

Portfolio Manager Perspectives

Mark Dowding's Global Macro Update

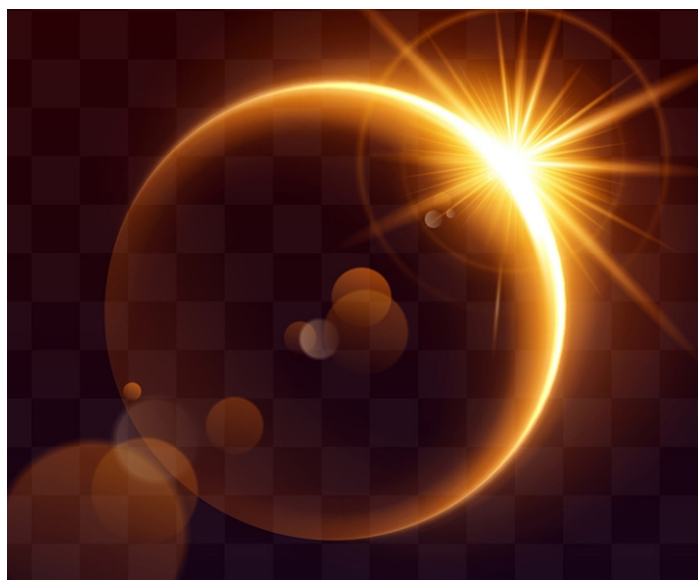
April 12, 2024

Rate cut hopes get eclipsed by the data

The only certainty across the pond is the extortionate cost of a US Uber!

Key points

- The March US CPI report marked the third consecutive month of stronger-than-expected data.
- It's difficult to sustain a narrative that inflation is headed back towards the Fed 2% target.
- The reality in the data is that there is no evidence that the US economy needs to lower rates any time soon.
- The US and European economies are on very different trajectories, and this week's ECB meeting teed up a prospective rate cut in June.
- As consensus thinking is challenged, the future can appear more uncertain, bringing volatility.



US yields lurched higher in the wake of this week's stronger-than-expected US CPI report. The March data marked the third consecutive 0.4% monthly rise in succession for core prices, and consequently it seems difficult to sustain a narrative that inflation is headed back towards the Fed 2% target any time soon. With oil prices also moving higher, this means that headline CPI will exceed core data later this summer.

“The reality in the data is that there is no evidence that the US economy needs to lower rates any time soon and, generally speaking, financial conditions appear more accommodative than restrictive.”

In this context, it is possible that headline prices will record a 5% annual gain, and so it is not at all surprising that hopes for Fed rate cuts are being beaten into a hasty retreat. In many ways it has been notable how solid the consensus around imminent rate cuts has been during the past several months, and it has felt pretty contrarian to be a voice pushing back against this.

However, the reality in the data is that there is no evidence that the US economy needs to lower rates any time soon and, generally speaking, financial conditions appear more accommodative than restrictive, at the current point in time.

Meetings with policymakers in Washington this week have underlined the resilience of US growth, with little discussion of the economy slowing at all. Anecdotally speaking, it would appear that the labour shortage is apparent at every turn in customer service roles, from airports to hotels and restaurants, where queuing is becoming more and more of an issue.

At the same time, US service standards are slipping, yet the presumption to add a 20% service charge to pretty much everything is more dominant than ever. It is also interesting to note how Uber fares for journeys have jumped very substantially, in the past six months alone. Furthermore, it might seem that in order to secure a car, one is now having to pay up for more expensive options such as ‘Uber Black,’ when this was never the case before. At the same time, regular cabs with regulated fares seem even harder to find.

A tight labour market continues to point to upside risks for wages, even if rapid immigration and net additions of more lower paid jobs are helping to suppress earnings data at an aggregate level. Elsewhere, the obsession with the solar eclipse in the US this week has meant that this is likely to be the top travel week within the US this year. With hotel rates skyrocketing, along with airfares and train fares, this is also something to watch for when April economic data are released next month.

Yet in DC, there remains a narrative that Powell would like to cut rates, if only data would permit him to do so. There is discussion that the Fed Chair wants to go into the history books as the central banker to have mastered the soft landing, and so secure himself a position in the figurative hall of fame. Yet for the time being, the data is just not co-operating. However, if there is an opportunity to do so, then a rate cut ahead of the election remains on the cards. Certainly, this is what President Biden thinks, at least!

“Many investors have been long and wrong all year on the assumption that rates would be falling materially, as the economy slows.”

However, the notion that there will be a sequence of upcoming rate cuts seems an unlikely prospect, aside from a scenario where growth slows markedly. Meanwhile an opposite tail scenario, which could merit the need for rates to rise further, cannot be ruled out, and may seem just as likely. Certainly, the economy feels like it is currently operating at a mid-cycle state. Consumer balance sheets remain robust and a credit-fuelled binge could create overheating risks, in the return of a 2003-2007 repeat.

