RBC BlueBay
Asset Management

Market Commentary

Who will be left to milk the cows?

The politics of dairy

Key points:

- The Mexican peso and Canadian dollar came under pressure this week, following Trump's comments with respect to a 25% tariff.
- Tensions are rising in France, with Le Pen threatening a no-confidence vote in the Barnier government.
- The economic backdrop in Germany remains depressed; there is a school of thought that Europe's problems are structural in nature and a reform agenda is needed.
- With Trump's picks now largely in place, market focus will be back on economic data and key central bank meetings in the coming month.

29 November 2024 (London) – US yields rallied in the run-up to Thanksgiving, with markets comforted by Trump's pick of Scott Bessent as Treasury Secretary. The market consensus appears to be that Trump's bark is worse than his bite, and that it is possible to look through his comments without taking them at face value.

In that light, the mainstream view is that Trump's comments this week with respect to a 25% tariff on all Mexican and Canadian imports can be viewed as a point of negotiation and won't actually come to pass. Nevertheless, the Mexican peso and Canadian dollar have still come under pressure, highlighting Trump's ability to impact market prices through his tweets, regardless of the ultimate intention.

The USMCA trade deal is due for renegotiation next year, although Trump has the ability to abrogate this via the use of executive orders, which he may choose to enact. In reality, much of Trump's gaze is directed towards the southern border of the US, noting that Mexican support will be needed in helping curb illegal immigration.

Yet, such is his personal disdain towards Trudeau and the agenda he stands for, so it is that Trump is equally happy to apply pressure in Canada too. In this case, he might reason that this pressure may help benefit Poilievre's Canadian Conservatives into next year's elections. In this respect, it seems highly likely that these Canadian elections are likely to see an administration in Ottawa much more closely aligned to Trump's thinking and world view than has recently been the case.

Across the Atlantic, the political temperature has also been rising in France, with Le Pen threatening a no-confidence vote in the Barnier government, in the wake of discussions around the French budget. The fiscal deficit in France this year is expected to top 6% of GDP and with the country subject to EU excessive deficit procedures, so there is an institutional requirement to lower this in the year ahead.

However, Barnier's proposals aren't popular, and Le Pen sees political capital in rejecting the lame duck currently residing in the Elysée Palace. We had thought that Le Pen would wait until next summer before pulling the rug, as new elections cannot be called within 12 months of this July's vote.

However, Le Pen is a populist and won't want to be seen to be propping up a government that seems tone deaf to what voters want to hear. In addition, moves on the part of the establishment to try to bar Le Pen from holding office and running for the Presidency in 2027 are likely to have served as an irritation to her, causing her to become impatient.

Ultimately, we would say that blocking Le Pen seems like a strategy that could serve only to boost her popularity, and those having watched the recent US election will understand that similar attempts only ended up helping the support of Donald Trump.

French 10-year yields now trade at the same level as Greece, and it is striking to think that a more up-to-date definition of what constitutes the EU periphery would now presumably include Italy and France, with Spain, Ireland and Portugal now firmly established in what we had termed the 'semi-core'.

It is hard to be too optimistic on the trajectory for France, and with overseas investors in countries like Japan being heavily exposed to France, there is a risk that OATs could see further selling pressure if the political backdrop deteriorates. Ultimately, we still think that any move in spreads should be capped for the time being. Le Pen won't have her hands on power any time soon.

However, France as a credit is on a structurally deteriorating path, which shows no sign of changing. The population feels entitled to its standard of living and the French way of life but hasn't yet grasped that it is not in a position to pay for it. Ultimately, only stress may change this assessment. However, for the time being, we continue to see the current move contained at a spread of 100bps versus bunds.

The economic backdrop in Germany remains depressed, though ECB's Schnabel appeared to push back on calls for more aggressive rate cuts, during the past week. There is a school of thought that Europe's problems are structural in nature and that an agenda of reform will be required.

From this perspective, there may be room for rates to decline towards a neutral 2% level in coming quarters, but if inflation is not dropping further, then additional monetary easing beyond this point will be problematic. Intrinsically we think that the stars may end aligning for a much larger EU fiscal package going in the direction of the Mario Draghi plan.

Yet, this won't be endorsed by Germany ahead of February's election, and even beyond this it is questionable whether the CDU will allow more of a push at a supranational level, which accelerates a path towards closer fiscal union and a single market, or whether Berlin will seek to keep control of its own spending, fearing fiscal profligacy engulfing the continent in years to come.

