RBC BlueBay
Asset Management

Market Commentary

Political risk going K-Pop

Beware the unknown unknowns!

Key points:

- As the political situation in the US begins to settle down, volatile situations have developed globally.
- The direction of US yields is largely dependent upon incoming payrolls data this week and inflationary data the following week.
- Due to key structural challenges facing key countries, we maintain a gloomy assessment of European prospects.
- Looking ahead, we think that we will only see one more rate cut in this cycle, before the Fed pauses, taking time to review the impact of past policy actions.

6 December 2024 (London) – US yields were largely rangebound in the past week, in the run-up to US labour market data, which is released later today. But just as the dust settles with respect to US politics, the past week has witnessed something of an explosion of political developments elsewhere. In the past several days, a vote of 'no confidence' has led to the demise of the Barnier government in France.

In Romania, fears of a shift towards a nationalistic, right-wing trajectory have been mitigated by parliamentary elections, which have shored up support for the pro-EU and pro-NATO establishment.

Meanwhile, in South Korea, we witnessed a shock attempt by President Yoon Suk Yeol to declare martial law, in what looks to have been a very ill-advised political gambit. It now seems likely that the President will himself be impeached and removed from office. Following a sharp fall, Korean assets have been swift to recover from the initial drop in prices. Nevertheless, it might strike us that efforts to cement Korea's status as a stable, developed market country may have taken a blow on the back of the latest events.

Investors may be more inclined to look on recent Korean developments as something that is more becoming of a country that remains classified as an emerging market, notwithstanding a GDP per capita of $33,000, slightly above that of a country like Spain.

That said, it just feels like we are living in times when political volatility and uncertainty is elevated globally. Voters in many democracies have been left resentful of rising prices, elevated income inequality, and rising social tensions.

Indeed, we would tend to look at Korea as a relatively healthy (if noisy) democracy. Yet it is also a country divided, as highlighted in gender-based politics and the feminist 4B movement, in which Korean women are rejecting men in the country. In this context, it is notable that the birth rate in Korea is now the 2nd lowest in the world….perhaps, small wonder there is an amount of pent-up tension!

Returning to France, it strikes us that the root cause of many of the problems facing the country are rather different. Simplistically put, France is a beautiful country with a heritage and culture that is much cherished by its citizens. Yet, for the French there is something of a sense of entitlement to a standard of living and a way of life, which makes the country resistant to change and reform. But with debt levels rising and the country subject to EU excessive deficit procedures, there has been a sense that the nation has been living beyond its means for some time and change will surely need to occur.

However, the past experience of other EU countries in southern Europe suggests that in such situations, change only occurs after a period of some pain and a prevailing sense of crisis. With OAT spreads only 80bps above bunds, we are some way from reaching such a point, at this particular juncture, and so this does not seem likely to occur for the time being.

Since Budget cuts and austerity are politically unpopular, it is not surprising that Le Pen and her populist leaning National Rally have sought to reject the Barnier proposals, leading to the government's collapse. In the near term, Macron may appoint a new Prime Minister to form a new government. In this case, a new Budget may be possible if cuts are watered down.

Alternatively, if a stable government can't be established, then the 2024 Budget will be rolled into the coming year, inferring a deficit similar to the 6% recorded in 2024. In either case, we suspect that Le Pen can bide her time, waiting to push for new Parliamentary elections in July next year. In the short term, this means that France remains a structurally deteriorating credit.

Therefore, we retain a negative stance on France, though we don't see a clear catalyst to push spreads materially wider for the time being. In this case, our positioning in OATs remains flat for now, but we look for opportunities to short French credit in the New Year, should spreads narrow over the course of the next couple of months.

Longer term, the bigger risk for France will come at the point of the 2027 Presidential elections. It might appear that voter antipathy towards Macron only continues to rise and were an election to take place today, then French voters would most certainly be presented with a choice between the hard left and the hard right, in a second-round Presidential run-off.

Indeed, this very point is an important reason why Macron won't want to resign his office, despite his unpopularity, at the current time. Meanwhile, with respect to bond valuations, with French spreads now matching Greece and materially wider than Spain, we feel that it is becoming appropriate to question the conventional wisdom that France is actually a better credit than Italy.

In the case of the latter, debt levels have been elevated for a very long time, but a responsible attitude towards the country's finances has seen a relatively balanced primary balance achieved in past years. By contrast, France is coming from a much stronger starting point, but is catching up with Italy relatively quickly.

