RBC Global Asset Management

Portfolio Manager Perspectives
Mark Dowding's Global Macro Update

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Market enthusiasm for lower rates risk getting over its skis

There's a lot to navigate before Santa comes to town.

Key points

- Inflation data, globally speaking, has been better over the past few months, making additional rate hikes less likely.
- Global yields have continued their recent rally, on growing expectations for central bank easing.
- However, we think that the market's enthusiasm for rate cuts is overblown, leaving room for disappointment.
- We stick with a view that rate cuts are only likely in the second half of next year.
- Japanese yields jumped, having been on a recent downward trajectory, in sympathy with US and European yields.
- We continue to hold the view that UK inflation is stuck at a much higher level than in the US or Eurozone.

Global yields have continued their recent rally over the course of the past week, on growing expectations for central bank easing in the first half of 2024. However, we think that market participants have become over-excited about the prospect of near-term rate cuts, leaving room for disappointment.

Consequently, we have been fading the rally in rates, adding to short duration positions, as yields have dipped lower. US economic data remains consistent with relatively healthy growth, in our eyes. Weaker JOLTS data on job openings may suggest some softening of activity, yet we still expect to see a relatively healthy US labour market report released later today.

Business confidence, per this week's ISM data, also remains consistent with growth close to trend, and although we ourselves expect activity to slow in the year ahead, we see few signs of the US economy hitting the buffers.

Inflation data, globally speaking, has been better over the past few months. In Europe, ECB's Isabel Schnabel even heralded the decline in German CPI as 'remarkable', leading her to conclude that no further rate hikes would be required and that the 2% inflation goal now looked attainable in the coming 12 months. This saw a sharp revision in short-term euro interest rate expectations, with short-dated contracts rallying by 60bps over the past two weeks.

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However, we would want to point out that the recent decline in inflation is much less remarkable than may appear to be the case. Base effects have pulled CPI lower, but we are now likely to see this head back up again over the next few months, as these factors drop out of calculations.

Consequently, we stick with a view that rate cuts are only likely in the second half of next year, with cash rates in the US and Eurozone both declining by 50bps. This is now more bearish than market pricing, with futures markets discounting a move in the Eurozone in March and one in the US as early as May.

We think that market enthusiasm for rate cuts has become overblown. Financial conditions have eased materially and unless we see notably softer data in payrolls and next week's US CPI, we think that the upcoming Fed meeting won't see much of a revision in tone from the FOMC.

At the last quarterly meeting in September, the dot plot of rate expectations showed Fed participants expecting one more hike at the end of 2023 and 50bps of cuts in 2024, in line with our own thinking.

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Although the 2023 rate hike will now be removed, we think that the trajectory will remain otherwise the same. From this point of view, the market is set to be disappointed if Powell doesn't play Santa.

Japanese yields jumped in the middle of the past week, having been on a recent downward trajectory, in sympathy with US and European yields. Bank of Japan (BoJ) comments appear to suggest that plans to exit the Negative Interest Rate Policy (NIRP) are accelerating. We had been calling for an end to NIRP in January, which has been well ahead of market consensus expectations.

In meetings with Japanese policymakers we have emphasised that there is little to be gained and much to be lost by the BoJ dragging too far behind the curve, and we have argued for more assertive policy action. Inasmuch as Prime Minister Kishida's popularity rating is very depressed at the moment, we see this partly linked to a weak yen, which in turn is linked to ultra-accommodative monetary policy.

Therefore, we think that political pressure has been building on the BoJ to change course and as markets have discounted a policy shift, it is similarly interesting to note how this is helping to lift the yen's valuation.

We continue to believe that Japanese economic activity is relatively healthy, and this should be confirmed in a relatively upbeat Tankan survey next week.

Inflation remains well above the 2% BoJ target and although we expect data to dip in the fourth quarter this year, we feel confident that we will see a broadening of price increases in the new year, which should add further impetus to prices.

