RBC BlueBay
Asset Management

# Market Commentary

## Rates cuts: Definitely Maybe...

**Back with a bang!**

**Key points:**

- It is a foregone conclusion that the rate cutting cycle will begin at the September FOMC, with the size of the first cut depending on the trajectory of incoming economic data.
- If we witness a contraction in employment and a further rise in the jobless rate, this could prompt the Fed to cut rates with greater urgency.
- Budget forecasts in the UK call for tax rises and spending cuts, as Chancellor Reeves is committed to demonstrating fiscal sustainability.
- In the Eurozone, Brussels is set to throw its weight behind delivering fiscal stimulus, to boost economic prospects and deliver on a number of strategic initiatives.

**30 August 2024 (London) –** Global markets were relatively quiet during the past week, as summer draws towards its close. During the course of the past month, global rates have rallied on the anticipation that the Federal Reserve will start a rate cutting cycle at the September FOMC, and in the wake of Powell's Jackson Hole comments,this now seems a foregone conclusion.

The question that now needs to be answered is whether this first move in rates will be by 25bps or by 50bps and, with the Fed Chair failing to rule out a larger move, it seems that this will depend on the trajectory of incoming economic data over the next few weeks.

The recent rise in unemployment has seen Powell emphasise that additional softening in labour demand is no longer desirable, in pursuit of a soft landing. In this context, this means that next Friday's non-farm payroll report will take on even more significance in the eyes of market participants.

We head towards this data release expecting a relatively healthy number, noting that last month's rise in the unemployment rate was partly impacted by hurricane disruption in July. This view is supported by the trend in jobless claims data in recent weeks, which has appeared benign, as well as a number of other labour market indicators.

However, payrolls can be a bit of a statistical lottery (and can often be subject to revision). From this point of view, were we to witness a contraction in employment and a further rise in the jobless rate at this time, this could be the sort of data that prompts the Fed to cut rates with greater urgency. Yet, although this scenario cannot be ruled out, we see this as relatively unlikely.

Meanwhile, we would observe that broad measures of financial conditions are relatively accommodative at the current time, thanks to declining yields, tight spreads and healthy equity market performance on a year-to-date basis. Economic activity is moderating from a prior rapid pace.

However, this was always expected. Generally speaking, the economy appears to be evolving in a fashion consistent with recent Fed projections. In that case, we still think it is right to believe that the views embedded at the most recent FOMC meeting remain intact.

From this point of view, we continue to consider that it is appropriate to look for a rate cut of 25bps in September, with similar moves to follow in December and Q1 next year. This trajectory discounts materially less easing than markets are presently discounting and, from this point of view, we continue to hold to a view which is short with respect to interest rate duration.

In the UK, the new Starmer government has taken the opportunity to 'kitchen sink' bad news with respect to the UK budget, noting a fiscal position of some GBP22 billion in arrears, relative to what the outgoing Tory government had projected. This headline saw gilts underperform, though this was tempered by messaging preparing the country for tax rises and spending cuts to be announced later this year.

In part, the Labour position reflects its own decision to spend an additional GBP9 billion, in order to pay off striking public sector workers, in a hope that this will see the country 'back to work'. This notwithstanding the increased union incentive to continue to take industrial action, who will be feeling relatively empowered in the wake of recent developments.

Nevertheless, it has been clear for some time that the UK lacks much fiscal space, and consequently it is expected that capital gains and inheritance taxes will be raised in the upcoming Budget. In addition, we might expect adjustments made in terms of the ability to claim back relief offered to pension contributions and ending VAT sales tax exemption with respect to private school fees.

In this way, Rachel Reeves' commitment to demonstrating fiscal sustainability has been seen constructively by markets, though inasmuch as union wage costs have accelerated and utility bills are rising once more, we think that rising inflation creates a difficult backdrop for the Bank of England to reduce interest rates much over the course of the months ahead.

Meanwhile, in France, Macron's decision to reject the left-wing PM candidate, Lucie Castets, led to indignation from Mélenchon and the coalition on the left, who have called for a day of national protest on September 7th. For now, the coalition on the left remains robust and Macron's hopes to persuade more centrist-leaning policymakers to support a candidate who he is eager to endorse, look forlorn.

At this point, it is hard to see where a compromise will occur and this sets the stage for political tensions to rise in the coming weeks, as summer comes to an end. We expect this to be reflected in OAT spreads and have thought that OATs could trade wide relative to Spanish bonos for some time.

However, the extent of moves can be contained, unless developments lead to an outcome delivering material fiscal easing to placate parties on the left, which will put Paris on a collision course with Brussels now that France is subject to excessive deficit procedures or alternatively, were Macron to quit, which remains very unlikely for the time being.

Elsewhere in the Eurozone, newsflow has been relatively quiet. The German economy continues to underperform its Eurozone peers and recorded a contraction in growth in Q2. A downside miss on German inflation also helped pull Eurozone inflation somewhat lower. German manufacturing remains weak and high energy costs continue to weigh on producers across a number of sectors.

