RBC BlueBay
Asset Management

Market Commentary

Party like it's 1989?

It's been a week to 'turn back time'.

Key points:

- Recent re-pricing has left markets not far from where central banks have guided.
- In the US, the economy remains robust while core PCE data came in line with expectations, easing the fears of sticky inflation.
- Volatile political situations in the US and Europe continue to trouble investors.
- Policymakers continue to deal with the fallout from past QE, as the full bill comes due.

1 March 2024 (London): In a relatively quiet week for economic data, the past few days have seen government bond yields consolidate at higher levels. The recent re-pricing of future interest rates leaves markets not far from where the Federal Reserve (Fed) and others have guided their own policy expectations, and there is a sense that new economic information and upcoming central bank deliberations may be needed before markets move meaningfully, in either direction, over the weeks to come.

That said, there is little change in the narrative that the US economy remains robust. We also continue to reflect on a narrative of an AI-fuelled investment boom, as a further reminder of an economic cycle that seems to have plenty in common with what we witnessed at the end of the 90s.

In politics, Trump took another step towards officially securing the Republican nomination and should effectively wrap this up on Super Tuesday next week. Looking at polling data, it is noteworthy that Trump's net approval rating (although still negative) is now as high as it has been any time since before the last election.

By contrast, Biden's popularity continues to sink and is lower than any US president in the past 70 years at this stage of the Administration. In many respects, this seems doubly surprising, given the strong US economy, booming stock market and low unemployment. It is also interesting to reflect on, since many commentators in Europe will assume that Trump was a very unpopular president, yet on a relative basis, Biden has been considerably more unpopular with US voters.

Of course, the fate of the US election will be decided by a handful of voters in six swing states. Nevertheless, there is more widespread acceptance that Trump is the front runner at this time, and this is starting to have a growing impact on partners of the US overseas.

As previously shared, the notion that Putin will prevail in Ukraine is unconscionable in European capitals. Yet with the US quite probably stepping back, the growing question is who is prepared to fill the void. There remains more talk than action with respect to EU leadership on the matter. In this context, it is concerning to see a lack of co-ordination in the messaging coming from France and Germany.

Notwithstanding this, it does seem obvious that there will need to be a step change in military spending across a number of countries. This being the case, defence spending can be a contributor to economic growth and in some areas, this could also be a factor adding to price pressures. The narrative that Europe will need to ease fiscal policy in this way is also a factor that the ECB may need to take into consideration, with respect to its monetary policy decisions.

Elsewhere, it is striking to see the farmers' protests continue to create havoc in European capitals, with Brussels badly impacted in the past several days. This movement seems to have morphed into something of a right-wing populist cause, pushing back on globalisation, immigration and environmental policies which have contributed to higher prices and lower living standards. In a stagnating economy, this creates a challenge for mainstream political leaders. In many respects, politicians are not inclined to ditch past policies, yet some of the concerns being expressed are ignored at the peril of further fuelling right-wing populist sentiment.

In a sense, there is a section of the European electorate finding common cause in a leader like Trump, and we continue to monitor polls in countries like France and the Netherlands, to get a sense of whether this narrative has further to run.

On a different note, another recent topic of conversation with policymakers relates to losses stemming from past central bank bond purchases during the era of quantitative easing. Past monetary easing saw central banks purchase huge volumes of government bonds. For example, in the case of the UK, this totalled close to GBP900 billion. At the time of purchase, yields were not much above 0%. With interest rates currently standing at 5.25%, this sees the BoE incurring losses, as the central bank incurs a substantial negative spread between the interest rates on their assets versus their liabilities.

Additionally, with QE being unwound via bond sales in quantitative tightening, these losses are further compounded by the crystallisation of market-to-market losses on these securities. To give an example of the magnitude of these losses, in picking one single gilt issue, UK 0.5% 2061, this was a bond which the BoE purchased at a price of par, but can now sell at a price of just 30 cents; a massive 70% loss. In aggregate, it is now estimated that the total losses as a result of QE will total > GBP200 billion. This is a huge sum, which can be seen in the context of the disastrous Liz Truss mini-budget, which was set to cost a total of 'only' GBP30 billion in comparison.

