RBC Global Asset Management

Portfolio Manager Perspectives
Mark Dowding's Global Macro Update

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Scraping the bottom of the barrel

It's feeling like silly season in UK politics.

Key points

- In the US, the most recent CPI release showed lower-than-expected inflation, and Treasury yields retreated on the news.
- Moves in US yields were replicated in Europe over the past week, with UK inflation also slightly softer than expected.
- Fiscal sustainability seems likely to be a theme that influences global markets, as deficit spending has become ingrained.
- Assets in emerging markets have been stronger on improved risk appetite and declining fears with respect to the Fed.

US Treasury yields moved lower during the past week, in the wake of a softer-than-expected October CPI release. Annual headline inflation dropped to 3.2% last month, though we would note that underlying core inflation continues to remain at 4%, double the Fed's 2% target. From this point of view, we believe that it remains too premature to expect the FOMC to turn more dovish just yet.

That said, the likelihood that rates have now peaked seems to be a growing probability. In recent weeks we have seen some evidence of softening in aggregate demand in the US economy, but part of this is a function of growth cooling from a very strong quarter in Q3. Retail sales remain positive and the labour market remains healthy.

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Meanwhile, the decline in government bond yields coupled with stronger equities, tighter credit spreads and a softer dollar have all seen a material easing in financial conditions indices (FCI).

Measures of FCI now show a full retracement of the tightening witnessed since the middle of August. Noting that Powell cited these measures at the last Fed meeting, recent moves provide another disincentive for the Fed to encourage markets further.

During the course of 2023, we have frequently seen the market seek to front-run the prospect of Fed rate cuts, only to be disappointed when the central bank has pushed back. Although it is quite possible that data continues to trend softer into the end of the year, we don't think that current yield levels offer a very attractive entry in terms of risk/reward, with regard to a long duration position.

Moves in US yields were replicated in Europe over the past week, with UK inflation also being slightly softer than consensus estimates. Nevertheless, core UK inflation remains elevated at 5.7%. With the Bank of England already promoting a more dovish stance, we continue to think that price growth will end up stuck close to prevailing levels, highlighting the scope for stagflationary risks.

In this context, the latest UK wage data showed little sign of slowing, with pay gains remaining close to 8% last month, notwithstanding a weaker macro backdrop in the economy. Meanwhile, a government Cabinet reshuffle saw the surprise return to government of former Prime Minister, David Cameron, following the sacking of Suella Braverman.

This news was a surprise, not least since David Cameron is no longer a Conservative MP, with Sunak facilitating his appointment by proffering a peerage. Internal warfare in the wake of the Prime Minister's reshuffle continues to suggest a government going through its death throes, with polling indicating party support falling below the 20% threshold. These polling trends may mean that a desperate regime seeks to adopt populist measures to shore up support.

In this case, it seems increasingly likely that steps to cut taxes will be taken in an autumn Budget. Should these occur, it will be interesting to see how the gilt market reacts and having witnessed a bond market tantrum last year, we would not rule out a similar occurrence at some point in the future, if markets react with scepticism with respect to the government's fiscal plans.

Indeed, with Moody's lowering the outlook for the US credit rating to negative last Friday, the whole narrative around fiscal sustainability seems likely to be a theme that influences global markets in the weeks and months ahead. Although we think that the US losing its last AAA rating is not particularly significant in itself, we do see this action as symptomatic of a deeper underlying problem, at a time when many global policymakers continue to show an alarming lack of fiscal restraint.

Over the past 15 years, many governments have become accustomed to raising spending and cutting taxes, to the approval of voters. However, if bond markets start to exert more discipline on the back of debt sustainability concerns, one might imagine that the one thing which may change government's behaviour is when their own actions create a market reaction, which pushes asset prices lower and makes voters poorer in the process.

Japan is another country where fiscal fears are not far from the surface, and we wonder how long it might be before the Japanese sovereign rating is cut into BBB territory. Japanese government debt amounted to 263% of GDP at the end of last year, and yet the Kishida government has continued to ease fiscal policy in response to higher inflation, thereby eroding living standards. Such a large level of debt would seem hard to sustain, were borrowing costs to exceed much above 2%.

