RBC BlueBay
Asset Management

Market Commentary

The Second Coming….(minus Armageddon one hopes!)

Is an apocalypse just around the corner?

Key points:

- Market volatility in the aftermath of the US election has subsided and the market is roughly back to pre-election levels.
- It won't be "business as usual" in Washington and moving forward, we remain prepared to invest opportunistically, should markets become dislocated.
- Higher wages, driven by labour shortages caused by an ageing population, are seen as sustaining inflation in Japan above 2%. This leaves little doubt that Japan is on a path of monetary policy normalisation.
- European markets were quiet this week, while inflation in the UK appears likely to remain more elevated, limiting the options of the Bank of England.

22 November 2024 (London) – Over the past week, it has felt like the market volatility in the immediate aftermath of the US election has started to subside. Broadly speaking, it is interesting to observe that the levels on US Treasury yields and US stock indices are not much changed compared to levels which were recorded just prior to the US vote itself, with market moves having been more notable in the month running up to the election, as a Trump victory seemed to be priced in.

Moreover, with many investors having expected a very close election and possibly a contested and inconclusive result, there was a sense that the market had hyped up the election to an extent that it was almost inevitable that volatility would start to subside once the polling date was ultimately out of the way.

As we now move into Thanksgiving week in the US and thoughts start turning towards year end, it seems appropriate to question whether volatility in financial markets will be able to continue to recede into the end of the year. Indeed, even scary headlines coming out of Russia over the past week have failed to have much of a market impact.

However, a benign view may strike us as a complacent one to adopt, at the present time. For sure, Trump's picks for senior roles in his administration continue to be 'unconventional' and speak to a policy agenda which seeks to transform, not just change, the way things are done.

It is unlikely to be BAU when Washington returns from recess at the start of next year, and the idea that a few eggs get broken in the process speaks to us of a pattern of elevated volatility in policy and politics over the months ahead, which can easily translate into material gyrations in financial asset prices.

Thus, having positioned for Trump trades in anticipation of his victory, we have been happy to flatten out risk in a number of areas in the aftermath of the result, as we think it makes sense to be able to adopt a stance where we are positioned to add risk materially, in the event that volatility should resurface and asset prices become dislocated.

We now have a neutral directional view on the path of US yields. Nevertheless, we retain strong conviction with respect to yield curve steepening on a 2/30 basis. Simply put, we just don't see the fiscal paradigm altering until the curve is much steeper.

At this juncture, tax cuts might weigh more directly on asset prices and the housing market, prompting calls for fiscal change in order to lower long-term rates and avert a seizure in construction activity.

Yet these eventualities remain a way off and a curve still inverted on a cash versus 30s basis continues to give a green light to policymakers in terms of fiscal profligacy. Meanwhile, the December FOMC is shaping up to be an interesting meeting.

We think that with economic data remaining upbeat, the Fed will probably deliver the last cut in the mini-cycle for the time being, in either December or January, then signal that rates are on hold for a period. This will conveniently allow Powell and colleagues to assess the actions of Trump's team before taking additional action, as we progress through 2025.

On the one hand, material additional rate cuts are possible, should the economy slow and recession risks resurface. However, it may be just as possible that inflationary risks see the FOMC hiking by this time next year, albeit the magnitude of prospective rate cuts in this scenario may be smaller than the size of rate cuts would be in the former case.

Nevertheless, for those dismissive of Fed hike risks, we think it is worth asking the question in terms of what the Fed's inflation tolerance will be, should Trump's policies relating to immigration, trade and fiscal lead to inflation trending higher not lower next year, as prior Fed forecasts may have projected.

From this perspective, we would note that the downtrend in core PCE prices has recently appeared to stall, around 2.7% yoy, over the past few months. We think that should this series re-accelerate to 3.5% in the coming months, then it will be unavoidable for the Fed to ignore. This would be where we think a pain threshold would exist, at which point the FOMC would be simply obliged to start raising rates again or stand charged of a dereliction of its mandate.

While it is clear that Trump will be vocal on the performance of the Fed (as he was in his last term), it is our belief that he won't want to interfere in Fed policy directly. Powell will be replaced as Chair when his term ends in 2026, but we doubt that Fed independence can be challenged, as this would promote a big risk-off shift in financial asset prices, for which the President would rightly kop the blame.

Moreover, we actually would discern that it suits Trump to have optionality on Powell, in that going forward, any good economic news will be a product of him being the 'greatest president there ever was', whereas any data disappointment will be very much called out as a result of Fed incompetence.

Elsewhere, policymaker meetings in Tokyo this week have provided a healthy distraction from the machinations of US politics. Our principal takeaway from discussions is that analysis around the economy and demographic trends is now pointing to the conclusion that the ageing of the Japanese population is inflationary, not disinflationary, as had been conventional wisdom over the past couple of decades.

More current thinking has it that a contraction in labour supply creates competition for workers, thus pushing up wages. In the decade prior, rising female worker participation and rising employment of seniors helped mask the labour shortages which had been developing.

