RBC BlueBay
Asset Management

Market Commentary

Battered and bruised, but in better shape

Markets recover and are in a better place than they were two weeks ago

Key points:

- Markets continued their recovery after volatility spiked in response to investors closing Japanese carry trades and a troubled US jobs report.
- In our judgement, markets are probably now in better shape than was previously the case.
- In the US, macro data have appeared broadly consistent with the soft-landing thesis and the path appears clear for the FOMC to cut rates by 25bp next month.
- European markets have been relatively quiet, while UK data contained some positive news for the new Labour government.

16 August 2024 (London) - Global markets have continued to recover from the volatility witnessed at the start of last week, which had resulted in a substantial decline in bond yields, tumbling equity markets and a post-Covid high in the VIX index.

With a large part of this price action relating to a widespread closing of trades across hedge funds and CTA accounts, there is a sense that positioning is much cleaner now than it was a couple of weeks ago.

In this context, the turn in the yen has seen a material reduction in popular carry trades. Consequently, overall risk being taken stands at lower levels than was the case a few weeks ago.

In this way, markets feel a bit battered and bruised, but are probably now in better shape than was previously the case.

As a result, we expect to see some further recovery in risk assets over the course of the next couple of weeks before supply returns to credit markets once we move into September.

Meanwhile, macro data have appeared broadly consistent with the soft-landing thesis.

The Atlanta Fed Nowcast GDP forecast for Q3 remains relatively robust at 2.9% and July retail sales data remains supportive of solid activity.

Worries about a sudden slowdown in the labour market have been assuaged by the last two weekly jobless claims releases, which have shown a marked drop since recording an increase at the end of last month on hurricane-related disruption.

Elsewhere, this week's CPI release showed some further moderation in underlying price pressure. Core prices gained just under 0.2% in July, having increased by only 0.1% in June.

Inflation remains above the Fed's 2% target, and we are still inclined to believe that prices will be sticky going forward, noting that the past couple of months have been flattered by some one-off effects such as a drop in used car prices.

However, the path appears clear for the FOMC to cut rates by 25bp next month, notwithstanding data points still ahead of us.

Markets have been inclined to front-run Fed easing, discounting 100bp of monetary easing by December, with a further 100bp to follow by this time next year. We continue to believe that this is too aggressive.

Substantial Fed easing will occur if growth slows materially and, of course, this is a plausible scenario. However, in the short term, we are more inclined to believe that the economy can retain momentum, and this will mean that rates decline on a much more modest trajectory.

In addition, we continue to look for fiscal policy to remain easy. Current Fed projections are obliged to adhere to the baseline assessment, which assumes that prior tax cuts won't be rolled, as seems very likely to us.

Consequently, Fed projections are assuming that 2025 will witness fiscal policy tightening, when we feel that the opposite is much more likely the case.

In assessing value in US fixed income, it is also instructive to look at the prevailing levels of swap rates. Here, swaps have materially outperformed Treasuries in past months, such that 10-year swaps trade at a yield of 3.4%, some 40 basis points below Treasuries with 30-year rates down at just 3.3%, a discount of 80 basis points versus the 30-year T-note.

These are eye-catching levels and you might be forgiven to characterise these at looking 'weird' in many respects. In part, we can explain negative swap spreads as reflecting structural over-supply of government bonds and endemically indicative of a deterioration in the credit quality of US government debt in the eyes of market participants.

However, if this were just a credit story, then this would also show up in US CDS spreads and these remain subdued. Therefore, this differential as it stands, appears extreme in our eyes and we are eyeing opportunities to look for a reversal, though this may not be on the cards just yet, unless the fiscal narrative can change.

Another relevant point here is to highlight that longer-dated swap rates already appear to fully discount cash rates declining to levels consistent with the 2.75% terminal rate, recorded in the FOMC dot plot.

We believe that this is too low, as inflation is more likely to exceed the 2% target in years to come, rather than undershoot it, in contrast to what we witnessed in the decade of the 2010s.

Moreover, with markets already embedding such a benign forward-looking path on inflation and interest rates, we see plenty of scope for disappointment if inflation does prove a bit more stubborn and rates are slower to fall.

In this way, valuations across the fixed income curve do not appear attractive and we remain happy to retain a short-duration bias.

European markets have been relatively quiet over the summer and little news flow is anticipated in the next couple of weeks, with much of Continental Europe on the beach for the summer.

UK data contained some much-needed good news for the newLabour government, with growth surprising to the high side of expectations and inflation slightly lower than expected. We still see UK inflation trending materially higher over the next few months after base effects, which have been suppressing data over recent months, are reversed.

From this point of view, we doubt that the Bank of England will be in a position to reduce rates further before the end of the year. However, this week's data reduces the risk that July's rate cut will be viewed as a policy error in months to come.

Elsewhere, we have seen the Reserve Bank of New Zealand cutting rates in the first move of the cycle. Weakness in the Kiwi economy means further cuts are projected to follow.

Meanwhile, the economic backdrop across the Tasman Sea remains a lot brighter with the Australian economy materially outperforming on a relative basis. This has seen the A$ outperform NZ$.

Elsewhere in currency markets, firmer US data saw the dollar recouping losses, with the euro dipping, having breached $1.10 earlier in the week.

Looking ahead
Generally, this week has felt a lot quieter, notwithstanding a few notable economic data releases. The next couple of weeks look quieter on the data front and it is tempting to think that we may get something of the summer lull, which we had thought we could see at the start of the summer break.

Investors will be interested in the regular Jackson Hole monetary policy meetings, which take place at the end of August every year. However, we think that it is unlikely that we will see explicit policy guidance at this time, with the upcoming September FOMC providing the main event in terms of policy focus.

Politics could provide more volatility and in this respect it has been interesting to observe how the Harris bounce has continued to gain momentum, such that betting sites have her now the favourite to win the US election in November.

However, it may be that we are still in something of a honeymoon period for Harris and her allure could start to fade in the weeks ahead.

In all reality, the race as it stands, is probably too close to call. Yet in the short term, it seems that Trump has been floundering to lay a glove on his new opponent and seems inclined to become increasingly irritable and rambling in his comments.

Whereas markets may be rather battered and bruised after a challenging couple of weeks, and may now be in better shape because of it, the same may not apply to the former President.

Notes to Editors
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