



Market Commentary

Keeping calm in dangerous times

A lose-lose situation

Key points:

- The Fed has indicated it has time to lower rates toward neutral, unless there is a material deterioration in economic data.
- We continue to favour a short duration stance in the US, since we expect less monetary easing than consensus.
- Chinese assets have continued to grab attention as easing measures give a sense that Beijing is committed to doing 'whatever it takes' to support economic activity.
- In the Eurozone, a more dovish tone from the ECB means an increased pace of easing is now being discounted, however we think 25bp cuts is more likely.
- The US election represents a bigger risk event for financial assets than developments in the Middle East appear to be, for the time being.

4 October 2024 (London) – Events in the Middle East have put markets on edge over the course of the past week. Nevertheless, the relatively contained move up in oil prices in the past several days demonstrates the fact that a conflict, which is regionally contained, may have limited impact on the trajectory of the global economy.

Consequently, a flight to quality has proved short lived up to this point, with risk assets rebounding from earlier losses. Meanwhile, Treasury yields have pushed higher, following comments from Jay Powell suggesting that the FOMC can take time to lower rates towards neutral. This has reinforced a view that the Fed will plan to lower rates by 25bps at each of its next two meetings in November and December, unless there is a material deterioration in economic data in the interim.

For now, most data from the US economy continues to suggest that activity remains relatively robust. In this context, the index of US economic surprises now stands at its strongest reading since April, having improved by 50 points from its low back in July.

Yet with the Fed acutely focussed on labour market data, we head into today's monthly US jobs report with market participants obsessing over the outcome. We have thought that a net gain of less than 50,000 jobs in September and a rise in the unemployment rate to a new high of 4.4% could serve as a catalyst to think that the Fed may cut more aggressively in November.

Meanwhile, a net increase of 200,000 and a decline in the unemployment rate would seem to call into question the recent narrative of a weakening in the US labour market. This might put a bigger question mark over the path of future rate cuts, with markets still pricing close to 200bps of cuts by the end of 2025.

In terms of our own view, we continue to favour a short duration stance in the US. We have believed that short-term Fed futures discount too much monetary easing, on the basis that we think economic data is set to remain firm for the time being. Meanwhile, we have looked for longer dated Treasury yields to rise, with

the yield curve steepening, given ongoing concern over US debt levels, regardless of who wins November's election.

More broadly speaking, we think that it is difficult to be too bullish on fixed income yields, even as the Fed cuts interest rates, based on the extent that markets have already discounted this. We would think that a further rally from here would require the US economy to slow to a point which would require monetary policy to move to an accommodative stance, which still looks a long way off to us.

Further afield, price action in Chinese assets has continued to grab attention in the wake of policy easing announcements, prior to this week's Golden Week holiday. Stock prices on the Shanghai exchange are up over 20% in the past week, partly reflecting that fact that these had become oversold against a backdrop of bearish sentiment. The rally in the CSI index has raised prices back to the level last seen in May and has largely erased losses in 2024 on a year-to-date basis.

In the short term, the combination of monetary and fiscal easing measures has helped give a sense that Beijing wants to draw a line in the sand and is committed to easing fiscal policy and doing 'whatever it takes' to support economic activity. However, on a medium- to longer-term view, we would caution that unless fiscal policy manages to boost consumption, a policy push that seeks to boost exports could soon start to peter out.

On this basis, we remain relatively cautious on Chinese prospects on a medium-term view, notwithstanding short-term positive sentiment, which could have further to run.

In the Eurozone, a more dovish tone coming from the ECB means that more than 50bps of easing is now discounted across the next two policy meetings before the end of the year. In the wake of the Fed's 50bps move, there has been more speculation that the ECB could follow suit, with the risk of inflation receding, and economic clouds much darker in the Eurozone than they are on the other side of the Atlantic.

Given that Lagarde appeared to push back on the notion of easing in October, at the last ECB meeting just a couple of weeks ago, we think that moves of 25bps are more likely. Though we would note that with market forwards already discounting cash rates to drop to 1.5% in the middle of next year, it is hard to get too bullish on yields, at this point in time.

Meanwhile, Budget proposals in France may have managed to avert a collapse in the Barnier government in the near term, with Le Pen's RN Party seemingly more likely to abstain from any vote of 'no confidence' for the time being. Having won a few concessions for itself, the RN is probably calculating that fiscal tightening is only likely to make the Macron administration more unpopular than it already is, and that this should play into its hands, in quarters to come.

Additional French parliamentary elections can't be called within 12 months of this July's vote. Therefore, Le Pen may conclude that it makes sense to appear 'reasonable' in the eyes of the electorate and prop up a government in the short term, before pulling the rug next June. In this context, we have decided to close a short position on French OAT spreads, over the past couple of days.

Having traded from 55bps out to 80bps, we aren't convinced there is a catalyst for further widening just yet – even if we still struggle to adopt a more constructive stance, which would see spreads moving tighter.

