



Market Commentary

Some lies with that??

Trump works the McDonald's drive-thru...

Key points:

- We continue to witness ongoing evidence of US growth exceptionalism, and robust US data is cooling the enthusiasm towards more aggressive Fed rate cuts.
- The backdrop in the Eurozone continues to look dim, with potential tariffs on EU exports on the horizon, and we sense that the ECB could be prepared to accelerate its easing of monetary policy.
- Financial markets may be a little unsettled by political uncertainty in Japan, yet from our perspective, this will have little bearing on the economy nor on the BoJ.
- Looking ahead, it will be hard to pull ourselves away from US politics in the next two weeks, as we assess how different markets react to potential outcomes.

25 October 2024 (London) – Over the past week, markets have been inclined to discount a win for Trump on November 5th, with betting websites inferring a 60% probability for this outcome. It may seem that the momentum is with Trump, and that it will be difficult for Harris to turn this around in the little time left now until polling day. Subsequently, as the race has swung towards Trump, US yields have continued to push higher, with the yield curve steeper and inflation breakevens wider.

The dollar has also been gaining ground in FX markets, moving below \$1.08 versus the euro. However, this is still a tight race. From that point of view, it is also worth recalling that on the eve of the 2016 election, those same betting sites only placed an 8% probability of a Trump win. Therefore, we think it may be difficult for markets to jump too much more on a 'Trump trade', this side of the election result.

That noted, we would nevertheless highlight that recent market moves have not just been about US politics. Underlying economic developments continue to drive price action, and we continue to witness ongoing evidence of US growth exceptionalism, in a global context.

This has seen robust US data, cooling the enthusiasm towards more aggressive Fed rate cuts. Forward curves now only discount 40bps of cumulative rate cuts through the end of 2024, and the December 2025 contract has repriced by as much as 75bps compared to the lows recorded in mid-September.

In light of this, we feel that the front end of the US curve is now close to being fairly priced. However, we continue to look for higher yields with respect to longer dated bonds, on a view that the yield curve will need to steepen, as investors demand greater term premium compensation for holding longer dated debt, at a time when there is an abundance of government bond supply and fiscal policy continues to be managed on a profligate basis, regardless of the election outcome.

At the same time as the US economy powers ahead, so the backdrop in the Eurozone continues to look increasingly dim. A Trump victory in the US elections also raises the prospect of tariffs on EU exports, adding to economic woes.

In this case, we sense that the ECB could be prepared to accelerate its recent easing of monetary policy, in anticipation of tariffs being announced, should Trump prevail. Perhaps it is also possible to speculate that, on a Trump win, then Lagarde may want to act in order to get her revenge in first, perhaps hoping that more aggressive monetary easing weakens the euro and strengthens the dollar, and this limits Trump's room for manoeuvre.

In light of this, markets now discount a 40% chance that Lagarde will cut by 50bps in December, on a dovish pivot. In this sense, it strikes us that monetary easing could remain the one area where the EU is actually able to outpace the US in the months ahead.

Meanwhile, Japan will hold general elections this weekend. Polls have indicated a poor showing for newly installed Prime Minister Ishiba. It appears possible that the existing LDP coalition could lose its majority, meaning a period of some political uncertainty as policymakers seek to form a new government configuration.

In this case, Ishiba will have a very weak mandate and may not survive very long. Perhaps unkindly, we might speculate whether he will be the latest in a string of global Prime Ministers seeking to outlast a lettuce, as per the Liz Truss 'hall of shame'.

Financial markets may be a little unsettled by political uncertainty in Japan, yet from our perspective, this will have little bearing on the economy nor the BoJ. Early indications suggest to us that the next spring Shunto wage round may top 5% once more, against a backdrop of strong corporate profitability and ongoing labour shortages.

Indeed, we have already seen a few companies looking to award workers a wage hike of as much as 7% next year. From this point of view, we continue to see the BoJ on course to hike rates in January or December. Indeed, the latter may be growing more likely with the yen under some pressure, over recent days.

