RBC BlueBay
Asset Management

Market Commentary

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While the world turns to the Paris Olympics, macro markets turn towards Tokyo

Key points:

- Thoughts of a quiet start to the summer have been dashed with the recent pickup in cross asset volatility.
- Political developments continue to provide macro markets with plenty to ponder.
- Core government bond curves have steepened aggressively.
- In Continental Europe, PMIs continue to point towards subdued growth.
- In the UK, the BoE is faced with wage and services inflation remaining stubbornly high.
- In Japan, expectations are rising for a more material policy action.

26 July 2024 (London): Far from the summer lull, core government bond curves steepened over the past week, as heightened volatility in equities on the back of Q2 earnings and unwinds across various asset classes cascaded through overcrowded positions.

The VIX topped 19 for the first time since April, while in FX, the yen and yuan saw outsized moves.

Fixed income investors clamoured around the relative safety of short maturity bonds, awaiting a more fundamental catalyst to drive direction.

Moreover, political developments continue to provide macro markets with plenty to ponder, with this week's earthquake seeing President Biden calling quits on re-election, setting up a Trump versus the current VP Harris showdown in November, re-energising the Democrats in the process.

With Biden departing the race, it will be interesting to see how Trump approaches the contest now that he is facing a younger, more invigorated candidate in Harris.

Just last week, some betting sites placed a probability as high as 85% on Trump winning re-election in November, after a few good weeks for him on the news front. However, this has swiftly dropped back down to 60% as the Democratic engine rallies around the new candidate, with donors having already mobilised $100m to the cause.

Having said that, Harris will likely face a monumental task in the three months ahead. Her track record on economic policy (and how to combat Americans feeling financially worse off) is non-existent and she lacks credibility on the biggest issues, such as immigration and border security.

As we hear more on policies from both sides, we continue to expect the unexpected in this race.

Turning to the Fed, futures contracts now fully discount a move in September and a few commentators have even speculated that a first move could come next week. However, we think this seems extremely unlikely, with Powell and the FOMC wary of signalling too early, particularly given there will be two more CPI prints between now and the September meeting.

Further out, we think the market is discounting too many cuts out to the end of 2025, given that we continue to see the US economy avoiding recession and inflation remaining around 3%. We think a 2-30 yield curve

steepening trade is a position with room to perform further, despite the large moves this week, with the view that this will manifest through longer-dated yields rising from current levels, rather than from short-dated maturities rallying further.

Broadly speaking, this leaves us skewed towards fading the recent rally in Treasury yields.

In Continental Europe, PMIs continue to point towards subdued growth in manufacturing with the services sector expanding moderately.

We continue to think bund yields don't represent much value here, given the likely path is for fiscal expansion over the medium term once push comes to shove and policymakers get their act together.

In general, we struggle to have much directional conviction on EU fixed income for the time being, seeing clearer opportunities in other markets.

With the Olympics starting in Paris, French politics will likely take a breather for a month before resuming its uncertain path in September.

In the UK, the BoE meets next week after recent disappointments on the data front – with wage and services inflation remaining stubbornly high. However, with headline inflation at 2.0% but projected to move higher in the coming months, the BoE has a narrow window (and the cover) to potentially cut rates next week.

From this perspective, any BoE easing could be 'one and done' for the time being.

Market attention will also turn to the new government's review of public services and the huge funding hole inherited from the previous Tory government. The promise to provide teachers and healthcare staff with significant pay rises adds to the deficit and it seems the time has come to make some very bold choices on taxes revenue, increased borrowing, and current spending.

It seems as if Labour's honeymoon period is over before it even got started.

In Japan, we look forward to another highly anticipated BoJ meeting next week with expectations rising for a more material policy action notwithstanding movements in the yen. We think there is an understated chance that Ueda announces a small interest rate increase to 0.25%, signalling an intent to normalise monetary policy and step away from QE.

Recent data has corroborated the inflation view, with services PPI topping 3% and Tokyo CPI still above 2%. Moreover, political noise is growing, most notably from LDP Secretary General Motegi, calling for more clarity and guidance around the rate path.

We continue to view fair value on JGB yields closer to 1.25% on 10-year bonds.

Meanwhile, with the yen already moving, interest rate rises from the BoJ could solidify the turning point. Intervention alone has its limits, but clearer evidence of a closing policy rate gap could be the catalyst the yen needs to make a more sustainable comeback.

The aforementioned positioning unwinds in popular funding currencies, like the yen and yuan, has had a significant impact on EM currencies – in particular, it has led to further unwinds of popular carry trades, causing sharp weakness in Latin American currencies.

We remain neutral on the EM FX asset class, but still see value in a number of local rates markets – softening global growth and declining inflation should support bonds in countries where real rates are already high, namely South Africa, Mexico and Brazil.

Corporate credit edged wider over the week with US credit slightly underperforming. In general, the market has been quieter, particularly in Europe, as we move into the summer period, but fund flows have re-accelerated post French election volatility and insurance buyers have resumed their buy programs.

The main story has been the UK water company Thames,where we saw the first rating agency (Moody's) move the company rating into HY territory, with many expecting S&P to follow. Trading volumes in the issuer picked up markedly and the range of investor views is extremely broad with some expecting severe haircuts, whereas others see a path to new equity and improved terms from Ofwat. We do not have a position.

Looking ahead

Thoughts of a quiet start to the summer have been dashed with the recent pickup in cross-asset volatility. However, we think volatility should revert in the short term until a more fundamental catalyst appears – be it important meetings for the Fed and ECB in September or the US presidential election in November.

The re-invigorated presidential race makes macro for the rest of the year much more interesting. While the 'Trump trade' has had a setback, with three months still left to go until election day, more twists and turns are to be expected.

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

For now, while the rest of the world turns to Paris next week – this time for the Olympics rather than the politics – macro markets will be looking towards Tokyo – over to you Ueda, Kishida and the yen! As the Olympic motto goes: Faster, Higher, Stronger!

Notes to Editors

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