RBC Global Asset Management

# Portfolio Manager Perspectives
# Mark Dowding's Global Macro Update

September 15, 2023

## Chinese takeaway

And a story of lower ice cream sales.

### Key points

- The US CPI release showed that core inflation is not falling as quickly as hoped, which opens the door for additional rate hikes.
- The ECB hiked rates by 25bps, and the Board may be done with tightening rates now at 4%.
- UK GDP contracted, driven by weaker consumer spending.
- BoJ Governor Ueda appeared to reassess monetary policy, in the wake of rising inflation and pressure on the yen.
- While the relationship between China and the US and Europe remains intertwined, signs of strain persist.

US Yields were not much changed in the past week, in the wake of this week's US CPI print. Nevertheless, we would reflect that core price inflation at 4.3% is not dropping as quickly as some may have hoped. Consequently, the prospect of further Fed tightening remains in play in the fourth quarter, albeit we expect a pause at the upcoming September meeting, as the trajectory of hikes becomes more shallow and monetary policy moves further into restrictive territory.

> "A steepening of the yield curve appears more likely than a flattener, over the months ahead."

Our own sense is that inflation is becoming stickier, as expectations re-set. Should the CPI end up trending between 3-4%, then it will likely be difficult for the Fed to endorse any easing in monetary policy for several quarters to come. Against this backdrop, it continues to feel premature to own much duration risk in a structurally inverted yield curve environment.

However, if and when it becomes more attractive to buy, then there may end up lost value at the front of the yield curve, if future rate cuts are priced out. In this context, a steepening of the yield curve appears more likely than a flattener, over the months ahead.

Eurozone yields are little changed over the week. A decision by the ECB to hike rates by 25bps this week appears to have been a close call, and we think that the Board may be done with tightening cash rates now at 4%.

Somewhat higher inflation projections, at a time when growth forecasts are downgraded, paint a rather sombre picture for European prospects in the months ahead. Stagflation risks are present across the region, though in a broader European context, these are probably most elevated in the UK.

UK GDP contracted in July, partly due to poor summer weather. However, consumer softness was not just a story of lower ice cream sales, and with house prices sliding, we see building evidence of consumers feeling the pinch.

Meanwhile, data showing an acceleration of wage growth to 8.3% must be a concern to the Bank, even as payroll growth slows.

Ultimately, we think this could be the shape of things to come over the next few months, and as growth disappoints and inflation is stuck around 5%, then we see the BoE delivering one more hike for the time being, but then being at risk of needing to tighten further if inflation reaccelerates once more on second round effects.

We think that the pound will end up taking part of the strain and so we stay structurally negative on the currency, even though this is a trade which has not delivered much joy on a year-to-date basis.

In Japan, press comments by Governor Ueda appeared to open the door to an earlier adjustment to monetary policy, in the wake of rising inflation and building pressure on the yen. Since taking office in April, Ueda has been committed to a dovish stance and has appeared reluctant to endorse much of a change in policy.

Yet core inflation is running at 4% and price rises appear to be broadening across the economy. Early estimates for next year's wage round look to be around 5%, as workers seek to restore lost purchasing power, against the backdrop of a very tight labour market.

Meanwhile, as real interest rates become more negative at a time when other central banks have been hiking, the BoJ is now responsible for weakening the yen, and so leaving efforts to bolster the currency by the MoF as relatively toothless.

As this dynamic continues to play out, so we expect the pressure on Ueda-san and colleagues to continue to build. We don't think there will be any change in policy stance at this September's monetary policy meeting.

However, in October, we believe that inflation projections will be revised higher and that a declaration around achieving inflation sustainably at 2% may be the pretext for a further policy move. We think that Yield Curve Control may be scrapped or rendered redundant at this time.

Meanwhile, we are now projecting a first BoJ rate hike above 0% to occur prior to the end of this year. This being the case, we continue to hold onto our conviction that longer-dated JGB yields will need to continue to rise, projecting a target of between 1.0-1.2% by the end of 2023.

