Market Commentary

Pre-election nerves or is it a bout of the 'cheese sweats'

Food for thought…

Key points:

- Global markets have been treading water, as investors await the outcome of the US elections. Polling has remained within the margin of error for months.
- We have retained a curve steepening bias in the US, as we see fiscal policy continuing with deficit spending, regardless of the election outcome.
- Somewhat better GDP data in southern Europe has been welcomed by European policymakers, however, the news coming out of northern Europe remains downbeat.
- The mixed political developments in Japan should not matter to the Japanese economy nor the Bank of Japan.

1 November 2024 (London): There has been a sense that global markets have been treading water over the course of the past week, as investors await the outcome of next Tuesday’s US election. The last few weekshave seen momentum in polls swing in Trump’s favour, though there is a sense that this result has been partly discounted in financial asset prices.

Implied odds of a Harris win from betting markets now only imply around a 1-in-3 chance of the Democrat candidate emerging victorious, and there is a sense that should Harris prevail, this will come as a bit of a surprise to markets.

Although we are inclined to expect Trump to win, polls remain close, and we would note that this election may still end up being decided by 100,000 votes or less in a small number of swing states. In that context, turnout on polling day could be the deciding factor.

We would also observe that whereas polls have typically understated Trump’s chances, in this election, a gender split that sees Harris favoured more widely by female voters could mean that it is support for her which is underplayed.

In that case, there remains uncertainty over the outcome and, having witnessed poll shocks before, we are aware that it makes sense to be positioned whatever the outcome.

From this standpoint, we have closed or reduced directional trades which had been benefitting from recent Trump momentum. From that point of view, in the past week, we have been reducing credit beta exposure in corporate spreads, selling cash bonds which have performed well on a spread basis.

We have retained a curve steepening bias in the US, as we see fiscal policy managed on a profligate basis, regardless of the election outcome, and we continue to look for this to lead to a materially larger term premium over time.

We have also retained a long bias in US dollar versus euro and sterling, on the notion that the US will continue to experience growth exceptionalism relative to European economies, under either Harris or Trump.

However, we would note that a Trump win would certainly be seen as the most beneficial for the dollar, on an assumption that the incoming President would look to raise tariffs on the United States' trading partners.

With respect to duration, we think that a flat overall stance is warranted, away from Japan, where we continue to hold conviction in terms of a short stance. We would also express a modest preference for euro yields to continue to outperform their US peers.

US economic data may be a little difficult to read over the next few weeks, with a number of releases impacted by recent strikes and hurricane-related disruptions. This could infer some downside risk to the next US jobs report, though we would be doubtful that this is much of a forward-looking signal, even if this does transpire to be the case.

Nevertheless, we continue to think that it is highly likely that the Federal Reserve will cut interest rates to 4.5% next Thursday. A further move in December remains probable, but further monetary tightening will require more evidence of growth and inflation cooling. From this point of view, should a Trump victory see a further rally in risk assets and an easing of financial conditions, then a Fed pause may be more of an open question.

Somewhat better GDP data in France in Q3 may have been welcomed by European policymakers, though it seems quite possible that this could partly be attributed to an Olympic effect. Data in Spain has been strong, with the economy outpacing the G7, and witnessing a 3.4% expansion in the past 12 months.

However, the news coming out of Germany and elsewhere in northern Europe remains very downbeat. In many respects this was typified by an announcement this week by VW to shut three plants in the country, with the loss of thousands of jobs. German manufacturing remains woefully uncompetitive due to regulation and elevated energy costs. Consequently, VW is looking for remaining workers to take a 10% pay cut, in stark contrast to the announcement from IG Metal calling for a 7% pay increase.

Although the auto sector is at the eye of the storm in many respects due to structural overcapacity, the tone coming from energy-intensive sectors in Germany, such as chemicals, seems depressingly similar. Meanwhile, the CEO of Siemens has deemed investing in Germany 'pointless', at the current point in time.

In that case, although the outlook in southern Europe is undoubtedly much better, the outlook for the EU as a whole remains downbeat and we sense a depressed narrative coming from senior policymakers, admitting there is little that can be done to address structural problems, at a time when there is such a dearth of political leadership in France and Germany.

In light of this, bunds have underperformed over the past week, though we don't see this as particularly justified, and a further move up in yields would leave us inclined to continue to add euro duration.