Returning to the data, it occurs to us that, although the seasonals on inflation data may be more benign in the next few months, the reality is that CPI looks stuck between 3-4%, in line with the arguments we have been making of late. This remains well above the FOMC inflation target, though the Fed still believes that interest rates are in restrictive territory. This infers the base case, is that rates continue to remain broadly where they are. This being the case, we see 2-year Treasuries around 5% as fairly priced, but remain more wary of the longer end of the yield curve.

Another takeaway from policymaker discussions is that an inverted yield curve is failing to send any signal to the fiscal authorities that there is anything to worry about with respect to the trajectory of fiscal policy. Elevated deficits should put pressure on the curve to steepen and investors should demand greater compensation for holding longer-duration assets.

Indeed, this week also saw a soft 10-year Treasury auction, suggesting that enthusiasm for duration is waning. Many investors have been long and wrong all year on the assumption that rates would be falling materially, as the economy slows. As this is called into question, this means that there are few investors wanting to step into the market in the short term to add duration, in the wake of a move to higher yields.

Meanwhile in politics, Washington meetings highlight that the presidential race remains close, even if Trump is the favourite. A Republican clean sweep is a possibility, whereas this is very unlikely for the Democrats. Yet, it seems that a split between the Congress and the Senate is the most likely outcome. Such an outturn would mean that not much is done in policy, away from trade, immigration and foreign policy. This could infer a tighter fiscal stance, if a portion of prior tax cuts are allowed to expire in 2025.

By contrast a Republican sweep would infer an easier fiscal stance. A Trump win would also mean more tariffs and moves on immigration, which would be net inflationary. That said, there is a sense that Trump can talk tough on immigration, yet actually reducing the flow of individuals across the border is likely to be hard to achieve.

The other takeaway from DC is that the focus of US foreign policy remains much more towards China than Ukraine. Rhetoric around China remains hawkish and adversarial across the political spectrum. Meanwhile, on Ukraine, there is some hope that the Bill on supplemental aid, which has been stalled, could make it to the floor as part of a larger package, in the next couple of weeks.

However, Ukraine is not seen as especially important and it is viewed as more of a European problem to deal with, at this point. There is an expectation that Russia will seize additional territory, ahead of a point where Putin decides that he has had enough for the time being. The question is how extensive these Russian gains will be.

Thereafter, it is assumed that there will be a deal and that Ukraine as a country will be partitioned, with the establishment of a DMZ, akin to the Korean peninsula. This thinking is much more troubling to swallow, from a European perspective and it will be interesting to see if the EU can really ramp up its support for Kyiv under a broader EU type package, which adds Euro 100bn or more in terms of military spending. However, observations from the US are that the Europeans will be ‘a day late and a dollar short’, with anything they deliver, given competing national interests in the bloc.

Staying in Europe, this week's ECB teed up a prospective rate cut in June. The reality is that the US and European economies are on very different trajectories, and so greater policy divergence stands to reason at this point. However, bund yields risk being pulled higher by Treasuries, and a weaker euro in FX terms could also become a factor limiting the ECB over the months ahead.

In the UK, gilt yields have also risen, as rate cut hopes fade. Consensus positioning has been long in UK rates, and as investors pull back on the bullishness for duration globally, so this could put gilts under more pressure.

Meanwhile in Japan, BoJ policy has been exposed, as US yields have risen. Ueda and colleagues have thought they had plenty of time, before taking additional steps to normalise monetary policy in Japan. Yet the dovish BoJ stance continues to undermine the yen and having broken up through 152 versus the US dollar, the idea that the MoF may intervene is only likely to deliver short-term respite, until the BoJ communicates a change in its own thinking.

We have advocated that the BoJ needs to slow JGB purchases and stop the expansion of its balance sheet at its policy meeting, later this month. It also needs to outline a path to raising cash rates, and we have expected a move to 0.25% in July and 0.5% later this year.

Yet the reality is that even such steps are not materially closing the policy gap that exists between the US and Japan. From that point of view, we see pressure on the yen feeding back into Japanese inflation, and as such, we would caution policymakers in Tokyo against making the mistake of letting inflation overshoot to the upside and risk moving out of control.

If the BoJ ends up too far behind the curve and needs to raise rates to levels seen in a European context over the past few years, then this could have pretty dire consequences, given the magnitude of Japanese debt levels. Moreover, sticking to a short duration stance in yen rates remains compelling in our eyes. Simplistically speaking, either the BoJ will need to deliver more hikes now, or otherwise it is likely to need to hike much more, at a later point in time.