Last weekend's G20 summit saw India exert its growing influence with respect to the joint communique agreed at the end of the meeting, which failed to mention Russia with respect to the war and ongoing suffering in Ukraine.

Geopolitics is re-shaping in a more multi-polar fashion, with the preceding BRICS summit in South Africa seeking to expand its membership and influence over the developing world. Positioning BRICS+ as a potential rival to G20 saw Xi, as well as Putin, fail to attend the latest G20 meeting. A decision to include the African Union as a G20 member, which India has championed, can be seen in the context of the battle for allegiance within the global South.

**"Early estimates for next year's wage round look to be around 5%, as workers seek to restore lost purchasing power."**

At a time when China is confronted by domestic economic woes, one may have thought that international considerations would take a back seat. However, this is not part of Beijing's long-term thinking and Western capitals are waking up to the risks of failing to engage more constructively with the developing world, during a period when China has been doubling down on its efforts in the context of the Belt and Road programme and other initiatives aiming to turn nations away from the US and its allies.

With respect to China more specifically, the past week has seen developments across Europe pointing towards a degradation of relations between the respective powers. In the UK, there has been a public outcry with respect to Chinese spying and espionage within the corridors of Westminster. German auto manufacturers are waking up to Chinese firms now eating their lunch as they compete against state-sponsored competitors.

Meanwhile, Italy announced that the country would formally exit Belt and Road, having been previously criticised by the US and EU for having joined the initiative. In the US, the past week has seen fresh concern around AI capable chips being installed in Chinese-manufactured smartphones, in a field where the US has maintained an advantage.

Elsewhere it strikes us as notable how many investment firms and others seem to be now deliberately retrenching from China, having previously made a big noise about needing to adopt a China strategy as a future engine of growth and earnings.

Yet, up to this point, an ongoing pivot away from Beijing has not been particularly discernible in trade data. However, news this week that Mexico has now displaced China as the number one trade partner of the US certainly shows how this shift is underway, and it would appear that the direction of travel is clearly signposted. Indeed, from a macro perspective, this would be a factor which we think can add to inflation outcomes over the next several years, as the global landscape re-shapes to a new global order.

In corporate credit markets, new issue activity has been relatively brisk in the past week and is now likely to slow somewhat. At an index level, Euro IG has outperformed the US market over the past fortnight, reversing some earlier underperformance. Investor demand for new paper has been relatively robust and generally speaking, low volatility conditions continue to be relatively supportive across credit markets.

**"Building geopolitical risk could be a potential source of market volatility."**

In the sovereign space, demand has also been robust. However, some growing concern over easy fiscal policy and rising deficits has the capacity to weigh on spreads, as has been seen in Italian BTPs over the past week or so.

By contrast, the Greece credit rating was upgraded by the DBRS agency, though markets seem to be awaiting the outcome from the next S&P review in October as a potential catalyst for Greek IG index inclusion, which could provide a powerful technical bid for bonds, as passive investors are obliged to buy.

## Looking ahead

As we look ahead, we would reflect on the idea that Chinese decoupling may be an inflationary factor, which markets still do not account for. It seems that the easy work in pushing inflation down has taken place but progress will be much slower as we enter the 'last mile'. This may make it difficult for monetary policymakers to change course on a foreseeable basis, meaning duration offers limited upside for the time being.

Credit valuations look pretty full and although we don't see a strong catalyst towards spread widening, credit seems to offer more opportunities in terms of relative value than from a beta perspective.

Meanwhile, building geopolitical risk could be a potential source of market volatility. A Chinese takeaway could well end up leaving a few investors feeling a bit queasy....

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 2023 © 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 Global Asset Management Inc., RBC Global Asset Management (UK) Limited and RBC Global Asset Management (Asia) Limited, 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 77 Grosvenor Street, London W1K 3JR, 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**