even speculated that a first move could come as early as this month's FOMC. A July move seems extremely unlikely, though we have held a September cut as our baseline expectation for a long time.

That said, we have witnessed on several occasions during the past year how many market participants have wanted to frontrun the idea of Fed easing, and we may be witnessing a repeat of this at the moment. In our eyes, there remain an excessive amount of rate cuts expected in the coming 18 months, given that we continue to see the US economy avoiding recession and inflation remaining around 3%.

Of late, we have maintained conviction in a 2-30 yield curve steepening trade and continue to believe that this position has room to perform further, notwithstanding recent curve moves in this direction. That said, our conviction is now more that this will manifest through longer-dated yields rising from current levels than from short-dated maturities rallying further. Broadly speaking, this leaves us skewed towards fading the recent rally in Treasury yields.

The failed assassination attempt on Donald Trump has seen the former President's rise all the stronger, with powerful images of the leader – bloodied but unbowed – dominating news coverage across the globe. Coming on the back of coverage of Biden struggling to demonstrate his levels of acuity and fitness to govern, the comparison between the two candidates could not be much starker.

Betting sites now place an 85% probability of Trump winning re-election in November, with a Republican clean sweep seen as quite likely. That being the case, calls for Biden to step down are only getting louder and the implied probability that Biden is the Democrat candidate, by the time of the election, has fallen below 40%. Yet, for now the President soldiers on, to the seeming delight within Republican ranks.

Indeed, confidence within the Trump camp has seen the selection of JD Vance as a Vice Presidential running mate. In many respects, Vance can be seen as a true Trump acolyte and potential successor

beyond 2028. In this case, it is notable that Trump did not feel it necessary to select a more centrist, less populist candidate in order to help broaden his appeal. In this context, we feel that this gives a hint in terms of what to expect in a second Trump administration.

Assuming Trump does prevail later this year, he won't be seeking re-election at the end of his term and so he will likely be emboldened to advance his agenda as assertively as he can. This means more expansive fiscal policy, with an extension of past tax cuts and additional new measures also being planned. It means a clamp down on immigration. It also means tariffs on overseas imports and a more isolative stance for the USA.

This policy mix under Trump would likely add somewhat to US inflation data in 2025 and beyond. This should mean that interest rates and bond yields should stay at higher levels, relative to an outcome where a Democrat President is elected to office. Indeed, existing Fed projections are based on prevailing fiscal baseline estimates, which have assumed an amount of fiscal tightening, not easing, in the coming year.

Furthermore, any short-term additional boost may be seen as pushing back the timing of recession risk towards 2026, and this is a factor helping to continue to support risk assets. That said, there is some narrative that Trump will want to use his weight to prevail on the Fed in order to deliver rate cuts, and one can imagine a relationship between the incoming president and Chair Powell coming under pressure very quickly after the election takes place.

Trump's return to the White House is also an outcome that has been feared in European capitals for some time. Policymakers across the Continent are left in dismay at the notion that the US will soon pull back on support for Ukraine, and this may even trigger a push for a peace deal with Russia before the November US vote takes place.

It is clear that there needs to be an aggressive step change in defence spending in the EU. However, the bloc is suffering in terms of quality of leadership, with Scholz in Germany remaining mostly on the sidelines and Macron fully marginalised due to domestic woes.

This may see Brussels seeking to push the agenda, though it is far from clear whether many ambitious objectives will really get off the ground. The threat of US tariffs also weighs heavy on Europe, whilst initiatives around a global climate initiative seem to lie in tatters.

In aggregate, we still look for net EU fiscal expansion and with populists on the advance across the continent, we believe that this will be the direction of travel for some time to come. This may also end up supporting EU growth and raising inflation somewhat.

This, in turn, may act as a limiter on further ECB rate cuts. In the wake of an uneventful ECB meeting this week, we still expect a cut in September, along with the Fed. However, thereafter it may become more difficult for the ECB to cut rates a long way in the quarters that follow.

From that point of view, bund yields don't represent much value. However, we struggle to have much directional conviction on EU fixed income for the time being, seeing clearer opportunities in other markets.

On a relative value basis, we may look for opportunities to adopt a more cautious stance on sovereign spreads in the fall, as political concerns around the French and Italian budgets are pushed to the surface at that time.

In France, Braun Pivet's selection as head of the National Assembly was a surprise win for centrists and opens the door for Macron to select a centrist prime minister. However, we see any coalition government as intrinsically fragile, and it could quickly fracture. Yet, in the short term, we think volatility will be contained, and so see it as largely appropriate to position for carry over the remainder of the summer.

