



Market Commentary

Clockwork Orange

Is the future bright?

Key points:

- Financial markets are preoccupied with the US election, and while it is still very close, momentum seems to be with the Republicans.
- With no desire to address the deficit, debt levels will continue to rise, meaning that we continue to favour structural steepening in the US yield curve.
- A key difference in the candidates involves applying tariffs on imports, based on Trump's belief that this will raise revenue and bring investment and production back to the US.
- At its policy meeting this week, the ECB tilted towards a more dovish stance, lowering interest rates again.
- It continues to be the case that political, as well as geopolitical, risks continue to abound.

18 October 2024 (London) – Financial markets have been increasingly preoccupied by the run-up to US elections in the past week, with the vote now only two and a half weeks away. Polls have suggested a swing towards Trump over the past couple of weeks, and betting sites now place around a 60% probability on the former President being re-elected. Meetings in Washington this week have certainly endorsed this perception, in our eyes. If anything, it strikes us that Trump's prospects may continue to be under-reported.

The mood from Republicans appears quietly confident, notwithstanding ongoing complaints relating to the 'fairness' of the election itself. Meanwhile, Democrats appear much more downbeat. Complaints and recriminations are already being voiced and may be summarised in the line: 'Biden was supposed to save democracy but his own ego likely lost it'.

For now, the momentum is with Trump, and it is not clear in Democrat ranks what can shift this back in their direction. Having been relatively silent, Harris has been seeking to engage voters at recent events, though the sense is that much of that has been falling rather flat.

It remains unlikely that the Grand Old Party will win the House, and so there will be a split in Congress. In that case, it is expected that past tax cuts, due to expire next year, will be rolled. From this point of view, there is consensus across DC that the US fiscal deficit will remain around 6.5% next year, which infers it is neither adding to, nor subtracting from, GDP in 2025.

With no desire to address the deficit, so debt levels will continue to rise, meaning that we continue to favour structural steepening in the US yield curve. Ultimately, we feel that the differential between cash rates and 30-year Treasuries could climb as high as 150bps, before the fiscal narrative starts to shift.

For now, a loose fiscal stance remains popular with voters. Eventually, with a much steeper yield curve, there may be more of a desire to lower long-term rates to benefit mortgage borrowers. However, currently we remain a long way from that point in time. For now, ongoing deterioration in government finances seems likely to drive an increase in the term premium. Moreover, an inverted yield curve has given a green light to policymakers that they can keep cutting taxes or raising spending.

Elsewhere, a Trump win means it is likely that an incoming administration will be applying tariffs on imports, based on a belief on Trump's part that this will raise revenue and also bring investment and production back to the US. An immediate hike on Chinese import tariffs is very likely. Elsewhere, a blanket 10% or 20% global tariff could be more of a negotiating ploy, though there seems certain to be the application of a number of tariffs on European imports, in a host of sectors.

We also see Trump being tough on USMCA re-negotiations, and it has also struck us recently that the mood music from Ottawa seems to be much more closely aligned to the Trump position than it ever was before, which might seem problematic for Mexico.

The adoption of tariffs seems likely to strengthen the US dollar. Meanwhile, ongoing US growth exceptionalism also continues to favour the greenback. In this context, it is interesting to hear Trump claiming that he would like a weaker dollar, though it is not clear that this will be achieved, based on the policy path he has laid out.

At the same time, we would see tariffs as adding to inflationary pressures. This may make it more challenging for the Federal Reserve to lower interest rates next year, if Trump prevails on November 5th. There is also a scenario where higher inflation may mean that the FOMC ends up needing to hike rates again, in the quarters to come.

Trump hopes to lower inflation by reducing energy prices. In this context, he will push ahead with plans to expand drilling in Alaska and encourage oil and gas production, rolling back environmental legislation enacted in the past four years. Energy is a large component of inflation and, in this regard, he may have some success. However, prices can't fall too much before investment in the sector will dry up, given breakeven rates on production.

More broadly speaking though, we don't see the US election outcome having a very substantial impact on the US economy from a growth perspective. Economic activity remains very healthy and there is little evidence of much slowing in the economy for the time being. Indeed, this was shown by further strength in retail sales data released this week.

From this point of view, additional policy easing from the Fed doesn't seem needed at the current time. However, having cut by 50bps in September, we would be surprised if the FOMC does not follow this with 25bps in November, not wanting to give the impression that its last move was a policy error. Thereafter, further policy easing may be warranted, but it is likely to be much more contingent on evidence that economic activity and inflation are actually on a softer trajectory than is currently the case.

In some regards, a win for Trump may actually be more significant for countries overseas than it is for the US itself. This is certainly the case for Ukraine, but also more generally for the EU, which may be forced into making progress on increasing military spending on security. In some senses, one wonders if Trump could actually deliver the shock therapy that the EU needs, in order to get its act together and deliver policy change, to confront a more obvious crisis.

