Portfolio Manager Perspectives
Mark Dowding's Global Macro Update

September 29, 2023

Biden undermining the inflation fight as wages become political

The US president heads to the picket line.

Key points

- The wait for lower interest rates is likely to be a long one.
- Sentiment has not been helped by a looming US government shutdown.
- Within the Eurozone, yields have followed US Treasuries, with sovereign spreads widening.
- Higher Treasury yields have put pressure on corporate credit spreads and stocks.
- Downside risks to growth continue to be a greater concern in Europe than the US.

Global yields moved to new multi-year highs over the past week, as investors continue to adjust to the dawning reality that the wait for lower interest rates is likely to be a protracted one. With 10-year US yields breaching 4.5%, this has seen additional selling from trend-following models and having noted that many investors had already been positioned long and wrong in this particular rate move, so there has been an absence of new buyers wanting to support Treasuries.

Sentiment has not been helped by a looming US government shutdown, which may prompt renewed analysis with respect to debt sustainability and underlying credit worthiness. However, we don't see this as a material factor in the world's largest economy, with the dollar unrivalled as a reserve currency. Rather, more tangible concerns may relate to the ongoing move up in oil prices, which points to disappointing inflation prints over the next couple of months.

Meanwhile the UAW auto workers strike continues to be a focal point with respect to wage hike concerns. Indeed, seeing the US president endorsing very substantial wage claims may act as a catalyst for stronger wage increases from other sectors and it is likely that the Fed will be very vigilant in this regard.

As we have argued before, following meetings with policymakers, there is a view at the Fed that it may be acceptable for them to hold rates too high for too long, leading to a growth slowdown, given that they would have the ability to cut rates thereafter and course correct. What would be more unforgiveable as an error were if policy was to turn too dovish too soon.

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In this case, if inflation was to re-accelerate then this would put the Fed in a very difficult position and they may need to endorse further aggressive tightening in order to restore price stability, with this resulting in a more severe recession were this to be the case.

Looked at in this context, and with the economy remaining robust, it is easy to understand why the FOMC messaging continues to highlight the prospect of one more hike in the coming quarter, with little prospect of lower rates until well into the second half of 2024.

We have previously argued that it is difficult to become too constructive on the outlook for US rates until we reach a point where it is easier to project a path to rate cuts within an investible time frame. In the interim, an inverted yield curve means that being long duration is a negative carry trade at best and a loss-making trade at worst.

Indeed, it is striking that the total return of the US Broad Market fixed income index now sits at -1.4% on a year-to-date basis, with this return substantially behind cash and burning those who have wanted to become too bullish on fixed income too prematurely, after the sell-off in 2022.

That said, following an aggressive move higher in yields in the past month, we think that the current sell-off may have gone far enough for the time being and we can see some value in long-term forwards, with the 5-year, 5-year forward rate now sitting at 4.6%, having been as low as 3.4% at the end of June.

We are not yet convinced being long of US Treasuries is a compelling trade on an outright basis. However, we have become more constructive on a cross-market comparison and consequently have moved long in US rates relative to UK gilts.

Ultimately, we think that inflation and interest rates in the UK will settle at a materially higher level than is the case in the US, and so buying 10-year US rates at a positive yield premium in excess of 20bps versus 10-year gilts is compelling to us.

Our views have held that inflation may trend around 3-4% for the time being in the US and Eurozone, whereas in the UK, a core inflation rate closer to 5% is likely, exposing the economy to growing stagflationary risks.

From a trading perspective, we think that if US yields reverse lower then this spread between the US and UK yields should compress. Similarly, should US rates continue to move higher, then we think that UK yields will head in the same direction and could well end up underperforming on a relative basis.

Within the Eurozone, yields have followed moves in Treasuries, with sovereign spreads also widening as risk assets have come under pressure more broadly. Higher Treasury yields have put pressure on corporate credit spreads and stocks. In part, this is a result of markets becoming less convinced that this cycle is destined to end with a soft landing.

At the same time, as long-term rates rise and real rates move higher, so this is impacting valuations for all long-dated assets and has been weighing on valuation multiples. Downside risks to growth continue to be a greater concern in Europe than the US.

However, we remain relatively sanguine on the backdrop for high grade credit as we feel that credit quality remains well supported. Further down the credit spectrum we see more stresses looming.

The past week has seen the default of French retailer, Casino, and it is interesting to note how the price of Casino bank loan debt has been deeply discounted, on the assumption of a substantial write-down. More broadly, we would note that levered companies in private markets continue to see a substantial rise in their all-in borrowing costs, which can challenge the viability of some firms on a go-forward basis.

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We continue to run little directional risk in corporate credit, with exposures largely hedged using CDS indices. These indices have widened in line with cash bonds over the past couple of weeks, though we would note that we have not seen a moment of capitulation at this point, which would cause an acceleration in price action.

This could be ahead of us if recent trends persist beyond the quarter end. Were this to occur, we would look to trim these hedges at wider levels and move to a more constructive stance. However, this is only compelling to us if it becomes more apparent that price action is starting to overshoot.

Elsewhere emerging assets have also been on the back foot, thanks to higher US rates and a stronger dollar. The dollar itself has moved to a new high for the year on the back of US exceptionalism. From a fair value perspective, there is no doubt in our minds that the dollar is rich on a relative value basis.

Yet for now we can see how the greenback remains supported and we have only been slowly unwinding a long dollar bias as the currency moves higher. Meanwhile, it continues to interest us how policymakers in countries such as Japan are eager to prompt a stronger yen but have been undermined by an overadherence to overly dovish monetary policy.

We are clear in our thinking that Japan inflation will continue to surprise materially to the upside of expectations, and we continue to wonder how long it will be before this trend is grasped by the BoJ. Ultimately, we see policy change coming in Japan. But what is also clear is that the BoJ has been making a mess in assuming that the US economy and US yields would be headed in a negative direction by now, having materially overestimated near-term recession risks.

Looking ahead

One of the quirks of a possible US government shutdown is that this may mean investors are starved of upcoming data releases. At a time when there is considerable economic uncertainty, it won't be a great moment to be driving blind, so to speak. An extended shutdown will also impact future data collection, and this may make life difficult for investors and policymakers alike.

That said, we would continue to expect some incremental evidence of slower economic activity and somewhat higher inflation pressures over the next few weeks, and this does not project a particularly supportive backdrop for financial market assets.

We have previously highlighted how we have been happy to remain quite patient over the past couple of months, looking for market weakness and capitulation from other investors as a catalyst to start to increase risk. In this respect, we believe that we are now closer to this point, but that we have not seen the definitive moment which could lead to a turn in sentiment just yet.

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The pain trade continues to be towards higher yields and weaker risk assets, given how many investors appear to have drunk the soft landing Kool-Aid over the summer, and had extended duration and cut downside bearish trades during this period. The sense that the market is long and wrong will probably prompt calls that the Fed is making a mistake, as investors nurse losses.

Yet a more sober reflection is that Central Bank messaging is not changing ever so much, and it is more a case of the markets coming to the realisation that the Fed may have had it right all along.

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