However, it has been observed that worker participation drops off sharply beyond 75 years of age and with Japanese female participation already one of the highest in the G7, it is no longer possible to avoid a contraction in labour supply.

Wage growth in the 2025 Shunto, announced in Q1 next year, is likely to exceed 5%, in our view, which seems to be shared by many policymakers and domestic investors.

Higher wages are seen as sustaining inflation at or above 2%. This being the case, there is little debate that Japan is on a path of monetary policy normalisation. We think cash rates will hit 1.00% at the end of next year, with a hike likely in December 2024 (or possibly January) taking cash rates to 0.50%.

Interestingly, BoJ analysis on the neutral level of cash rates now sits in a range of 1.00% to 2.50%, in a world where inflation is stable at 2%. This would appear to mark an upward revision compared to prior

conversations, and it is also striking to us that the top of this range infers that the neutral real interest rate is in positive territory.

Meanwhile, the sense from Tokyo meetings is also one that as YCC unwinds, with Rinban purchases on bonds reduced on a pre-planned schedule in the coming year, so 10-year yields can also rise, with the shape of the yield curve normalising as they do so. Arguably 10-year bonds in Japan are artificially rich when compared to 30-year maturities, as a legacy of eight years under YCC, and we think that this part of the yield curve can flatten, even as we project long-end steepening in the US and Eurozone in the months ahead.

The unwind from YCC has been relatively cautious thus far, noting that this policy had previously been characterised as the 'Hotel California' policy; it is easy to check into, but nigh impossible to check out of. In this light, so the BoJ has been very content that the exit to date has been a smooth one.

Although it is clear that the BoJ is content that policy normalisation thus far has been relatively smooth, what wasn't smooth in Japan was the market's reaction to a BoJ rate hike back in August. This has created a level of angst that history could repeat itself, since December is a month when market liquidity is similarly low.

However, we just don't see the same prevalence of carry trades at this juncture, compared to before, and hence any impact is likely to be more modest. Moreover, we would expect the BoJ to take a leaf from the Fed's book and be much clearer in terms of leaking its intentions to the market ahead of any monetary policy meeting taking place.

Monetary policy needs to avoid surprises, and the BoJ could do a better job of communicating with more clarity and consistency. We are hopeful that the BoJ is listening to market participants in this respect.

Moves in European markets have been more modest in the past week. The UK gilt market continues to underperform, and data showing an upside surprise in inflation this week reaffirmed fears, which we have held, that the BoE will have very little room to lower rates in the year ahead.

Meanwhile, the fact that borrowing costs are overshooting the expectations of the Labour government means that fiscal space has all but evaporated, given the elevated level of interest rate costs in the UK Budget. Should yields continue to rise, then Labour will be forced to raise taxes further and a political crisis could quickly materialise.

Unfairly or not, the UK remains vulnerable to a challenge in terms of fiscal debt sustainability and the nation is in the debt of Liz Truss in this respect. Like it or not, the UK will be something of a canary in the coalmine and the UK government will do well to avoid provoking a conflict with investors.

We think that technicals in credit could continue to help spreads into the end of the year, though we are wondering how far euro swap spreads can tighten versus German bunds, given that we can't see the CDU abandon the Schwarze Null commitment to a balanced budget this side of the February election.

We continue to be bullish on the dollar for now and also express confidence in positioning long yen versus the euro. It is becoming cheaper for Japanese investors to hedge their euro FX exposure, as the yield differential between bunds and JGBs narrows. We also see Japanese investors allocating more towards domestic assets and less overseas, in the coming year, with Japan yields rising and the BoJ stepping back from the bond markets.

Looking ahead

In many respects, I feel an apology is due at this stage, for those still reading this comment, given that it is a longer read than normal this week. The truth is that there is so much going on and so much to write about, I'm aware that there is plenty that I have not covered in the paragraphs above.

Yet, if we are correct that volatility can continue to wane into Thanksgiving, this may mean there is more that can be discussed next week, when things are quieter (at least on the surface). Otherwise, as we look ahead, we seem set to remain in a market landscape in which uncertainty in policy and politics can continue to drive volatility in financial markets.

From this perspective, staying close to the thinking of policymakers, by engaging in proprietary research, continues to have much merit for ourselves. We remain hopeful that our insights and understanding around these topics help to give us an edge that we can continue to hone, in order to drive active returns.

Meanwhile, in a week of sabre rattling from Russia, in response to a decision to allow western missiles to be fired by Ukraine against targets inside Russia, there has been a sense that the apocalypse could be just around the corner. That said, our own assessment, for now, is that Russia's comments are designed more towards creating disagreement and discord between the Allied powers than anything else.

Mind you, with some elements of the Christian community highlighting that the End Times could be upon us, there is also a narrative that Donald Trump's ability to survive an assassination attempt and his election is by divine appointment. A Second Coming of Trump might seem to be stretching the imagination, yet in financial markets, as in all walks of life, it is easy to fall into the trap of seeing things that aren't really there….

Notes to Editors

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