We also think that the BoJ is encouraged to act sooner, because if it leaves a policy exit until later in 2024, then this could become more problematic, if this coincides with monetary policy elsewhere moving in the opposite direction. From that point of view, this all points to the December BoJ meeting on the 19th of the month being a live policy meeting.

In the UK, 10-year gilt yields rallied below 4%, mirroring gains in other markets. However, we continue to hold the view that UK inflation is stuck at a much higher level than in the US or Eurozone. UK CPI may dip further this month before heading up again in the first quarter. We continue to see core CPI in the UK around 5% and it is not clear to us how current levels of interest rates will manage to bring this back to the 2% target.

Meanwhile, at a time when we are starting to see a bit more fiscal responsibility come onto the agenda in Europe, in the UK we think that Sunak and colleagues are already planning another fiscal give-away in the spring, before calling an election later next year. They seem to have got away with the latest cuts to National Insurance rates, with the OBR assuaged by spending cuts – even though many of these only kick in well after the date when the Tories are likely to have departed from office.

Consequently, the temptation to ease fiscally again, in order to bolster the Conservative vote share, is plain for all to see. We think that elevated inflation will make it very difficult for the BoE to cut interest rates next year. Indeed, should inflation remain problematic, as we expect, then there remains the risk that Bailey and colleagues may re-start a policy tightening cycle later next year, after holding policy on pause for the time being.

Within the Eurozone, we were pleased to note the Fitch upgrade to Greece's credit rating at the end of last week. This move will see GGBs return into investment grade indices, after a 13-year hiatus. This can be viewed as the final closing of a chapter which once saw Ireland, Portugal, Cyprus and Slovenia all consigned to the wilderness of the high yield universe.

With respect to Greece, we have anticipated that index inclusion may lead to something of a scramble for bonds from passive, index tracking investors, as we saw in Portugal and other sovereigns alike. Indeed, it was interesting to see that on the back of lobbying from the passive community, Greece's index inclusion has been delayed until the end of January – largely on the assumption that Greece will launch a new bond deal in the new year.

However, we would wonder whether Athens might be advised to delay planned issuance until February, if passive funds want to try to game issuance in this way. Thus, spreads could end up materially tighter, should the debt management office wait for spreads to rally first, in advance of launching a deal.

Elsewhere, some dysfunctionality within OPEC and signs of weakening demand has seen oil prices continue to move lower. Although this won't benefit European gas prices this winter, a lower oil price can both benefit inflation and also act as a tax cut for consumers, bolstering growth. From this point of view, falling oil prices can be seen as adding to the possibility of a soft landing, whereas much higher prices could point towards elevated risks for a hard landing.

Elsewhere, building hopes for a benign outcome seem to be expressed across risk assets. Equity indices trade close to their highs, strong flows have helped to benefit credit spreads and even bitcoin prices are now up more than 100% since the start of the year. We think that sentiment may be getting too bullish, as investors eschew downside protection.

Therefore, we continue to express a more cautious assessment on the notion that prices have recently run up a long way in a short space of time and could be vulnerable to a reversal, should data or the Fed cause the recent rally in yields and bullish rate cut expectations to be pushed into reverse.

Looking ahead

There is a lot of key economic data, not to mention live central bank meetings to navigate over the coming two-week period before we all shut down for the Christmas break.

From that point of view, we may witness an unusually busy December, before things get quiet and we can start thinking more about turkey. We have witnessed some substantial market movements in the last couple of months and from this point of view we do not see volatility dropping much into the end of the year.

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Over recent months, we have tended to have success taking positions when markets become overbought or oversold and then taking the opposing view. Right now, we think that investors are a bit over their skis in looking for early rate cuts which are unlikely to materialise, in our view.

From this perspective, being short duration on a tactical basis offers an interesting risk/reward to us at the current time, but we will obviously appraise this thinking and positioning in light of incoming data.

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