RBC BlueBay
Asset Management

Market Commentary

Peak Harris – or is there more to come?

A lot can happen in a short time, in politics.

Key points:

- We think the FOMC will cut rates by 25bps next month, with further similar moves to follow in December and in Q1, as long as inflation data remains benign.
- Weekly jobless claims data continue to suggest a relatively healthy labour market in the US.
- There are now 73 days until US election day and the race remains too close to call, from an investment perspective.
- Geopolitical risks continue to bubble close to the surface. The situation in the Middle East remains volatile, as does Ukraine.
- In our view, a lot remains up in the air and many of the key events lay just ahead of us.

23 August 2024 (London) – Fixed income yields pushed lower over the course of the past week, partly thanks to CTA funds adding duration, plus ongoing speculation that once the Fed starts to cut interest rates in September, they will look to do so in 50bps increments.

We continue to think that such a trajectory is unlikely and see little reason why the FOMC will deviate much from its thinking over recent weeks, suggesting a 25bps rate cut next month, with further similar moves to follow in December and in Q1, as long as inflation data remains benign.

Those pushing for a more aggressive Fed easing path have been talking up the notion that the US is sliding into recession. A couple of weeks ago, this took the form of commentators quoting the ‘Sahm rule’, which suggests that a recession will follow in the wake of a 0.5% increase in the unemployment rate, above the trailing 12-month average.

This occurred in the latest labour market report, though data appeared to suggest that some of this weakness was overstated due to hurricane effects. Indeed, it is interesting to note that even Claudia Sahm herself has disavowed her earlier analysis and cautions there is no evidence to point to a recession in the US, at this point in time.

Meanwhile, the past week has seen annual BLS revisions to the monthly payroll data. This means that the exceptionally strong pace of job gains seen previously has been tempered. But in part, this is because these revisions only utilise documented workers with insurance, and so strips out jobs that may have been filled by undocumented migrants.

Consequently, we don’t see historic revisions having much bearing on forward-looking policy decisions for the Fed today. Moreover, weekly jobless claims data continue to suggest a relatively healthy labour market at the current time.

Elsewhere, US data remain consistent with economic output growing around trend. Earnings from Walmart and Target have been relatively upbeat, suggesting that the US consumer continues to spend relatively freely.

Additionally, we would observe that financial conditions, as per the Fed's own favoured measure, are currently sitting around their easiest levels for the past year. None of this suggests to us that there is any need to panic over interest rates and policy can proceed on a progressive path, unless the outlook starts to shift much more materially.

This week's DNC Convention in Chicago saw Harris in an ebullient mood. Earlier this week, she edged ahead of Trump in betting sites for the upcoming election, though towards the end of the week, it might appear that this momentum is starting to wane.

The recent rise of Harris has been relatively miraculous, when contrasted with thoughts on how she would fare as a candidate just a short time ago. Certainly, her campaign has had momentum of late, but time will tell whether this has been a honeymoon period with voters, which proves only temporary in nature, or whether she is able to kick on and consolidate gains, placing her as a clear frontrunner.

There are now 73 days to go until election day in the US and the only rational conclusion, from an investment point of view, is that the race remains too close to call. After all, a lot can happen in just a short time in politics, and it was only 54 days ago that Biden had his nightmare Presidential debate, which set the Kamala train in motion.

Looking at possible scenarios, a win for Trump, with a clean sweep for the Republican Party, remains the scenario which could be the most fiscally stimulative in terms of lower taxes.

In this context, it is understandable that as this outcome came more clearly into view just over a month ago, this saw the US yield curve steepen, with longer dated bonds underperforming on building concerns over medium-term debt sustainability. More recently, this trend has been reversed, with the curve moving flatter as Harris has advanced.

However, we would note that Harris is certainly no fiscal hawk. We expect a Harris agenda in many ways, economically speaking, to represent more of the same, as we have already seen under Biden. In this respect, it is under the current President that we have seen the US fiscal deficit sit near to 7% of GDP, notwithstanding a robust economy, which has operated at full employment.