Other countries in the bloc have been performing better on a relative basis, though there remains a general malaise, which has prompted Mario Draghi and others in Brussels to throw their weight behind a grand plan to deliver fiscal stimulus to boost economic prospects and deliver on a number of strategic initiatives.

In this regard, it is clear that the EU needs to spend big, in order to bring defence spending to levels required to meet external threats in an increasingly uncertain world. Major investment is also needed in energy and in a drive towards net-zero objectives.

However, at a time when populism is on the rise, it is questionable whether EU leaders will want to cede increased authority to Brussels to spend, at a time when domestic priorities and national interests are dominating the debate. However, we still expect a material increase in spending in the months ahead, we just don't know by how much – and the extent to which this may offset the need for lower interest rates in the Eurozone.

Credit market activity has picked up over the past few days, with some opportunistic issuers wanting to tap markets before a heavy seasonal period of supply commences later next week, in the wake of US Labor Day.

Generally speaking, we think that total supply may be modest, and with increased flow into fixed income strategies coming at a time when many investors have got cash to put to work, so we are inclined to think that any upward supply pressure on spreads will be short lived.

Moreover, our general sense is that credit spreads at a macro level can continue to grind tighter, just as long as recession risks remain contained. Valuations in credit look somewhat expensive on a historic basis, but this overlooks the structural cheapening of government bonds, which can be seen in the ongoing outperformance of interest rate swaps relative to underlying government issues.

In FX, the US dollar has underperformed in recent weeks, and we have subsequently closed an underweight stance. In part, we feel that US$ weakness has coincided with increased speculation with respect to US rate cuts and, with this having gone too far in our opinion, we have now moved to a position long US$ versus euro.

At this juncture, we feel that it is more likely that the euro trades from $1.115 down towards $1.08, before hitting $1.15. We also think that the yen has appreciated enough for the time being, with the BoJ likely to sit on the sidelines until later this year. That said, we continue to favour adding exposure in yen, based on its structural undervaluation, should price action take the rate back above Y/$150.

We also continue to see value in some higher yielding EM currencies such as the Brazil real, which we like relative to the Colombian peso, and we have also become more constructive with respect to the Mexican peso at 19.50 versus the dollar, feeling that recent underperformance on political concerns has been overdone.

**Looking ahead**

Next week is likely to get off to a slow start, with the US out for Labor Day holidays. Thereafter, activity is expected to pick up, with next Friday's report on the US labour market the focal point of attention. We continue to have a relatively constructive view on the US economy for the time being but will be looking carefully at any signs that could foreshadow a more significant slowing in the pace of activity.

In this context, we have noticed something of a softening in travel demand, with flight prices declining now that the peak travel period over the summer is behind us. We have also seen some softness in demand for home improvements after a couple of years of robust activity, in the wake of the pandemic.

However, there will always be sector-specific pockets of relative strength and weakness and when assessed holistically, we see little reason to believe that the US economy is running into the buffers any time soon.

Indeed, the recent decline in rates may breathe more life into the housing market and more generally speaking, an easing in financial conditions over the past couple of months also has the potential to give growth a boost, as we similarly witnessed in Q1 this year, following the easing of financial conditions in the wake of the December 2023 FOMC meeting.

August has hardly been an Oasis of calm, though it strikes us that September has the making of a pivotal month in terms of the global macro investment environment. Come the end of the month, hopefully investors won't be left to 'Look Back in Anger', even if Powell fails to deliver a 50bps 'Champagne Supernova' on 18th September.

Our own sense is that risk assets will be able to 'Roll With It' and although the US growth outlook is no longer 'Supersonic', achieve a soft landing, making the Fed Chair something of a 'Rock 'n' Roll Star', in the pantheon of central bankers. Although the bull market in risk assets won't 'Live Forever', for the time being, we think that prices can climb the metaphorical '(Wonder)wall' of worry.

‘Half The World Away’, at least in the UK, the Chancellor seems likely to refrain from adding to taxes on ‘Cigarettes and Alcohol’ as Reeves’ ‘Masterplan’ seeks to ‘Acquiesce’ to market demands for fiscal restraint. Fiscal concerns are unlikely to ‘Slide Away’, but the hope will be that ‘Little by Little,’ she gains the trust of the market by demonstrating she is prepared to do ‘Whatever’ is required of her.

The Budget is still a few months away, but it will be interesting to hear if Reeves eliminates changes to the treatment of carried interest and is strong enough to tell private equity to ‘Stop Crying Your Heart Out’. ‘Some Might Say’ that ‘She’s Electric’ if she does so, but ultimately a new dawn of productivity leading to renewed growth needs to be seen if this is going to lead to a path of ‘Morning Glory’….

**Notes to Editors**

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**About RBC BlueBay Asset Management**

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