RBC BlueBay Asset Management

Market Commentary

Wise men follow a new light in the night sky

A time for reflection and bold predictions for the year ahead

My predictions for 2025:

1. 2025 will be another year of US growth exceptionalism, but will 2026 be the year we finally need to fear recession?
2. Fed and BoE policy on hold in H1, as the BoJ hikes and the ECB continues to cut rates
3. A year of curve steepening everywhere, with the exception of long-end flattening 10/30 in Japan
4. US dollar set to outperform at the start of 2025, but the yen to be the strongest G10 currency over the year as a whole
5. A year of clipping coupons in credit, as spread narrowing runs out of steam and credit compression trades start to reverse
6. A year of mounting problems in private market assets, as rates staying higher for longer proves toxic for business models reliant on leverage and cheap borrowing
7. National Rally to be victorious in French Parliamentary elections in August, but AFD in Germany remain largely sidelined in the Bundestag
8. Trudeau will leave office by end of March, Musk won't last in the DOGE beyond June and Reeves (and possibly Starmer) may be gone next October
9. Chelsea to win 2 trophies, but miss out on the League title this year………

20 December 2024 (London) – As 2024 draws to a close, there has still been plenty going on to sustain the interest of market participants in the last active trading week this year.

In the US, the FOMC cut interest rates by 25bps, as largely expected. However, as we have previously noted, further monetary easing will be subject to data highlighting a weaker economy and lower inflation.

We now see the Fed on hold in the first half of 2025. There remains plenty of economic and political uncertainty in the year ahead, but for the time being the US economy continues to exhibit solid growth momentum.

Although interest rates remain at a level deemed relatively restrictive, if the policies enacted by the upcoming Trump Administration lead to inflation risks emerging on the upside, then the next move could conceivably be a hike, not a cut, in the second half of the year.

Nevertheless, short-dated yields continue to look fairly priced in our eyes, when aggregating possible scenarios over the year ahead. However, we continue to think that longer-dated tenors could remain under upward pressure in the coming months, on the view that fiscal concerns are unlikely to abate any time soon.

Eurozone fixed income has outperformed US Treasuries during 2024, with the 10-year yield spread now standing at 220bps.

Unlike the US, Bund yields trade well below current cash deposit rates, reflecting expectation that Lagarde and her colleagues will need to continue to ease policy further in the coming months, with futures markets seeing a cumulative 100bps of further rate cuts before the end of the summer.

This assessment seems plausible to us, though with much of this good news already embedded in market valuations, we struggle to form to strong a conviction with respect to Eurozone yields for the time being. Instead, we think that ongoing economic and monetary policy divergence is likely to manifest more clearly in FX moves over the coming months and continue to look for a test of parity in the euro / US$ exchange rate.

The Bank of England maintained cash rates at 4.75% at its MPC meeting this week. As we have noted of late, UK inflation pressures remain elevated, notwithstanding a weak economic backdrop.

This was demonstrated by the latest wage data, showing an acceleration to 5.2% growth, which is not compatible with the Bank of England inflation target, in an economy devoid of any productivity growth. Bailey and colleagues continue to want to project a path towards further monetary easing going forward, though there is a sense that their hands may be tied by the data.

UK Gilts have continued to underperform other markets and are now approaching levels recorded at the time of the Truss tantrum in 2022. Higher borrowing costs are feeding back into a deteriorating fiscal profile and there is a growing sense that the Labour government is quickly running out of ideas.

If current moves persist, there is a danger that Rachel Reeves will be breaking her promise not to raise taxes further, less than a month after making this claim.

Meanwhile, it is interesting to note the rise of Reform UK in the polls. With Nigel Farage now the bookmakers' favourite as the next PM after the next General Election, it is striking how the success of Trump in the US is striking a similar chord overseas.

In Japan, the BoJ kept policy on hold this week, which wasn't a big surprise, given that markets had downplayed expectations for a move over the past couple of weeks. However, it had been widely expected that Governor Ueda would use his press conference to firm up the expectation of a January hike and when this was not forthcoming, this has seen the yen coming under renewed selling pressure.

Ueda stated that the BoJ wants to see more data and does not want to pre-commit. Though with inflation rising and every indicator of the upcoming wage round already looking very firm, one wonders whether it was political factors that influenced the BoJ decision making, as much as anything else.

The current LDP government is in a very weak position and there is thinking that delaying monetary tightening may help them garner support from the ranks of the DP. Yet, inasmuch dovish policy could undermine the Japanese currency, this also goes against the wishes of policymakers in the Diet and so there is a risk that the BoJ could be making a policy error, if data highlights inflation risks building to the upside and the BoJ falling further behind the curve.