This is one reason why we have thought that the BoJ would be advised not to allow inflationary pressures to build on an accelerating trend. Core CPI is currently at 4% and although this may recede in Q4 this year, we would expect further reacceleration thereafter. In this context, real interest rates are materially negative. Consequently, the longer the BoJ delays policy normalisation, so the higher the ultimate peak in yields may be.

Meanwhile, we would note that demographic factors point to a declining Japanese population in the years ahead, meaning that debt payments will need to be supported by a declining tax base. Japanese income taxes are already an eye-watering 57% for high earners and so seem to have little scope to rise, meaning that wealth needs to be taxed instead.

At the same time, should interest rates start to rise, then the BoJ will start making losses on the bonds on its balance sheet, as has been seen in other developed economies. For now, these structural issues may be overlooked by investors, though at some point in the future, we think this worrying dynamic could be a focus of attention. This is another reason why we believe that it is attractive to maintain a structurally short position with respect to JGBs.

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Elsewhere, the softer US CPI data this week has seen a material softening in the dollar. We had previously closed a short position with respect to the China renminbi as this rate had become stuck around 7.30, notwithstanding a bearish view with respect to the Chinese economy, and in the wake of the US data we also closed a stance which had seen us favour the dollar versus the euro.

During the week, we also reduced short currency risk in the pound relative to the euro, though a structural short stance in sterling remains a high conviction view. Risk-on moves were very positive in credit, with CDS indices squeezing materially tighter, outpacing moves in cash bonds. With the Itraxx Crossover Index spread at 390bps, down from 465bps at the end of last month, we are inclined to think this move tighter has gone too far too fast.

From that point of view, we are now more inclined to add to index CDS hedges at prevailing levels. That said, positive risk sentiment may persist for the time being, with few data catalysts to upset markets prior to the end of the month.

Assets in emerging markets have also enjoyed a strong week on improved risk appetite and declining fears with respect to the Fed. However, Romania suffered a poor week on the back of pension legislation, adding to the government deficit in 2024. In the scheme of things, we think that a lot of bad news is already embedded in Romania credit spreads and that these bonds, denominated in euros, look cheap on a relative value basis.

Meanwhile, in Iceland, a pending volcanic eruption weighed on the krona. This raises the risk of disrupting tourism and impacting the fishing industry, though we see this as a temporary factor. With the Icelandic economy remaining strong and a constructive outlook heading into 2024, we believe that the krona is now cheap relative to fair value, and we may look to add exposure on further weakness relative to the euro.

Looking ahead

We are not convinced that the macro landscape has changed ever so much in the past few days. From this point of view, should a rally extend in the absence of supporting information, then we may become inclined to fade this.

On US rates, were we to become more bullish on a structural basis, then we are more inclined to look at front end yields. Here, we may target a level around 5.1% as an entry, but are happy to be patient for now, with no position at present. Day-to-day volatility remains relatively elevated for the time being but may calm into Thanksgiving next week.

The festive season will soon be upon us, but we are less than certain that seasonal cheer alone will be able to sustain much more of a run-up in asset prices over the next couple of weeks. In this case, we are not inclined to chase moves, but rather to pick levels where we think it makes sense to add and reduce risk and invest with a degree of discipline with valuation in mind.

"With many candidates not expecting to retain their seats, it seems that the sorry Conservatives are already planning for a different future."

As for UK politics, it feels like we are already in the middle of silly season. What seems ever clearer, is that it is a question of when, not if, we see a Labour Starmer government. Indeed, an intriguing sub-narrative over the past week suggested that few Tory MPs were seen wanting to take ministerial roles at this point, on the basis that ministers are prevented from taking roles in the external sector for six months following leaving Westminster. With many candidates not expecting to retain their seats, it seems that the sorry Conservatives are already planning for a different future... even though it is less clear who would want to hire a number of them!

Portfolio Manager Perspectives

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