In the UK, investor focus will be on next week's Budget. It appears likely that the UK government will amend its debt rule, based on a definition of Public Sector Net Financial Liabilities. This might suggest fiscal headroom of GBP62billion over the next five years, but if the Labour government spends more than GBP20 billion on infrastructure projects, without offsetting tax hikes, then we would worry that this will be too much to absorb.

Meanwhile, analysis relating to fiscal headroom has assumed that interest rates and gilt yields will fall, and this will help to reduce the GBP100 billion in annual debt servicing costs, which is now one of the largest line items of government spending. With yields close to their highs for the year, this is already weighing on these calculations.

Meanwhile, any move upwards in yields from here could easily see attempts to free up fiscal headroom evaporate in front of the government's eyes. Hence, there is a sense that Rachel Reeves is walking a tightrope, with the memory of the Truss tantrum still fresh in investors' minds. This should argue for some caution, but we await what is actually delivered next week.

Meanwhile, dovish comments from the Bank of England make us inclined to look for a steeper UK yield curve and a weaker pound. More generally speaking, we also think that FX, as an asset class, may see higher volatility than fixed income, on a relative basis, depending on the result of the US election.

Given that one of the largest policy differences between Harris and Trump relates to trade and tariff policies, we could easily see a differential of 5-10% in major dollar crosses, depending on who wins 11 days from now. In this case, we think that a move below \$1.20 on cable and towards parity versus the euro is possible, on a Trump victory.

Credit markets have been relatively quiet during the past week. Higher absolute bond yields have encouraged demand from insurance buyers, targeting all-in yield levels. This has supported demand for high quality corporate credit, enabling cash spreads to continue to squeeze tighter.

Meanwhile CDS indices have been range trading, meaning that cash has been outperforming CDS from a basis perspective. Yet, perhaps what has been more notable has been the ongoing tightening of euro swap spreads. This has continued to push euro invoice spreads tighter over the past week, with swap rates materially outperforming euro government bonds. In this context, bund swap spreads have fallen to 15bps today, from 30bps one month ago, and 60bps this time last year.

As ECB QT policy progresses, and TLTROs wind down, so this has reduced the need to hold government bonds on the part of the banking system. Previously German government bond collateral has been scarce, and this was a factor leading to elevated swap spreads. This over-valuation has been correcting as QT unwinds.

However, unlike the US, where swap spreads are well below 0bps due to an abundance of Treasury supply, bund issuance remains capped by the German government. German debt issuance is locked, by the commitment to deliver the fiscal 'schwarze Null', which is designed to ensure a balanced budget over the cycle. Therefore, this may limit how much further euro swaps spreads can rally.

However, with QT set to progress for some time to come, so some further narrowing of euro swap spreads remains likely, at a time when generic government bond supply across the continent remains relatively elevated and is unlikely to fall.

Looking ahead

It will be hard to pull ourselves away from US politics in the next two weeks. As we assess how different markets have moved to discount a Trump victory, we have been reassessing our positioning and making a few adjustments in the run-up to polling day. With respect to inflation breakeven trades, these have rallied by 30bps since we incepted a position, and consequently we feel that, at this juncture, it makes sense to close these trades.

Meanwhile, we think that the dollar could rally materially more than is discounted on a Trump win, especially in light of short dollar CTA positioning and ongoing evidence of US growth exceptionalism, versus other developed economies. We continue to favour the dollar and have continued to add to positions.

We also continue to maintain a curve steepening bias in the US and Europe. Meanwhile, we have moved long in euro rates, offsetting our duration short in long dated US yields. Elsewhere, we continue to hold strong conviction towards higher JGB yields and have been starting to grow a long yen FX position versus the euro.

As the clock ticks down, there is a growing sense that we will now all be glad to get the US election behind us. In the final push for the line, it seems that team Harris is desperate for a catalyst that could turn the tide in momentum back her way. However, recent media engagements have not played well, leading to some desperation in Democrat ranks.

By contrast, with just over a week to go, McDonald Trump has been on ebullient form, even having fun handing out fries (or were they lies?!) this week. Clutching at straws, you half bet that Harris is left dreaming that the recent McDonald's e-coli outbreak linked to dodgy quarter pounders could be traced back to her tormentor-in-chief! Whilst that is far-fetched, it would appear she certainly seems in need of a lucky break!

Notes to Editors

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