



Market Commentary

They eat your pets!

Anyone for a purrito?!

Key points:

- Data releases have cooled enthusiasm for a 50bps rate cut at the upcoming FOMC meeting.
- We continue to push back against the narrative that data are trending much weaker and this will require larger rate cuts in the next few months.
- In Europe, the ECB lowered rates by 25bps to 3.5% this week and further cuts are expected.
- Comments from Bank of Japan policymakers have continued to highlight an expectation of future tightening.

13 September 2024 (London) – Treasury yields have remained well bid over the past week, notwithstanding data releases, which have cooled prior enthusiasm for a 50bps rate cut at next Wednesday's FOMC meeting. Last week's US labour market report saw unemployment tick lower, after jumping the month before. New job adds remain largely healthy, though prior revisions cast those figures in a weaker light. Meanwhile, weekly jobless claims data give no particular reason to feel concerned that a more pronounced softening in the labour market is occurring, at the current moment in time. Elsewhere, a slightly firmer US core CPI release leaves the core rate unchanged at 3.2%, even as softer energy prices mean that the headline rate continues to trend lower.

Reflecting on these releases, we continue to think that Powell will cut rates by 25bps next week and we think that the Fed dot plot is likely to infer a cumulative 75bps of rate cuts to the end of 2024. The Fed Chair will most likely want to highlight the ability to lower rates at a faster or slower pace, based on incoming data.

In this respect, with the Atlanta Fed nowcast of Q3 GDP having moved up to 2.5% over the past week, we continue to push back against the narrative that data are trending much weaker and this will require larger rate cuts in the next few months. This being the case, we continue to believe that markets are discounting too much monetary easing in the short term and we maintain a short rates position, expressed via the December 2024 3-month futures contract.

In Europe, the ECB lowered rates by 25bps to 3.5% at its policy meeting this week. Further rate cuts are expected in coming quarters, as the Eurozone inflation rate comes closer to the 2% policy target. Yet, notwithstanding anaemic economic growth across the continent, Eurozone unemployment, at 6.4%, sits at the lowest level in the 25 years since these data have been collated.

The lack of slack in the labour market is an impediment to lower rates as it suggests upside risks to wages. We have previously noted how a changing labour supply function since the pandemic has led to some structural tightness in labour markets, as populations in the West express an increased desire to spend their time in leisure rather than work. This is also a factor which limits productivity growth and suggests that growth in economic activity will remain modest on a forward-looking basis.

Seeking to counter the relatively weak structural prospects in the Eurozone, Mario Draghi's report to the European Commission sought to identify specific challenges that the bloc needs to address in order to improve its fortunes. This report described the innovation gap, which has impacted the ability of European companies to successfully commercialise their ideas.

It also spoke of the challenge to EU competitiveness, the need to increase security and decrease energy dependency, and the imperative to invest in order to decarbonise the economy. In order to address each of these issues, Draghi has called for aggressive EU level fiscal investment of a transformative scale.

The initial response to Draghi's ideas across the major European capitals has been relatively cool. The plans are certainly ambitious and, at a time when countries such as France and Germany are confronting major challenges at home, there seems limited appetite for a shift in the direction of a fiscal union, when populist parties are undermining support for the political establishment.

However, we think it would be wrong to be totally dismissive of these ideas and even if a modest portion of Draghi's suggestions are implemented, then this could still infer a material fiscal stimulus, which could support the economic outlook in 2025 and also negate the need for more aggressive monetary policy easing from the ECB.

Over the past week, it was also interesting to note Germany's sale of a 4.5% stake in Commerzbank to Italy's UniCredit. This means that UniCredit owns 9% of the German lender and has said that it may be considering a takeover for the bank. Cross-border transactions in the EU have remained few and far between, and there may be a sense that the landscape could be changing in front of our eyes.

In France, Macron has commented that he would not stand in the way of a transaction of this nature in France. Consequently, if UniCredit is successful in its ambitions, one could imagine this being the catalyst for a wave of European bank consolidations, noting that there are a number of institutions whose stock prices languish at multiples as low as 0.3 times their book value.

Indeed, we would observe that from a German perspective, it is in the national interest that such a deal should progress, for a bank that has been struggling for a number of years. Furthermore, in the context of some of the proposals in the Draghi report, such as investment in clean energy and in external security, these are aspects that would stand to disproportionately benefit Germany relative to its European peers.

In this way, German scepticism of the use of EU funds may start to wane, if this is fully understood. Although the German constitutional court will always be a potential hurdle to overcome, it has been seen that in past periods of crisis, exceptions have been made. From that point of view, Germany is already confronting a security crisis on its border, and a climate crisis which affects us all. Would it not be better to act now, before an economic crisis and political crisis are added to this list of the country's problems?

In contrast to the discussion of monetary easing elsewhere in developed markets, comments from BoJ policymakers during the past week have continued to highlight an expectation of future policy tightening, as long as the economy continues to evolve in line with the central bank's projections. We do not expect a policy shift at next week's BoJ meeting. We think that shifts are more likely at the quarterly meetings in October or January, at which point the central bank will update its economic forecasts.

In the short term, the focus on Japan is more skewed towards politics and the LDP Leadership election, which will determine the next Prime Minister to replace Kishida. There remains a relatively wide field of candidates at the current time. However, with little difference in economic agenda being apparent, this election has had limited bearing on financial markets for the time being.

Meanwhile, we would note a national rice shortage, which has boosted the price of the nation's staple over the past few weeks. This may show up in future CPI releases, highlighting that risks may continue to lie to the upside, for now.

Despite a widening of credit spreads over the past few weeks, which are associated with fears of an economic slowdown, we are inclined to project an improved backdrop in the second half of the month. We see little reason for Japanese yields to rally when data and policy intentions are headed in the opposite direction.

We also think that the FOMC output may lead to a tempering of aggressive rate cut expectations in the US. In credit, a narrative of consolidation in the EU banking industry could be a positive catalyst for the sector, as national opposition to such transactions appears to be on the decline.

Looking ahead

Next week's Federal Reserve meeting will be the closely watched event of the week. Thereafter, the second half of the month will be quieter in terms of economic data and also quieter, we believe, with respect to corporate bond supply. If equities can stabilise and volatility subsides, then we feel that credit spreads can retrace their early month widening and with a CDS index roll coming up shortly, we would not be surprised if this is not a catalyst for a squeeze tighter.

US politics will remain in the news with the election now counting down and the race remaining too close to call. This week's debate saw Harris perform relatively well. However, there is still a long way to go and although a celebrity endorsement from Pennsylvania's Taylor Swift will have been well received, it is most likely that her fanbase (which is of an age to vote) would have been heavily Democrat leaning anyway.

The race itself will be defined by a small number of marginal voters in a small number of swing states. At the margin, this is where Trump may have a slender edge, notwithstanding trailing in nationwide polls.

In some regards, one wonders if Trump's worst enemy might be himself. Certainly, the comment that immigrants to the country are eating the nation's pets seemed downright weird and you half wonder what might come out of his mouth next. That said, who doesn't love a bit of sausage (dog)....

Notes to Editors

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