Meetings with policymakers in Brussels this week saw plenty of discussion around the recent Mario Draghi proposals to tackle Europe's economic malaise. However, there is growing realism that the inertia in other EU capitals is likely to limit much being done, in the absence of an external shock, with a lack of clear

direction of leadership coming from France or Germany. In this regard, there was discussion about the EU being the 'boiling frog' and some concern that the moment of realisation could end up coming too late to do too much about the situation.

Across the Channel in the UK, we continue to get a sense that the BoE would like to do more to cut interest rates and support the economy, given that the incoming Labour government has very little fiscal space and is likely to deliver a relatively austere Budget next month. However, inflation remains elevated, and in an economy with next to no productivity growth, there is a sense that elevated wage gains will inevitably end up feeding back into prices.

New Japanese Prime Minister Ishiba has had a slightly bumpy start to his tenure over the past week, with equity prices dropping in response to his election, only to rebound later during the week on more dovish comments suggesting no imminent change in monetary policy. These comments saw JGBs hold onto some of the gains of the past few weeks, notwithstanding higher US Treasury yields.

However, our own sense is that Ishiba's comments probably only applied to the upcoming October BoJ meeting, and we had already expected further monetary tightening to be pushed back until January. In this case, not much has changed in our eyes. However, the reversal in US rates has seen the yen weaken above 146.5 versus the dollar. This move may have a bit further to go in the short term and we don't have a position in the Japanese currency. However, a move to 150 could represent an attractive time to start to build a long position in the Japanese currency, in our view.

In FX markets more broadly, the dollar has rallied from its lows at the start of the month, also making gains versus the euro. However, EM currencies have held up relatively well, particularly noting the volatile global backdrop which has pushed the VIX above 20.

As geopolitical risks in the Middle East have risen, we have incepted a short FX position on the Israeli shekel, noting the relatively robust performance of the currency in the past few months, just as economic fundamentals have deteriorated as the country becomes more deeply involved in fighting a war on multiple fronts.

In credit, we have remained content to maintain a net long position in credit duration. Ultimately, we think that credit will continue to outperform, as long as the US does not slow into recession. We think recent Fed actions make this outcome unlikely in the near term and given our relatively constructive economic view, we think that spreads could squeeze tighter, given that many investors have been positioned more defensively, expecting a more challenging macro backdrop.

Looking ahead

Next week the focus will be on US CPI data, once payrolls is out of the way. For now, we see limited signs of weakness in the economy, and we are hopeful that, as long as this remains the case, the trends which have benefitted returns over the past week or two can persist for some time to come.

Meanwhile, the US election approaches and, in all reality, represents a bigger risk event for financial assets than developments in the Middle East appear to be for the time being. The race itself remains very tight, though with Trump pushing the line that the world was a much safer place when he was in the White House than has been true of his successor, so there may be a line of thinking that suggests an Israeli escalation only plays into the hands of Netanyahu's favoured candidate.

For all the sense that the situation in the Middle East can be managed and contained, history does serve as a reminder of how situations and escalation can end up triggering a further chain of events, which can quickly develop their own momentum.

Consequently, we will need to continue to assess current developments carefully and be prepared to shift our thinking, as events may demand. Clearly, the military powers in the region will be preparing and analysing various scenarios and trying to solve for optimised outcomes, which can be a complex exercise in game theory.

In that sense, those familiar with theories relating to 'Nash equilibrium' and 'prisoner's dilemma' will realise that such 'games' can often conclude with a 'lose-lose' scenario as the natural outcome. More realistically perhaps, military strategists may do well to remember that in wars and conflict of any kind, there are only ever really losers, on both sides of the divide.

Eventually dialogue will be needed to restore peace, and hopefully this day is not long in coming. Sadly, ongoing conflict and hatred can feel like the norm in a region like the Middle East, which can seem a long way away.

That said, it was seemingly shocking to hear the revelation this week, that in the midst of the Covid pandemic, Prime Minister Boris Johnson actually looked into performing a military raid in the Netherlands to bring home our country's vaccines from the evil EU. Quite a preposterous suggestion!! Yet at Tory Party conference this week, he continues to be put on a pedestal by many, seemingly awaiting his eventual return....

Notes to Editors

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

About RBC BlueBay Asset Management

RBC BlueBay Asset Management ("RBC BlueBay") represents RBC Global Asset Management outside of North America and is an active asset manager with expertise across fixed income, equities and alternatives.

RBC BlueBay's solutions-driven approach means it endeavours to empower clients with the knowledge they need to help shape their investment decisions. It works and evolves with clients, creating and customising investment products that meet their needs.

Responsible investment is embedded across RBC BlueBay's business. This means it is not just an investment focus but is also ingrained in its client service experience and work to deliver solutions that support real-world impact.