From this point of view, QE can be viewed as a massively expensive folly. Yet, in the absence of a counterfactual, it will always be difficult to know what would have happened to the economy through the Covid pandemic, had such accommodative policies not been put in place. Indeed, the UK was far from alone in terms of the QE experience and similar policies were adopted by mostly all other major advanced economies at the time. Where the UK has more of an issue is that the overshoot in inflation has meant that losses are more pronounced. UK finances were also hurt by liabilities to inflation-linked bonds (which weren't included in QE purchases) rising in value.

Meanwhile, it is also interesting to use the example of Japan as a point in contrast. Here, the BoJ also owns huge volumes of government bonds and stands to make losses as yields rise. However, with the BoJ also having purchased Japanese equities, these holdings now sit on large offsetting profits, which total close to USD150 billion.

It is tempting to think there is learning here for the future, should central banks ever be lured towards QE again. This is something which, in many respects, seems unlikely and it may only become more unpalatable as wider understanding of QE losses is properly understood in the political mainstream.

In Japan, CPI data exceeded the BoJ's 2.0% target for the 22nd month in a row. Meanwhile, core prices excluding food and energy continue to increase at a 3.5% pace and although recent price trends have shown some moderation, price pressures in Japan remain elevated.

With corporates delivering strong earnings which have been boosted by a weaker yen, we think that the overall outcome of the Shunto wage round will be close to 5%, which would be 1% higher than the 2023 outcome, itself a 30-year high in the data series. This being the case, we continue to look for BoJ policy adjustment, and we will be in Tokyo in the coming week meeting with investors and policymakers as we continue to test this thesis.

As credit spreads have continued to rally in both corporates and sovereigns, we have sensed that market momentum is starting to fade over the course of the past week. In the short term, we have continued to

experience relatively strong primary issuance, as issuers have sought to take advantage of relatively strong demand.

Over the past month, many issues have been launched with literally no premium to existing deals already trading in the secondary market, though this is unlikely to persist as buyers become more selective. On this basis, with spreads having compressed, we would not be surprised to see more of a trading range over the coming weeks.

However, we expect supply to fall, and this could be a catalyst for spreads to narrow further in the months to come, should the economic backdrop remain benign.

Volatility in FX markets remains very subdued for the time being. Hungary cutting rates by 100bps saw the forint softer during the week. An unwind of long carry positions in selected EM currencies has been a theme we have been looking to play out, and consequently this is a move which we think has further to run.

Elsewhere in EM, strong investment from UAE and other countries in the Middle East in Egypt has led to a strong rally in credit spreads and this has benefitted certain other high yielders trading at stressed and distressed levels.

The macro story in Egypt has been challenged for some time, with the country having been badly exposed as an importer of food and energy, over the past few years. Having stood around 1,900bps in October, the CDS spread for Egypt has subsequently rallied down to 720bps in the past week, as fears for a near-term default recede materially.

However, we think it would be wrong to conclude that the problems in many highly indebted sovereigns have been solved and a selective and cautious stance continues to be recommended.

Yesterday's US core PCE data came in line with expectations, providing some respite from recent upside surprises on the prices front. However, high prints in the coming months remain a risk and could add to fears that progress towards lower inflation has stalled.

Looking ahead
Risk assets have been able to trade well so far in 2024, even as yields climb, as these moves have reflected the partial unwinding of future rate cuts at a time when recession risks have been priced out.

However, if recession risks were to return, or alternatively, were data to call into question whether Fed rates have yet peaked, then in these tail outcomes there is more likely to be an adverse market reaction.

There is plenty more data and central bank action to come over the next few weeks, in the run-up to Easter. It seems unlikely that we will get much of a change of view from the ECB at next week's meeting, with the Governing Council continuing to favour keeping policy on hold, pending more evidence of inflation returning to target.

Unless data surprises us in the interim, we doubt that there will be much change in tune from the FOMC at the end of the month, either. Consequently, it could be the BoJ which delivers the biggest policy surprise relative to expectations, though data in the next couple of weeks will need to be robust, if this is in prospect.

From this point of view, the ongoing rally in Japanese stocks is further evidence that something is stirring. It has taken the Nikkei index nearly 35 years to return to levels approaching 40,000. In that case, if Nvidia was the market theme last week, under the Prince refrain of 'Let's party like it's 1999', then this week's soundtrack might be more appropriately Cher's classic hit, 'If I could turn back time'.

In this respect, when this anthem was in the charts and the Nikkei last peaked at the end of 1989, Japanese inflation stood at 2.6% and Japanese interest rates were at 4.25%. Food for thought perhaps….

Notes to Editors
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