RBC BlueBay
Asset Management

Market Commentary

Come what May

It's sunshine season but an uneasy equilibrium lies ahead….

3 May 2024 (London): Government bond yields declined slightly over the past week, led by gains at the front end of the yield curve. The May FOMC gave little catalyst to price action in fixed income markets, with the FOMC reiterating that monetary policy remains on hold.

Powell continues to communicate a desire to lower rates butneeds better inflation data to substantiate this. This could become more apparent in future months but coming on the back of recent disappointments in CPI, ECI and PCE core readings, it will likely take a few months of better numbers before this is the case.

Meanwhile, although further rate hikes cannot be ruled out, Powell's messaging gives the clear impression that the bar to moving in that direction is relatively high. Were core inflation to head back up towards 4.5%, then this could challenge the Fed's thinking. Yet with November's election looming, don't be surprised that some ongoing disappointment with inflation can be tolerated, on the notion that elevated interest rates just need more time to have their desired effect.

This notwithstanding, we are inclined to think that inflation data is much more important in determining the direction of policy and financial markets than activity data is, for the time being. We generally see economic activity moving ahead on a healthy trajectory, supported by a labour market which continues to look in good shape.

On the softer side, there have been a few anecdotal reports in earnings and other meetings held by our sector analysts that are pointing to some slowing in consumer sensitive sectors, though there is not enough evidence to draw too many conclusions, thus far.

Meanwhile on the stronger side, even if the upcoming jobs report is another strong one, these readings may be downplayed, as they are now subject to a discussion with respect to immigration and the impact this dynamic is having on the data.

If unchanged monetary policy infers that US rates trade in a range for the time being, this can notionally be supportive for risk assets. However, May tends to be a month which has led to something of a reversal, and one wonders if the narrative of 'sell in May and stay away' could be, in part, self-fulfilling, ifenough investors build this into their considerations.

The reality of rates being 'higher for longer' may start to pressure some weaker borrowers and we have observed a bit of a tick higher in event risk, in areas such as bank loans and certain parts of the high yield market. However, none of this feels systemic at this point. Investors seem largely content to earn carry and, as long as recession risk is kept at bay and rate hikes do not come back onto the agenda, these factors could remain broadly supportive of risk appetite for the time being.

In the Eurozone, the May Day holidays have made for a quiet week. Relatively benign data with respect to Eurozone inflation have cemented expectations for a June rate cut. Yet, as mentioned last week, there is more uncertainty thereafter, in terms of how much more policy easing can be delivered.

Activity in the region looks to be on an improving trend, with Q1 GDP expanding 0.3% quarter-on-quarter, which was the strongest reading since the middle of 2022. With labour markets remaining tight across the continent, the ECB is likely to remain vigilant with respect to wage pressures.

Consequently, it remains appropriate to look for 2-3 rate cuts in total during 2024, though in saying this, it might seem unlikely that Eurozone rate policy moves will diverge relative to the US by more than 50bps this year, as things currently stand.

UK data have also been a bit firmer of late, leading markets to price out BoE rate cut expectations, as US yields have moved higher. Gilt yields have risen in line with other developed market yields, though our sense is that consensus positioning remains long duration in UK fixed income, with the market expecting a big drop in April CPI data when it is released later this month, in the wake of lower energy utility prices.

Yet we think that after an initial drop, inflation data will then push higher again, and it is noteworthy to observe UK wage growth at 2% faster than is the case on the continent, notwithstanding that fact that productivity growth in the UK is weaker, not stronger, than is the case across the English Channel.

Golden Week holidays have also made for a quiet week in Japan this week in equities and fixed income. However, with the yen under pressure, following a more dovish-than-expected BoJ meeting last week, this has seen the Ministry of Finance ("MoF") intervene in currency markets as the yen hit 160 versus the dollar.

Although intervention has not been confirmed, current account data suggest that the MoF spent upwards of USD60billion in yen purchases. Certainly, the timing of intervention has been aimed at getting the biggest bang for the buck, coming during more illiquid trading hours. These moves have helped push the rate back down to 153 versus the dollar.

However, with the Japanese currency undermined by excessively accommodative monetary policy, the impact of intervention may prove short-lived. Commonly, we have always seen that intervention can only smooth moves and a change in the directional trend requires a change in BoJ policy.

We believe that the BoJ must cease its balance sheet expansion as soon as possible. Deliberately adding to monetary easing is not justified and runs in the opposite direction to other central banks who are actively shrinking their balance sheets in QT policies.

We also think the BoJ needs to outline a path to eventually normalising rates around an R* at 1.5% or thereabouts, acknowledging that inflation is now stable around 2%. The BoJ has consistently under-estimated Japanese inflation in the past few years. It has also consistently under-estimated the strength of the US economy, where it had hoped for rate cuts to alleviate pressure on itself to need to act.

We would argue that the BoJ needs to adjust its mindset, before it is even more behind the curve and does more damage in the event that the yen continues to move lower.

A return to 160 for $/Yen could remain a possibility, once intervention ends, should the US economy remain upbeat. This could put the BoJ and Japan in a more difficult position. It could also be a catalyst for additional volatility in global financial markets. Although Ueda may want to wait until the next BoJ policy meeting in June, the clock is ticking.

Yet, inasmuch as policy normalisation is delayed and this helps hold JGB yields anchored for the time being, the more likely yen weakness triggers a bigger inflation overshoot and the need for even higher yields in periods to come. In short, Ueda needs to understand that his monetary policy decisions are driving the yen. He may not see the yen as his responsibility, but he is the architect of its current weakness and there is not much the MoF can do to avert this without his help.

Looking ahead

As we look forward, there is a bit of a sense of an uneasy equilibrium. We think that rate expectations are now largely appropriate on both sides of the Atlantic and there may be a period where rates can trade in more of a range – at least up until the next pivotal US CPI release in the middle of this month.

However, there seem to be a host of political and geopolitical risks that surround us across global markets. There remains plenty of macro uncertainty in terms of the trajectory that rates and policy will take in the months ahead, and there is also a bit of an uneasy sense that risk assets have been content to look through the noise and look for the positives for the past six months.

Although there is no reason why this may not persist, you start to wonder at what point the excitement around AI will start to ebb, and when might investors start looking at a glass that appears more half empty than half full.

Assessing such shifts in sentiment will always be difficult to assess. Yet broadly speaking, we think there is a case for markets to rally into the summer, if only we can see some better inflation data and an economy that continues to grow at a healthy pace.

Meanwhile, any upside surprise in inflation is now more likely to be the catalyst for a bigger reversal, and were this to coincide with any signs that the economy were slowing too, then this could become even more problematic. From our perspective, we will await the next CPI print with interest.

However, we continue to advocate focusing on what look like the easier trades with a better risk-return profile. These continue to be shorts in Japan and UK long-term bonds, curve steepening trades in the US, overweight financials in IG credit and overweight sovereign credits at wide spreads, such as Romania, within the EU.

As investors, it is always good to keep an open mind. You also hope to be able to construct portfolios that can deliver performance, come what may….after all, you never know what might be just around the corner!

Notes to Editors

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About RBC BlueBay Asset Management

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