Rachel Reeves delivered a long-awaited UK Budget this week. 'Rachel Thieves' as some unkind parts of the media have labelled her, announced a series of tax rises, with the Labour government driving up public share revenues and expenditures in the UK to a 50-year high.

The desire to drive up investment in the economy in order to drive growth and productivity is laudable, though in many respects it has been seen that the state can be an inefficient allocator of resources, and so time will tell whether this will have the desired result or not.

Moreover, concerns with respect to rising debt levels and interest rate expenses have meant that plans have been backloaded, rather than frontloaded, in order to mitigate pressure on gilt issuance over the course of the coming year. In that case, the impact of the Budget changes could seem to underwhelm over the course of the coming quarters.

Meanwhile, adding to employers' labour costs could see these passed onto consumers, with wages continuing to materially outpace inflation, notwithstanding very limited productivity growth. A BoE rate cut in November is very likely, but thereafter, we remain wary that poor inflation news may limit the Bank's ability to ease that much further over the quarters ahead.

Gilts have had a rollercoaster 48 hours and have materially underperformed other government bond markets of late; it may now be that much of the bad news is ‘in the price’. However, we struggle to build much of a bullish narrative,and we also retain a relatively downbeat assessment on the valuation of the pound.

Last weekend’s elections in Japan saw a miserable outcome for newly installed Prime Minister Ishiba and the LDP coalition government. The ruling party has lost its majority, but given the divided policy agendas of the opposition, we think that the likely outcome will be for the LDP to lead a minority government, with Ishiba remaining in place, at least in the short term.

A change in LDP leader seems quite likely early next year, ahead of Upper House elections in the summer. However, these political developments should not matter too much to the Japanese economy nor the BoJ. Wage growth remains upbeat and is structurally underpinned by a labour shortage.

It is interesting for us to reflect that in the past decade, there was a narrative that ageing populations would see inflation fall. Yet in Japan, we have observed that as economic activity steeply declines in those aged over 75 years, so a contraction in labour market supply will end up boosting wages and feeding into higher consumer prices.

Looking ahead, we continue to think that the BoJ will hike rates to 0.50% in December or January, with a further 50bps of hikes to come in the 12 months thereafter. With the Japanese economy more vibrant than is the case for much of the Eurozone, interest rate differentials between the economies are set to narrow sharply in the coming months. With the yen also structurally undervalued, so we think that long yen versus the euro could be one of the most compelling FX trades to look for in the course of the year ahead.

Credit market volatility was relatively subdued over the course of the past week, with equity markets largely rangebound. That said, impressive bank earnings results have helped underpin performance across the sector and, more broadly speaking, corporate earnings in the US continue to remain healthy.

On an objective basis, IG credit spreads may appear to be moving towards a tight valuation, when considering the degree of forward-looking economic, policy and geopolitical uncertainty. However, an ongoing oversupply of government bonds relative to corporate paper can continue to be a technical factor that underpins spread tightening, and this theme continues to be prevalent in the euro swaps market, where QE unwinds mean that there is an ongoing reversal in the bid for AAA-rated government collateral.

Elsewhere, political developments have cast a shadow over Latin American markets, including Brazil and Colombia, of late, while the sight of South Africa cosying up to Russia has done little to help the country’s image in the eyes of overseas investors.

Looking ahead

This time next week, the US election will finally be behind us (or at least that is the hope, unless we end up with a very close and contested outcome). Market volatility will most probably pick up, though we are doubtful that this will be a trend that is sustained. Consequently, our playbook as we approach next Tuesday is to look for opportunities to buy (or sell) any extremes in price action, thinking that moves could subsequently reverse.

That said, keeping an open mind to upcoming developments remains important. Feelings towards Trump and Harris are polarised into two distinct camps, but dispassionately assessing what the new administration will do (not just what they might say) will be important when it comes to inferring macro trends and identifying opportunities. Pondering what lies ahead of us and how emotions are running high, it may not seem a time for cheesy puns or comments.

However, headlines this week of ‘The Great British Cheese Robbery’, which saw 23 tonnes of high-quality cheddar go missing, means that it is hard to look the other way. And with many edible Trump images doing the rounds, there’s plenty of opportunity for food art with a political bite. Say cheese….!

Notes to Editors

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