Looking ahead

The data calendar turns quiet over the next couple of weeks. On the back of the strong jobs report and CPI, so it seems that there are many forecasters rehashing their expectations, for the year ahead. At this point, there are few, if any, who see US interest rates needing to rise towards 6% and in this context, the herd of forecasters seem likely to stick with projections for future rate cuts, albeit pushed more into 2025.

If this thinking holds, then the idea that rate cuts are still coming means that the hope which has been supporting asset valuations will be hope deferred, rather than hope cancelled. In this case, risk assets may perform ok, with the US economy continuing to grow at a robust pace. After all, we were at 5% on 2-year notes in the second half of 2023, and it had little discernible economic impact then. Moreover, it doesn't seem like we are at a moment when recession fears will return to the fore, as they did last March, for example.

“There are few, if any, who see US interest rates needing to rise towards 6% and in this context, the herd of forecasters seem likely to stick with projections for future rate cuts, albeit pushed more into 2025.”

That said, as consensus thinking is challenged, so the future can appear more uncertain. This suggests scope for volatility to rise, and so this may limit the scope for markets to rally very much in the coming weeks. Otherwise, in a world where cash continues to yield more than government bonds, it remains challenging to make a strong case for owning much duration – especially with respect to longer-dated maturities.

Away from financial markets for a moment, it has felt strange to be in the US in a week overshadowed by the solar eclipse, coming on the heels of an earthquake here in New York last week. We have half joked that the gods must be demanding some sort of sacrifice! In that context, it feels that it's bank economist rate cut projections which really have been put to the sword in the past week...



Portfolio Manager Perspectives

Our experts offer their perspectives on the latest developments in global credit and the state of the markets.

[LEARN MORE](#)

This document was prepared by RBC Global Asset Management (UK) Limited (RBC GAM UK), authorised and regulated by the UK Financial Conduct Authority (FCA), registered with the US Securities and Exchange Commission (SEC) and a member of the National Futures Association (NFA) as authorised by the US Commodity Futures Trading Commission (CFTC).

In the United States, this document may also be provided by RBC Global Asset Management (U.S.) Inc. ("RBC GAM-US"), a SEC registered investment adviser. The entities noted above are collectively referred to as "RBC BlueBay" within this document. The registrations and memberships noted should not be interpreted as an endorsement or approval of RBC BlueBay by the respective licensing or registering authorities.

With respect to the investment performance presented, past performance is not indicative of future performance. Actual account performance may or will vary from the performance shown because of differences in market conditions; client-imposed investment restrictions; the time of client investments and withdrawals; tax considerations; economies of scale; portfolio turnover; the number, type, availability, and diversity of securities that can be purchased at a given time; differences in the underlying currency of the assets in the account, and other factors. Client assets managed using these strategies in separate accounts or different vehicles may be subject to restrictions, fees or expenses that are materially different than those found in the non-US funds.

This document is confidential and, without RBC BlueBay's consent, may not be (i) copied, photocopied or duplicated in any form by any means or (ii) distributed to any person that is not an employee, officer, director or authorized agent of the recipient.

Information herein is believed to be reliable but RBC BlueBay does not warrant its completeness or accuracy. This document contains information collected from independent third-party sources. For purposes of providing these materials to you, neither RBC BlueBay nor any of its affiliates, subsidiaries, directors, officers, or employees, has independently verified the accuracy or completeness of the third-party information contained herein.

The information contained herein does not constitute investment, tax, accounting or legal advice. Recipients are strongly advised to make an independent review with their own advisors and reach their own conclusions regarding the investment merits and risks, legal, credit, tax and accounting aspects of all transactions. Any risk management processes discussed refer to efforts to monitor and manage risk but should not be confused with and do not imply no or low risk. No chart, graph, or other figure provided should be used to determine which strategies to implement or which securities to buy or sell.

Copyright 2024 © RBC BlueBay. RBC Global Asset Management (RBC GAM) is the asset management division of Royal Bank of Canada which includes RBC Global Asset Management (U.S.) Inc. (RBC GAM-US), RBC Global Asset Management Inc., RBC Global Asset Management (UK) Limited, RBC Global Asset Management (Asia) Limited and RBC Indigo Asset Management Inc., which are separate, but affiliated corporate entities. ® / Registered trademark(s) of Royal Bank of Canada and BlueBay Asset Management (Services) Ltd. Used under licence. RBC Global Asset Management (UK) Limited, registered office 100 Bishopsgate, London EC2N 4AA, registered in England and Wales number 03647343. All rights reserved.

RBC Global Asset Management (U.S.) Inc.

Minneapolis | Boston | Chicago

800.553.2143 | rbcgam.com