We see these trends pointing towards a steeper EU yield curve, mirroring our thinking in the US market. However, we are more inclined to look at developments in the EU right now, and we see greater opportunities in FX rather than in rates or sovereign spreads. The euro has been weakening, and we see scope for this move to run further, as the Eurozone economy lags, regional political risks build, and the threat of tariffs looms large.

Although Trump did not call out the EU or any European countries for special attention when making comments relating to China, Mexico and Canada this week, it does not mean this won't be forthcoming in the days and weeks ahead. In this context, we continue to look for parity between the euro and dollar into the end of the year, whereas an even larger move may be possible versus the yen during 2025, with European interest rates shrinking and Japanese interest rates moving in the other direction.

Elsewhere in Europe, the first round of presidential elections in Romania produced a surprise result, with a nationalist candidate who has sympathies aligned towards Russia winning the most votes. Alarm at this outcome may actually lead to a better result for the pro-EU parties at this weekend's parliamentary elections, with voters already having an opportunity to protest their frustration with the incumbent government.

In many respects, we would note that in pretty much every election held worldwide this year, incumbent parties have been punished and lost vote share. In many respects, voters remain angry at rising prices and an erosion of purchasing power. Even where wages have risen, there is a sense that workers assume that such moves are a reflection of their own hard work and talent, whereas increases in the price level are seen as something that those in power are to be blamed for. This said, we are hopeful that Romania will maintain its pro-EU stance and, in that light, we are inclined to see any underperformance in Romanian assets as a potential opportunity to add.

Looking ahead
As we head into December and the Trump picks are now largely in place, we are moving into a period where market focus will be back on economic data and key central bank meetings in the coming month.

Payrolls and inflation data may determine whether the Fed delivers a third successive policy easing at its December FOMC meeting. In many respects, we might question whether further rate cuts are required at the current time, and certainly we expect some material upward revisions to the Fed's dot plot.

That said, we have thought that Powell might like to deliver one more easing of 25bps in either January or December and then communicate that policy is on hold for a period of time. In this case, the Fed will have delivered 100bps of easing, and a pause after January will mean that Powell and colleagues are in a position to assess any measures enacted by the incoming administration and their impact on the economy.

Thereafter, rate cuts may resume later in the year – but only it would appear, if growth slows more materially, or if inflation resumes its downward trend. Conversely, if growth remains robust and should upside inflation risks re-emerge, then we see the Fed forced into hiking if core PCE prices move above 3.5% and appear to be on a rising trajectory.

That said, with the skew towards larger rate cuts in the former scenario, versus smaller rate hikes in the latter, then we see short-dated yields as reasonably priced between 4.25%-4.50%. In this context, should 2-year yields rally down towards 4.00% in the absence of much weaker data, then this may create the opportunity to move back to a short duration stance.

In the Eurozone, a 25bps cut from the ECB appears a much more predictable event. The Bank of England is seen as remaining on hold, whilst one of the most important policy meetings could take place in Japan, where we expect Governor Ueda to announce a 25bps hike, taking Japanese interest rates to 0.50% at the end of 2024. The last Japanese rate hike triggered widespread dislocations across markets as carry trades were unwound.

However, we would note that such positions are now much smaller. Moreover, a policy shift in December is approximately 50% priced according to interest rate futures markets. We think that Ueda will be careful to leak his intentions to the markets in order to avoid another policy surprise, and so we will be assessing BoJ commentary prior to the blackout period very closely. In that case, if there is to be a December move, then we look for this to be signalled in advance during the next couple of weeks.

Otherwise, as we assess the prospective impact of Trump's policies in the weeks to come, one anecdote that has been striking to us pertains to the potential impact of a clampdown on immigrants in relation to milk production in the US. Industry data shows that immigrant workers account for 51% of all dairy labour and by many accounts, many such workers who have to operate gruelling 10-hour shifts starting at 4am may be undocumented.

Consequently, any move to round up illegals could see workers disappear in a hurry, creating a labour shortage, which it may be hard to replace. Simplistically speaking, there is not much of a queue of young American kids who will want to rush to perform this sort of work. In this light, you can see that even a fear of a clampdown can create impacts in basic industries, leading to rising prices and disruptions across supply chains.

Although this may be a relatively trivial example, it does show how policy actions can start to have unforeseen consequences, which are not always easy to spot in advance. Indeed, attempts to Make America Great again may not lead to a promised land flowing with milk and honey….

Notes to Editors
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