Arguably, the one outcome that Japan really needs to avoid is to allow too much of an inflationary overshoot to develop. If this needs to be addressed through monetary policy, the outcome could be very painful at a future point in time.

Consequently, we remain confident that the BoJ will hike to 0.50% in January and that rates will reach 1.00% in Japan by the end of 2025. 10-year JGB yields should climb as the BoJ purchases wind down, leading to a flattening of the 10/30 curve, which appears too steep in Japan at a time when it is much too flat elsewhere.

Furthermore, a narrowing of rate differentials should ultimately favour the yen. Already, the difference between 10-year Chinese and Japanese government bonds stands at 50bps and is not much more than 100bps relative to Germany. In this context, we continue to like the yen structurally versus the euro and CNH and would target a level below 140 on euro/yen by the end of next year.

Elsewhere, political risk has picked up in Canada over the past week, with the resignation of Chrystia Freeland, the country's Finance Minister.

Early elections are now coming into view and in the short term the C$ has come under pressure, as risk premia increases. We are confident that Pierre Poilievre from the Canadian Conservatives will be the next Prime Minister.

This may lead to a much warmer stance from the Trump Administration than Trudeau has seen to date. Trump has done little to hide his disliking towards Trudeau and his distaste for his policies.

In that context, we are inclined to see the C$ recover after an election takes place, but in the near term it seems premature to turn more optimistic.

Credit spreads have closed the year near to the tights. Default rates have remained low, and liquidity remains relatively abundant, notwithstanding shrinkage in central bank balance sheets over the course of the year.

At a time when there has been an excess of government bond supply, the relative market technicals have favoured corporates versus governments from a spread narrowing perspective.

2024 has witnessed credit compression trades with higher yielding securities outperforming higher quality peers, as recession fear has dissipated. Financials have also had a strong year with AT1 assets outperforming, and the debacle that was Credit Suisse is now more of a fading memory.

EM credit has also performed well, though it has been a more challenging year in local markets in EM. Both EM rates and FX have been under pressure in a number of countries.

Deteriorating growth prospects in China, as well as political turmoil and fiscal concerns in countries like Brazil, have weighed on fundamentals. With Trump winning the race for the White House, a strong dollar and a higher trajectory for US rates have also been hurting EM sentiment in local markets.

In credit, we have been continuing to reduce positioning after a strong run. Ahead of new year supply and potential Trump volatility in January, we have reduced credit beta exposure to the lowest level we have run, in the past couple of years.

At this point, we feel that the opportunity cost from moving towards a short stance in credit now looks pretty modest, though we struggle to get too bearish at a time when we continue to have a relatively constructive view on the US economy.

In that context, we are happy being close to flat and using any potential widening as an opportunity to add at more attractive levels.

Meanwhile, we have been speaking about an increased opportunity set in FX relative to rates and credit as we head into the new year, and this is broadly reflected in our overall positioning.

Looking forward

We are now into the wind down for the year end. 2024 has been a year when US growth has proved the sceptics wrong and has been challenging for those who have chased a rally in duration, which has failed to materialise.

We would observe that investors still aren't paid much of a premium to own longer-dated bonds relative to cash rates (with the exception of long-dated JGBs).

We are also at a juncture where spreads are very tight, albeit part of any credit compression is explained by a structural cheapening of government bonds at a time when there is endemic oversupply.

Confidence in economic forecasting is already shaken after those in the profession have had such a poor consensus call on growth and inflation for the past couple of years.

Meanwhile, economic uncertainty seems compounded by ongoing political and geopolitical uncertainty, at a time when Trump is about to take office.

Yet for all the uncertainty, we would continue to argue that having a focus on policy and politics, which has served us well in the past 12 months, and over the past number of years, will continue to be a source of opportunity for active global macro investors.

At a time when benchmark returns are difficult to project with much confidence in any asset class, an absolute return, long / short, approach to investing can continue to hold merit – especially noting how compressed term, credit and equity risk premia are across global markets.

Thanks for reading the Weekly Macro Commentary over the past year. We will be taking a short break over Christmas and so the next weekly mail won't now be released until 10th January.

In the meantime, in time-honoured tradition, it is that moment to make some bold predictions for what we might expect for the year ahead and so I would close by wishing everyone a Merry Christmas.

Notes to Editors

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About RBC BlueBay Asset Management
RBC BlueBay Asset Management ("RBC BlueBay") represents RBC Global Asset Management outside of North America and is an active asset manager with expertise across fixed income, equities and alternatives.

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