RBC BlueBay
Asset Management

Market Commentary

It's spring, but there's more talk of hate than love currently filling the air

The flowers are out but optimism is in short supply.

Key points:

- Global yields moved higher, as strong economic data led investors to scale back their rate cut hopes.
- Economists continuing to project a more abrupt economic slowing have been forced into retreat.
- Eurozone inflation data have been behaving somewhat better, and we continue to see the ECB as on track to deliver a first rate cut in June.
- Japanese yields were also higher, and the quarterly Tankan survey delivered an upbeat portrayal of the economic backdrop.
- The first quarter was positive for risk assets, and if activity data remains upbeat, we may continue to see risk assets post gains in Q2.

5 April 2024 (London): In a holiday-shortened week, global yields moved higher as strong economic data led market participants to scale back hopes for future rate cuts. Last week's ISM survey was above 50 for the first time since 2022, with underlying sub-components also pointing to strength. This type of data behaviour is more typical mid cycle, rather than late cycle, and in this context, those economists continuing to project a more abrupt economic slowing have been forced into retreat.

Meanwhile, the narrative that US cash rates at 5.375% don't appear to be particularly restrictive to economic activity is one which appears to be gaining momentum. Subsequently, Treasury yields have climbed to their highest levels since November last year, in a move which runs in contrast to much consensual portfolio positioning.

We have long argued that markets have been too quick to write off the US economy and to assume that benign inflation would tee up an extended monetary easing cycle. At the same time, we think that investors will want to continue to believe that rate cuts are not too far distant, and this is a factor that could help to contain bearish price action. We also sense that Chair Powell would like to have an opportunity to cut rates, if only data will allow for this.

We will be meeting policymakers in Washington in the coming week, though our sense is currently that Powell is eager to gamble on a soft landing, in order to secure an enviable legacy. Moreover, there is a desire to start to cut rates before the election cycle gets into full swing. On this basis, we still think that the FOMC may cut in July, but that we are likely to see only one or two rate cuts this year, unless the pace of economic activity cools materially.

Higher oil prices on the back of escalating Middle East tensions also represent a risk to yields. Inflation data for March are likely to record another +0.3% month-on-month, meaning that progress towards the 2% Fed target is likely to be limited in this month's figures, with core CPI expected around 3.7%.

In contrast, Eurozone inflation data have been behaving somewhat better, with core figures declining to 2.9% in March. In this context, we continue to see the ECB as on track to deliver a first rate cut in June, and it is not inconceivable that Lagarde will have eased policy twice, by the time that Powell is able to deliver any easing of his own.

Elsewhere in the Eurozone, sovereign spreads have widened as yields have moved higher. That said, there has been little newsflow to drive price action and, by contrast, Eurozone corporate bond spreads continue to trade relatively well, supported by a constructive supply/demand technical.

European banks have continued to outperform, with stock prices reaching a 9-year high, thanks to strong earnings in a higher interest rate environment. We continue to see value in bank credit, with index spreads for Euro financials materially wider than non-financials, notwithstanding a shorter duration and a higher average credit rating at an index level.

UK gilts have tried to resist the move higher in yields led by the US. However, we continue to think that it will be very difficult for the BoE to deliver early rate cuts as inflation newsflow, away from lower energy bills, is more likely to be a source of concern than reassurance.

Anecdotally speaking, it seems commonplace to hear stories of insurance bills doubling and prices linked to an 'RPI-plus'annual revision, recording ugly headlines. This sort of sticker shock on inflation is important, as it feeds into inflation expectations. In this regard, we see more evidence of a de-anchoring of price expectations than is necessarily the case in other economies overseas.

JGB yields have also been pulled higher by Treasuries over the week. From a domestic standpoint, the quarterly Tankan survey was also important in delivering an upbeat portrayal of the economic backdrop and broad-based sentiment and spending intentions. Policymakers continue to prevaricate with respect to declaring the 2% inflation objective as fulfilled.

However, with ongoing pressure on the yen, it would not be surprising if markets force the BoJ to pre-announce plans for future tightening steps, so as to hope to stymie currency weakness. As previously mentioned, any attempt to boost the currency, in the absence of additional policy action, is likely to have only a short-lived effect.

Moreover, with US rate expectations shifting by a much greater quantum than is the case in Japan, so it may be the timing and magnitude of the coming US rate easing cycle which holds more of a key to determining the path of the yen, specifically versus the US dollar.
Over recent weeks, we have been selling down exposure to sovereign credits including Greece, Israel, Latvia, Lithuaniaand Estonia, as spreads have tightened to levels which appeared to offer limited scope for further compression. We retain a neutral stance with respect to Italy BTPs, seeing more value elsewhere.

Looking ahead

Today's US payroll release will once again grab the headlines. Our own analysis suggests downside risks on the unemployment rate, which could drop as low as 3.6%. Yet with a broad swathe of labour market indicators already suggesting a robust labour market, we are not sure this release carries much new information.

In contrast, we think that it is next week's US CPI print that has the potential to be more significant. With growth holding up relatively well, we think that it is the inflation outcome which will hold the keys to Fed action in the next couple of months.

In this regard, we see some upside risk in the March CPI print, and this could add to concerns that the recent disappointing data are a bit more than a statistical blip. However, we would also observe that after this March CPI print is out of the way, then the seasonals on CPI data look a bit more favourable into the coming quarter. Therefore, Treasuries may look more interesting once this data is behind us, depending on where the market is trading at that point in time.

The first quarter saw a period of marked strength in risk assets. In many respects, we can attribute this outcome as the result of a confluence of robust economic activity data and earnings, coinciding with a point where we appear to be approaching the start of a monetary easing cycle.

Consequently, it strikes us that should there either be a marked slowing in growth or, should there be an outcome which causes markets to discount a narrative of rate cuts altogether, then this could mark a more difficult period. However, for the time being, if activity data remains upbeat and the rise in yields is contained, so it is possible for sentiment to hold up for the next few months.

On this basis, we may continue to see risk assets post gains in the second quarter, but if this is the case, then the set-up for the second half of the year could easily be more challenging. From that point of view, this could make for a narrative of ‘buy the rumour – sell the fact’, when it comes to risk assets and the timing of a monetary easing cycle in 2024.

Elsewhere, we would observe that the onset of spring is often a time for optimism, with love euphemistically in the air. However, we seem to be living in a world where there is more talk of hate than love, for the time being, as conflicts in Gaza and Ukraine continue to deliver upsetting images. Meanwhile,populist politicians seem content to stir up the masses, with largely negative messaging.

Closer to home in the UK, this week it is the Scots who have been making the headlines, with their new anti-hate crime legislation. Yet with the legislators themselves accused of creating their own hate crime in the drafting of their bill, and Scottish premier Humza Yousaf finding himself the leading individual being referred to the police authorities, it only serves to show that even good intentions can have bad consequences. You could say that, in contrast to politics, at least the world of financial markets is making a bit more sense for the time being!

Notes to Editors
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