Indeed, we think that Harris will be tempted to continue to spend and we continue to be struck at the general disinterest in Washington, with respect to reducing the deficit, at a time when policymakers feel that the bond market is doing little to push back on these plans. After all, 30-year borrowing costs remain far below cash rates and in this way the inverted yield curve represents a green light to those who would like to keep spending and cutting taxes.

Consequently, we believe that it is appropriate to look towards curve steepening regardless of the election outcome, and we struggle to see too much value in longer dated bond yields at current levels.

Geopolitical risks continue to bubble up close to the surface. Despite attempts to deliver positive spin, it seems that Blinken's latest push for progress towards a peace deal for Gaza seems stuck going nowhere.

It strikes us that Netanyahu sees limited benefit to drawing back from the military campaign just yet, and with Iran seeing plenty of downside to material escalation, the Israelis may continue to push to eliminate Hamas, notwithstanding international protests and human cost.

Ultimately, a negotiated settlement will need to be found, but Netanyahu will also be hoping that any eventual deal may end up more favourable to him, if Trump returns to the White House.

This said, it is very plausible that Tehran will feel the need to escalate, if peace initiatives in the near-term yield no results, and so the situation in the Middle East remains very volatile. The same can also be said of developments in Ukraine at present. The recent push into the Kursk region of Russia by Kyiv troops has come as quite a surprise.

However, with Western weapons being used to conduct offensive operations on Russian soil, so there is a growing risk that Putin will want to hit back in a material way. However, it is not clear what form this may

take, and one only hopes Zelensky's gamble has the desired effect of pushing Moscow into peace negotiations.

France has gone quiet over the summer, with the holiday season, combined with the Olympics, serving as a distraction. However, we expect that the political situation will be back in focus in the Fall as policymakers work on a Budget for the coming year.

Left-wing parties supporting Macron will push for concessions, leading to increased government spending, which may see the fiscal deficit rise and put France on something of a collision course with Brussels. This may see some renewed underperformance of French bonds, in our view. However, we still think that any move in spreads is like to be contained below 100bps on 10-year OATs, ahead of the Presidential election in 2027.

With risk appetite recovering over the past couple of weeks, the spread on CDS indices is now largely back at levels seen prior to the market turmoil at the start of the month. Cash bonds have lagged somewhat in the rally and ordinarily we would look for some seasonal softness as we head towards September with new issue supply, typically in one of the peak months of the year.

That said, we think that this year's issuance could surprise below consensus projections. This could help to see spreads pushing tighter still, as a supportive technical backdrop in terms of supply and demand in corporate bonds coincides with a weaker demand backdrop for government bond securities. Elevated deficits globally mean a relative abundance of government bond issuance.

Meanwhile, demand for government paper from big buyers in Asia could be limited in the case of Japan, due to FX hedging costs, and in China, due to geopolitical concerns and the notion of the US weaponising the US dollar.

Looking ahead

We still have another couple of weeks to go before summer is done (even though those of us living in the UK may be forgiven for thinking that summer never arrived properly this year). Next week is a holiday-shortened week in the UK and the following weekend will see US Labor Day holidays, before markets swing back into full action as we start September.

At this time, the coming payrolls report will be an important litmus test and may go a long way towards sealing the Fed's favoured course of action at the September FOMC. Our views on the economy have not changed much in recent weeks, and we continue to have a cynical thought that there are a lot of banks and stakeholders whose interests are best served by more aggressive monetary easing, in order to help mitigate unrealised mark-to-market losses they are nursing on a host of assets. Hence this crowd have been the most vocal in calling for the Fed to cut by 50bps.

We are now nearly two-thirds of the way through 2024, but there is a real sense that a lot remains up in the air and some of the really key events lay just ahead of us in the next couple of months. In this context, there is plenty to play for.

From a portfolio perspective we remain content, for now, to run with short positions in Japan and US rates, with long positions in credit. This reflects a view that we see a low near-term probability of recession and an economy on track for a soft landing, not a hard landing, in the months to come.

As for US politics, the question we are left with following the past few days is whether we have just witnessed peak Harris – or is there much more yet to be seen?? For sure, it does strike us that this campaign may get increasingly personal and nasty in its attacks and characterisations. In this respect the recent headline from The New York Post – 'Kamunism' – only reflects the shape of things to come….

Notes to Editors

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