Moreover, it seems that Italian governments and society have learned the lesson of what happens during periods when debt sustainability is called into question and have no desire to repeat this again. In France, it seems those lessons may only be learned by experience, and it will be important for French society, as a whole, to embrace the imperative to change.

Elsewhere in Europe, we maintain a gloomy assessment of regional prospects. Many commentators will observe the key structural challenges facing the Continent, along the lines described by Mario Draghi. However, there just doesn't seem the political will to get much done about this, and with the political vacuum in France and an upcoming election in Germany, we doubt this picture will change much for the next few months. However, we do think that there will be more of a move towards EU fiscal deployment in the quarters ahead, as the growing challenges facing the region will become increasingly impossible to ignore.

Fiscal risks are a reason to be wary of becoming too bullish with respect to euro duration, notwithstanding a downbeat economic outlook. Meanwhile, as we look at the economy in 2025, we are inclined to think that inflation risks could be more tilted towards the upside than the downside, even though the economy is only limping along. This may limit just how far the ECB is prepared to lower interest rates in the coming months, though a 25bps cut in December remains very much a done deal.

We also see inflation risks as prominent in the UK and this being a factor limiting further BoE rate cuts. However, a mildly stagflationary backdrop does not create a backdrop likely to benefit FX, even if rates remain elevated, relative to elsewhere. In Japan, we await more commentary from Governor Ueda and his BoJ Board colleagues, to cement the likelihood of a rate hike to 0.50% on December 19th.

At the current time, markets only attach around 1/3 probability to such a move, and we think it will be important for the BoJ to message to the market ahead of the meeting, in order to minimise any potential for a policy surprise and market volatility thereafter. With global markets largely closed for Christmas in the immediate wake of the BoJ, liquidity will be thin and from that perspective, we know that the authorities in Tokyo will be seeking to avoid a repeat of the market volatility in August.

Yet, with Tokyo CPI accelerating to 2.6% in November and expectations for a 5%+ wage gain in Q1, there seems little economic justification for the BoJ to delay, noting that it appears to be revising upwards its thinking with respect to neutral interest rates in the country.

Risk assets have traded with a constructive tone over the past week. Bitcoin has finally managed to breach USD100k and the S&P has traded to new highs around 6,100. In this context, credit spreads have continued to tighten, with swap spreads also pushing lower. Since the US election, we have been reducing credit risk across our strategies.

Meanwhile, we have reached a point where we think that the move in swap spreads have gone far enough and we are now looking for this to reverse, in the Eurozone, at least. 10-year euro spreads are around -9bps having been above 30bps earlier this year. In part, this move reflects an abundance of government bond supply and forward-looking fears relating to fiscal profligacy.

Government bonds have also been negatively impacted by an unwind to past QE policies, which has reduced the need to own bunds and taken away from the relative scarcity, which previously saw spreads above 80bps, just over two years ago. However, we now think this move has gone far enough and could be likely to reverse over the medium term.

Should EU fiscal policy lead to large scale issuance of EU debt next year, then we would anticipate this to push swap spreads wider. This direction in spreads may also be seen in scenarios where the German government adheres to the Schwarze Null policy of the balanced budget, or in a scenario in which rising political tensions morph into renewed concerns with respect to EU break-up risks and questions about the stability of monetary union, in the absence of political union.

Conversely, only a material deterioration in German fiscal finances are likely to drive swap spreads even more negative towards -20bps. Yet we would note that relative to US Treasuries, German collateral is relatively scarce, with a debt-to-GDP only half that of the US.

Looking ahead

There is key US payrolls and inflation data to come ahead of an FOMC decision in 12 days' time. Following recent Fed comments, a December cut is discounted with a 75% probability, notwithstanding projections for data releases which are broadly robust.

We are largely in agreement with this profile, though we would continue to highlight that we think that we will only see one more hike in the current sequence of rate cuts, before the Fed sits back and pauses, taking time to review the impact of past policy actions. Doing so also provides a great opportunity for the Fed to reflect on the policies of the incoming administration and the impact on the economy in the wake of any changes.

We will be interested to listen to Powell's commentary at the next press conference, and we expect growth and inflation forecasts to be pushed higher, with the dot plot also reflecting a projected path in which rates stay higher for longer than previously appeared to be the case.

Meanwhile, this week's news from Korea is a timely reminder to be aware of the unknown unknowns. We have highlighted that there is an abundance of economic, political and geopolitical uncertainty in the period ahead. This week's K-Pop of volatility was short lived…. but other developments may be much more long lasting in nature.

Notes to Editors
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