UK CPI data were slightly stronger than market expectations this week. Service inflation remains at 5.7%, with core prices at 3.5%. Headline inflation at 2.0% gives the BoE a window to potentially cut rates in August.

However, as we have been flagging, we see inflation trending higher again in the coming months as positive base effects drop out of the annual comparisons. From this perspective, any BoE easing could be 'one and done' for the time being.

Meanwhile, UK GDP prospects appear a little firmer, and so it is not clear to us that there is a strong imperative for the BoE to cut just yet. Some fiscal expansion is also expected in the UK in the months ahead, though for now, the incoming Labour government is happy to tread carefully, aiming to reassure markets of their financial responsibility.

Meanwhile, in Japan, the focus for markets is much more on prospective changes in monetary policy than fiscal, with the BoJ meeting on 31st July set up to be an important event, in what could be a relatively quiet summer. With respect to bond purchases, we see these reduced from yen 6 trillion to 4 trillion, and possibly tapering lower.

We also think there is an understated chance that Ueda announces a small interest rate increase to 0.25% at the July meeting, signalling an intent to normalise Japanese monetary policy, with inflation continuing to exceed the 2% inflation target.

Were this to occur, we may see a larger move up in yields, which may be a moment to start to reduce JGB shorts above 1.25% on 10-year bonds. Meanwhile, should markets become more convinced in the BoJ and a narrative that the policy gap relative to the US will close, this could mark a turning point for the yen.

Intervention alone is unlikely to turn the trend in FX, but clearer evidence of a closing policy rate gap could be the catalyst the yen has needed to make a more sustainable comeback.

In emerging markets, prospects for US tariffs under Trump are largely negative. However, we would note that in the period when the probability of Trump winning has been increasing, since the last presidential debate, EM assets have been faring relatively well.

Real yields in a number of markets remain very attractive and although we have often observed that it is the assets whose prices have gone up the most are the ones which keep performing in 2024, we continue to believe that valuations cannot be ignored for extended periods. From this perspective, we see bonds in countries such as South Africa, Mexico and Brazil, finding buyers in the weeks ahead.

Elsewhere, in credit markets, volatility remains relatively subdued. New issuance will pick up after Labour Day, at the start of September, but will likely be muted until then. From this perspective, we see positive technicals continuing to support the valuations of IG-rated corporate securities, with demand exceeding supply for the time being.

The valuation of credit looks relatively rich versus government bonds, though is more attractive relative to swaps, highlighting the structural cheapening of government bonds relative to other fixed income assets at a time of abundant government bond supply.

Looking ahead

We are now moving into the main summer holiday season. With important meetings for the Fed and ECB coming in September, we have thought that volatility could continue to subside in the short term.

If yields continue to trend lower in the short term, we are contemplating to add short duration trades, but we feel we can be patient for the time being, hoping for a more compelling entry opportunity on any new trades.

We have seen how political shocks have driven market price action over the past year. We would reflect that the direction of travel in politics and geopolitics globally appears to point towards more volatility, as we look towards 2025 and beyond.

With Trump in the White House, we will become accustomed, once more, to his pugnacious style of communication and bombastic approach.

That said, we have sometimes reflected on the Argentinian footballer Diego Maradona, who would throw the opposition off balance by jinking one way and then the next, when in reality the ball itself would actually travel in a relatively straight line.

From a political standpoint, Trump has been a master in controlling the narrative and confusing his opposition. In this way, what Trump says is often more alarming than what Trump actually does from a policy perspective.

From this point of view, a return of Trump to the White House will certainly create some winners and losers. Yet for all of the alarm, from a purely US perspective, the agenda he pursues could continue to perpetuate economic growth for the time being, even if you wonder whether there will be a day when the commander-in-chief goes to battle against a disgruntled bond market, only to learn that there are limits on his power after all.

Beyond this, it is interesting to postulate how a literal brush with death could end up changing Trump from a psychological point of view. You wonder yourself, would such an event leave you feeling more vulnerable or more invincible as a person?

Charitably speaking, one might hope that Trump reflects on how lucky he is to be alive and give thanks to God, pointing towards a desire for a more conciliatory tone.

Worryingly, however, it could equally drive a determination to combat his detractors and opponents with even more force and ruthless determination, noting that he was quick to stand up in the wake of the shooting, urging his supporters to 'fight'. With this latter behaviour response seeming more likely than the former, in our analysis of Donald Trump as an individual, there is also a sense that there may be increased self-vindication in his pattern of behaviour.

All of this could suggest that if and when things do go wrong, things could become pretty messy, pretty quickly. Yet in the shorter term, we are hopeful that calm heads can prevail.

Notes to Editors

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