RBC Global Asset Management

Here today, gone tomorrow: Understanding the $1 trillion wipeout

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Q. How would you characterize current market functioning/liquidity across Treasury and credit markets today? Any areas the team is particularly concerned about?

A. We have no concerns over our markets' functioning or liquidity across Treasury and credit. Bid/ask spreads may be nominally wider, but we do not have any particular concern about the fundamental health of our markets.

Q. Are there sectors, industries, or parts of the curve that have become more or less compelling given recent market moves or a softening macroeconomic picture?

A. The broader theme here, we believe, is that portfolio constructors can shift from generating more-alpha-than-usual from curve shape trades to now a more normative view that we can generate more alpha from compression trades in sectors we like that are more resilient to a slowing US economy. This may see us unwinding 2s30s Treasury steepeners or 2-year Key Rate Duration (KRD) portfolio over-weights (where we have them on) in the short-term and utilizing proceeds to purchase names we like and know that have been widening in concert with the broader market sell-off.

Q. As a result of recent data releases and market reaction, has the team's views regarding the economic outlook and path of Fed policy evolved or changed over the last few days?

A. Volatility spread across the markets as a weaker than expected jobs report prompted a major risk unwind across a variety of asset classes. As normally tends to be the case, many extrapolated this price action to suggest an imminent recession and call for a more imminent/acute rate cut from the Fed. We think this sentiment is overdone.

- Firstly, last week's payroll report was likely impacted by Hurricane Beryl, so adjusted for that, could have been easily within market expectations. This does not explain why unemployment moved up as much as it did, but we think broader conditions in the labor market suggest some cooling, but nothing indicating a lot of pain in the short run.
- Secondly, as demonstrated by the latest ISM Services report (this morning), conditions in the broader economy remain solid and yes, manufacturing is not faring as well, but we need to remember that the US economy is overwhelmingly service-sector driven.
- Finally, much of the sell-off is driven by the "machines". CTAs and quant investors got themselves overextended and that triggered a washout of positions across many markets ranging from Japanese stocks to AI darlings. While this process can continue for a short while, we expect conditions to stabilize when position squaring is mostly done.

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As for Fed path, we remain of the view that Fed will cut rates this year as soon as next month, but the magnitude of cuts in 2024 could disappoint market participants who have boosted their expectations toward more cuts (again). The market is currently pricing in around 125bps of cuts and, unless conditions in the economy change drastically for the worse, we see two, maybe three cuts ahead. We'd also note that after a few inflation reports helped, in part, by base effects, the next ones will not benefit from such, thus the pace at which inflation is moderating could slow down a bit.

Q. Has this changed our overall outlook?

A. We're still constructive on fixed income but note that in the near term spread products might have to go through a period of indigestion. A lot of recent demand was driven by historically attractive yields and as those declined considerably in recent weeks, investors might take a pause before adding to their exposures. Also, we note that lower yields lifted primary issuance volumes across a range of markets with corporates keen to lock in better funding costs. This means that the equilibrium level for spreads is wider, in our opinion. Unless the rate rally reverses in earnest or spreads widen considerably more to entice new buyers, we believe that a period of consolidation is warranted.

As we've been booking profits in an over-extended market of late, this bout of weakness suits us well and we stand ready to take advantage of dislocations, were these to extend further. More importantly, though, investors would be well advised to zoom out and reflect on the fact that the US economy is in relatively decent shape, inflation will continue to moderate, and fixed income assets look attractive from a yield perspective by historical standards.

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