At its policy meeting this week, the ECB was tilted towards a more dovish stance, lowering interest rates from 3.50% to 3.25%. Headline Eurozone inflation fell to 1.7% in September and with forward-looking activity indicators across northern Europe looking relatively bleak, it seems likely that much more monetary easing will be required in the months ahead.

That said, it is not clear that there is much that monetary policy can do to lift the sense of malaise across the continent, which seems as much structural as it does cyclical. Indeed, with the Eurozone unemployment rate at a 25-year low, it is not obvious that there is abundant slack in the economy and productivity growth remains very subdued.

EU yields have largely discounted a decline in ECB rates and, in this context, have not reacted much to the ECB. However, it is notable that bunds have largely resisted the upward pull of US yields of late, outperforming on a relative basis. Meanwhile, the euro has been under some pressure in FX markets, and we are inclined to think that this trend has further to run – particularly should Trump emerge victorious.

UK yields rallied in the wake of improved inflation data, which have reignited hope for Bank of England monetary easing. At a time when the UK doesn't seem to have much good news, a drop in core CPI from 3.6% to 3.2% is certainly welcome.

However, we would continue to express some concerns that with service inflation still around 5% and wage growth being fuelled by Labour's handouts to its union friends, so it will be difficult to see UK inflation coming back to the Bank's 2% inflation target, unless there is a more material slowing in the economy. We see this limiting the scope for the BoE to ease very much in the months to come. Meanwhile, elevated debt servicing costs further serve to limit the amount of available fiscal space to Chancellor Reeves at her upcoming Budget.

Indeed, with Labour seemingly trying to float a number of trial balloons with respect to tax and spending plans, there is a sense that they still haven't figured out exactly what they want to do, and it feels like they were ill prepared in their plans to take office. Certainly, Starmer has had a very difficult first 100 days and his approval ratings have fallen dramatically.

Inasmuch as Labour needs to convince investors that they are competent and know what they are doing, in order for the gilt market to support their intended investment plans, so recent struggles have not served to help them in this regard.

From that point of view, they will be coming to appreciate that there is currently very limited fiscal space to do that much, and one wonders whether internal politics within the Labour Party could start to become more fractious in the wake of the Budget, if it lands like a damp squib.

Japanese yields have seen some upward pressure in recent days. Meetings with Japanese policymakers continue to reaffirm our confidence in interest rate policy normalisation. It seems that the bar to adjust the QE bond purchase schedule remains high for the time being, and so no change is expected at the BoJ policy meeting at the end of this month, given the proximity to the general election.

However, if inflation data surprise to the upside, so a December hike to 0.50% is becoming more likely. Meanwhile, focus will turn to the yen on a break above Y150 versus the dollar. A weaker yen could thus also pull forward BoJ action from the next quarterly meeting in January to December. From this point of view, we have moved positioning long of the yen over the past few days, though we favour expressing this versus a short in the euro rather than versus the dollar.

Credit markets have traded relatively well over the past week. US markets have been inclined to rally on the prospect of a Trump victory, given perceptions that he is a more business-friendly presidential candidate. In this context, although there is something of a dearth of support for Trump across much of the C-suite of corporate America, we sense that many are quietly hoping for him to prevail, in private.

Yields were not much changed over the past week, although headlines that Israel was less likely to target Iran's oil infrastructure did see a reversal in crude prices, which saw inflation breakevens a little softer, after a recent strong run.

We have been paring exposure in LatAm-related risk over the past couple of weeks. Although a number of assets in that region appear attractive, we are mindful of weak price action after Trump's 2016 election win. From this point of view, we are more inclined to look for opportunities elsewhere.

Looking ahead

The focus on the US election is likely to continue to build in the coming days, as we count down to November 5th. There remains plenty of uncertainty, and we also note that there is a good chance a clear outcome won't be known for a number of days after the vote itself, given likely delays in counting in Pennsylvania, plus likely recounts in states like Georgia.

For the sake of US democracy, it seems everyone hopes for a clear winner and a smooth transition of power. However, there is also a sense that the scenes following the 2020 vote came as a surprise and a wake-up call, and they are unlikely to be repeated.

In this case, we think that the current administration is much better prepared and so we think that any attempt to question the outcome this time around will be quickly quashed. Nevertheless, any sense that an outcome could be contested could be a catalyst for a weak end to the year in financial markets.

In this way, it continues to be the case that political, as well as geopolitical, risks continue to abound. Yet for all of the potential negatives, we think that risk assets can continue to climb the metaphorical 'wall of worry'. Corporate earnings continue to grow, and the economy rolls onwards.

Meanwhile, investor positioning has remained relatively cautious, with cash balances elevated, and a sense that there is money ready to be put to work. It strikes us that the future could remain bright, even if looking at Trump this week, it's tinted orange...

Notes to Editors

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