



Market Commentary

Has the picture been subject to manipulation?

It's all about the dots and spots.

15 March 2024 (London): US yields rose this week, following a stronger US CPI report, which highlighted that inflationary pressures are taking time to subside. Core inflation currently stands at 3.8% on a year-over-year basis and were you to annualise numbers for the last 3 or 6 months of data, then the picture is not particularly different, at 4.2% and 3.9% respectively.

Last week, Fed Chair Powell suggested that rate cuts are not 'far away' and this provided encouragement to bond bulls. However, we expect that next week's FOMC meeting will deliver a message that more patience will be required, before policy easing can commence. In a sense, it seems difficult to imagine that Powell will sound more dovish at a time when economic data remain robust and risk assets are trading at their highs.

On this basis, the main change that could generate interest could relate to an upward revision in the 2024 growth forecast and a possible upward revision in the forward-looking dot plot. Ostensibly speaking, only a couple of meeting attendees need to shift their projections to lift the dot plot higher, which could be taken by markets as a relatively hawkish outcome.

Notwithstanding this, it seems that unless we move into a new regime suggesting that inflation is trending higher once more, then investor hopes for future rate cuts are likely to be slow to fade, even if hope is deferred. This may serve to contain price action, with investors bleeding some carry in an inverted yield curve environment, but remaining patient in the hope of a material rate cutting cycle to come.

However, we continue to suggest that neutral interest rates in the US may be much higher than many believe. Our dialogue with policymakers in Washington leads us to believe that there is scepticism around a long run dot as low as 2.5%. On the face of it, it might seem that monetary policy is not currently particularly restrictive, even with rates at 5.375%.

Although this is probably explained by policy lags and the full effects of past monetary tightening still not fully felt, it seems increasingly strange that economic activity is showing little sign of policy restraint, if rates really are close to 300bps above their neutral level. Reflecting on this, our view is that neutral policy is probably closer to 3.5% than 2.5%, and this speaks to a shorter and more modest rate cutting cycle, as and when it is time for the Fed to start to remove policy restraint.

If neutral cash rates are around 3.5%, then this could infer that longer-term rates should sit somewhere at, or above, 4.25%. With Biden, as well as Trump, talking about further tax cuts and fiscal easing this week, we also see an ongoing deterioration in public finances pushing a move towards a larger term premium for longer-dated assets and a steeper yield curve over time.

In this case, long-dated yields don't look cheap to us when reflecting on fair value. In this way, even though we are expecting some slowing in growth later this year and for the Fed to cut twice in 2024, it is not clear to us that there should be a large rally in yields and we see US fixed income struggling to deliver much more than cash in the coming year – unless, of course, there is a much more pronounced slowdown in the economy and a tip towards recession.

Yet such a scenario represents more of a tail risk than a central view. Conversely, on the upside, the tail risk that sees growth and inflation remaining robust, and the Fed maintaining rates at present levels all year, might also seem to deserve at least an equal probability.

In the Eurozone, the rhetoric around monetary policy is growing more dovish. Meetings with ECB policymakers this week confirmed our view that the ECB starts to cut in June, with a total of 75bps likely before the end of December. Against this trajectory, bunds are around fair value, though we would note that the notion of the ECB leading the Fed in a rate-cutting cycle is a factor, which suggests to us that a Euro/US\$ rate closer to 1.05 makes more sense to us than levels above 1.10.

Meanwhile, we have seen an ongoing compression of sovereign spreads within the Eurozone. 10-year Italy and Greece have traded through 120bps and 90bps respectively, as Eurozone risks are priced out. Tighter spreads benefit fiscal sustainability and so become a self-reinforcing trend, and with the political backdrop relatively quiet in the region for the time being, it's conceivable to us that spreads could challenge their 2021 lows in the weeks ahead.

UK labour market data was a touch softer this week, though wage pressures remain an issue for the Bank of England. Away from this, other economic data have been somewhat stronger. The housing market has been a source of weakness, but prices now seem to be rising again and speaking with UK lenders, it strikes us that mortgage market activity is returning to levels last seen before interest rates started to rise.

In this context, there may be a sense that consumers are starting to live with higher interest rates. Should economic activity lift in Q2, then we continue to think that the BoE will struggle to be in a position to deliver rate cuts in the months to come.

Japan has also remained in the spotlight. The Shunto wage round has been firm and now all attention switches to the BoJ. As covered in last week's note, we think that a March hike from the BoJ is likely, and we believe that next week's meeting can lift yields and also benefit the yen.

In the coming quarter, we target 10-year JGBs at 1.0%, before moving above 1.25% later this year. We expect higher wages to feed back into inflation and for CPI data also to be pushed higher on the back of tourist spending. As prices rise, so inflation expectations are starting to re-set.

As previously mentioned, the key for policymakers in Tokyo will be to tread a careful path and ensure they do not allow themselves to get too far behind the curve, in case inflation continues to surprise to the upside.

In credit markets, spreads have continued to rally strongly on the back of strong investor demand, at a time when supply is not growing to match this. With issuance starting to dry up, strong technicals are powering the rally and it is easy to see how this may drag spreads in further. Euro financials were helped by an ECB decision not to raise minimum reserve ratios. This threatened to act as a stealth tax on banks. In this regard, we have noted that past bank taxes and general 'banker bashing' have contributed to an outcome whereby Eurozone banks have traded at a discount to their book value.

On this basis, there is no incentive for banks to grow lending and it is more attractive for them to buy back their stock than invest to grow. In turn, this limits economic performance. Given that Europe is a very heavily banked economy, these policies have thus contributed to sluggish Eurozone growth in the past. Therefore, with profitability having improved, it is to be hoped that banks are permitted some respite from policymakers and in that case, more healthy banks can help position the region for growth, in years to come.

Looking ahead

Central bank meetings in the US and Japan will provide the focus for markets next week. The Fed meeting should not deliver a major surprise and we expect to hear more of the same from Powell. However, the forecasts and dot plot projections will be scrutinised and we continue to sense that were economic data to start to soften, then bond bulls, who have been frustrated to date, would ideally like to add to positions.

The BoJ meeting is a more uncertain affair. We express strong confidence in a change in policy in either March or April, and within this we see March as the most likely. Yet beyond exiting NIRP, ending ETF purchases and moving away from YCC, it will be interesting to note how the BoJ portrays the forward-looking outlook in the months ahead.

Returning to the Fed, it is notable that current market pricing on rates is very consistent with the December Fed dot projections. Over the past year, markets have consistently tended to price materially more easing than the Fed and on that logic, should the dot plot remain unchanged, it is understandable that this logic could see yields rally somewhat.

Alternatively, it may be that markets are already discounting a slightly higher path for the March dots. Either way, it is not clear that a major revision is necessary or likely at this point. Policymakers should be happy to reflect on another quarter of robust growth, in which there has been ongoing outperformance of the US economy versus its peers. Risk assets are riding high, unemployment is low, and inflation is coming down, albeit gradually.

Notwithstanding this, Biden's popularity continues to lag. On this basis, a Democrat Fed might ideally want to be able to deliver their favoured candidate some rate cuts before the election, yet will only be able to do so if conditions permit.

That said, one wonders whether there could be pressure to ensure that the dots don't turn more hawkish, and the leadership of the Fed may want to be able to manipulate the picture to ensure that this is not the case. This veers towards the territory of conspiracy theory, though this week serves as a reminder that if you do want to edit the picture and the Fed wants to permit politics to impact its judgment, then it better make sure it doesn't get spotted...

Notes to Editors

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