RBC BlueBay Asset Management

Market Commentary

Ping pong peace

When sport conquers all….

Key points:

- Market bets for imminent rate cuts intensified, following the latest Fed meeting and employment data.
- We think the market is discounting cuts more suggestive of a recession at some point, which we don't subscribe to.
- The Bank of Japan signalled its strongest intent to normalise policy and bring stability to its currency.
- The Bank of England delivered on market expectations and cut base rates 25bps to 5%.
- Geopolitical noise continues to simmer in the background, with tensions rising.

2 August 2024 (London) - Government bond yields took a sharp leg lower over the past week, as market bets for imminent rate cuts intensified, following the latest Fed meeting and employment data. 10-year US Treasury yields slid below 4%, reminiscent of the bond rally we saw at the turn of last year.

Mixed tech earnings saw jitters continue across equity markets, while in FX, the unwinding of carry trades, led by the yen, continued to put pressure on overcrowded positions. Notwithstanding the central bank action, geopolitical noise continues to simmer in the background with tensions in the Middle East rising, and with higher oil prices, in part, reflecting potential escalation risks.

Meanwhile, the race for the White House is getting closer, with some polls showing Harris edging out Trump in key swing states, though Trump still remains the front-runner in our eyes.

Turning to this week's Federal Reserve meeting, the FOMC gave little away in their prepared remarks regarding the future path of policy, opting for a wait-and-see approach, given the amount of economic data still to come between now and the September meeting.

Nevertheless, it seems the market is bound to seeing several cuts on the horizon, pointing towards a more equal balance of risks between inflation and the labour market. Moreover, with jobless claims ticking marginally higher and a weak ISM employment reading this week, markets have been quick to draw conclusions of a fast-deteriorating labour market.

We would note, however, that the labour market is very different to its pre-pandemic norms, exemplified by recent JOLTs data which showed layoffs at record lows, despite a sharp slowdown in hiring. Payrolls later today will provide more information in that regard and will be the first key data point ahead of September's meeting.

Broadly speaking, this leaves us skewed towards fading the recent rally in Treasury yields. With 80bps of cuts priced for the rest of 2024, we feel this is in overshoot territory, where fair value is between one to two cuts.

Further out to 2025, we think the market is discounting cuts more suggestive of a recession at some point, which we don't subscribe to. With inflation hovering around 3%, steepening yield curve trades led by the back end continue to offer good value in that respect.

To the contrary, at its latest meeting, the Bank of Japan (BoJ)signalled its strongest intent to normalise policy and bring stability to its currency, raising the policy rate to 0.25%, while promising to halve monthly JGB purchases by 2026.

Much of this was leaked to the press in the days prior, yet markets were still caught off-guard given how cautious aUeda-led BoJ has been in the past. It strikes us that the growing political noise seemingly didn't go unnoticed by Ueda, which called for more clarity and guidance around the rate path, given its impact on the yen (and the negative side effects on the economy).

In his press conference, Ueda kept all options open going forward, pushing back against any limit to how high rates could potentially rise, while echoing flexibility on JGB purchases in the future.

With inflation risks still tilted to the upside versus forecasts, we think further interest rate hikes are on the horizon and continue to view fair value on 10-year JGB yields closer to 1.25%. The yen broke through 150 versus the US dollar on the back of the announcement, as carry trades capitulated.

We have held the view that FX intervention from the MoF was futile, without clear and strong intent from the BoJ working in tandem. With the intent now seemingly there, you could argue there is now much better alignment between the institutions and the catalyst the yen has needed to make a more sustainable comeback.

In the end, the Bank of England (BoE) delivered on market expectations and cut base rates 25bps to 5%. However, it is not clear to us that there was a strong imperative, nor a necessity to cut rates at this juncture, so the scope for more cuts over the coming months will likely be limited, something Governor Bailey himself acknowledged.

Headline inflation is trending higher again into year-end, as positive energy base effects drop out of the annual comparisons, while services inflation and pay growth is far from what you would commensurate, with inflation returning back to 2% on a sustainable basis. From this perspective, this week's BoE easing could be 'one and done' for the time being.

Meanwhile, UK GDP prospects appear a little firmer, house prices are edging up and consumer confidence is improving. In that respect, the five MPC members who voted for a cut today may have acted too hastily, acting on a whim rather than concrete data to support the decision.

In other developed markets, on the data front, Eurozone July flash inflation came in slightly hotter than the market had been looking at, driven by continued stickiness in underlying services inflation. It has been interesting to observe how essentially no progress has been made on services inflation in the Eurozone since last November, where it has remained at 4%. This will likely limit the amount of cuts the ECB can deliver this year.

The downside surprise in second quarter core CPI in Australia saw hedge funds stop out of bets for a hike by the RBA next week, allowing the RBA to maintain its 'narrow landing' via higher for longer. We think the move weaker in the Aussie dollar on the back of the positioning flush opens an opportunity to go long the currency, which should be supported by a narrowing interest rate differential and growth.

EM currencies have seen sharply diverging performance over the past few weeks, with popular funding currencies (mostly in Asia) rallying in sympathy with the move in the Japanese yen; meanwhile, carry currencies in Latin America have remained under pressure. The rally in core rates has supported EM rates markets as well, and we continue to see value in a number of high real rate bond markets, such as South Africa, Mexico and Brazil.

Elsewhere, in credit markets, volatility remains relatively subdued. New issuance will pick back up again towards the end of August but will likely be muted until then. From this perspective, despite valuations in credit looking relatively rich from a historical spread perspective, we see positive technicals continuing, with demand exceeding supply for the time being.

UK water continued to be in the crosshairs as further downgrades from ratings agencies for Thames, which is now fully high yield, and Southern Water, likely hinder their abilities to raise required equity and cause further headaches for the regulator. Two other issuers, Severn Trent and South West Water, were able to bring new deals to market, highlighting the dichotomy between those who scored well in Ofwat's draft determination and those who did not.

Looking ahead

Despite lots of moving parts, we think volatility should revert in the short term as market participants settle over the summer period, or until a more fundamental catalyst appears. Therefore, a wait-and-see approach from an investing standpoint seems prudent, given the aggregate data to come over the coming months into important meetings for the Fed and ECB in September.

Moreover, uncertainty surrounding geopolitics and elections calls for running risk closer to home for now. The trend lower in rates markets has opened up some compelling opportunities, where we like fading the number of rate cuts priced into US markets this year, with moderate conviction.

With this week's central bank meetings behind us, it would be nice to kick back a little and enjoy a summer of love. This is certainly not the case in some regions in the world where politics and conflicts are coming to a boiling point.

Maybe we all need to take a leaf from our sportspeople at the Olympics - this heartwarming selfie of North and South Korean table tennis medallists is a lesson to us all that peace and unity is possible when good people get together!

Notes to Editors
Lydia Cambata: +44 7578 252 424
LCambata@BlueBay.com

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