RBC Global Asset Management

Portfolio Manager Perspectives
Mark Dowding's Global Macro Update

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All quiet (for now) on the Western Front

Next week looks set to offer plenty for markets to get on board with...is this the calm before the storm?

Relatively quiet trading conditions prevailed during the past week, with many Asian markets closed for the lunar New Year holidays, and investors elsewhere awaiting the outcome of central bank meetings on both sides on the Atlantic in the week to come.

Government yields were little changed over the week, but credit spreads continued to be supported by healthy demand for new issuance and flow data, which has confirmed anecdotal reports of investors adding to their allocation in fixed income, at the start of 2023. There were relatively few data releases in the past week.

Broadly speaking, the outlook has appeared to point to some slowing of economic activity, but with recession fears dying back, and hopes that inflation will move lower in the months to come.

In this context, it strikes us that a sizeable cohort of investors are working under an assumption that beyond 2023, inflation will ultimately normalise in the 0-2% range, which prevailed for much of the past decade. However, we would be much less confident that this will necessarily be the case.

We would observe that there were some powerful trends pushing inflation lower in the past decade or so, which may now have abated, or even started to reverse. Increased globalisation was one of these factors and although we doubt we will see a reversal in global trade, we think we may have passed peak globalisation already, with the future more likely to feature a multi-polar global economy, as the US and China continue to grow further apart. A move to an ever-leaner manufacturing process and inventory management was also a factor in pushing costs down.

Yet in the wake of the pandemic, we now operate in a world where some inventory needs to be maintained on a 'just in case' basis, given how businesses have been disrupted by supply chain issues over the past several years.

An increased preference for climate objectives and other ESG outcomes is also clear to see, at a societal level. However, such changes are not without cost. This could be an additional factor in why prices are more elevated in the decade ahead, than in the decade that has just gone. Lastly, we would also note how there has been a long-standing trend that has seen the % share of GDP going to capital as a factor of production, increasing at the expense of the % share going to labour getting increasingly smaller.

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This trend has impaired median real income growth, whilst benefitting asset owners. However, we are inclined to think that the onset of pandemic marked a regime change in this trend. In the new world, we would observe that there has been a shift in the supply of labour function, making labour markets structurally tight and that this is likely to see elevated wage growth compared to prior periods.

Looking at each of these factors together, we think that there is a real chance that inflation could normalise more at a level between 2-4% in the decade ahead, in contrast to the 0-2% levels seen before.

These long-term inflation trend assumptions are clearly very important, as this will frame expectations for the natural level of interest rates across the economic cycle. The R* rate may have been somewhere around 1.5% in a world of 0-2% inflation, but if this is now 2-4%, this figure could be closer to 3.5% on cash rates. This is clearly a theoretical discussion and data will determine the outcome in the course of time.

However, the near-term relevance of this is that we would note the majority of investors will frame what they perceive as 'normal', based on their experience of the recent past. This may explain the view many may hold that it is a question of when, not if, US 10-year Treasuries will return to yield levels closer to 2.5%. This desire by the market to disregard what the Fed and other central banks are saying may, in due course, result in the central banks ending up needing to follow the market.

Yet, we would caution that this is a complacent view and we would not be surprised if central banks provide a clear challenge to this thinking, in the course of the week ahead.

As the Fed meets, it strikes us that during much of the past year we have seen a specific focus on Financial Conditions, as a proxy of what policy is doing. In this light, these indices have been easing since September, even as the Fed hikes. Consequently, we sense a degree of concern within the FOMC that slowing the pace of rate hikes is tantamount to easing policy in the eyes of the market.

From that point of view, a move of 50bp at the upcoming FOMC could come as a nasty shock, though in reality it seems that Powell and colleagues would be slated for delivering such a surprise and upending markets. What seems much more likely to us, is that hawkish rhetoric will accompany a 25bp shift.

We think that the Fed Chair will want to make sure he says nothing that can be latched onto by investors as an excuse to take Treasury yields lower or risk assets higher, in the immediate aftermath of the FOMC. Whether markets are bothered to listen to the Fed is another question.

Yet we would note that with the market expecting rates to peak just under 5% and for the Fed to ease twice before the end of the current year, there seems plenty of scope for these projections to be disappointed, unless there is a much more significant slowing in economic activity, which would be bad news for corporate earnings and credit quality anyway.

If the Fed is likely to deliver a 'hawkish 25bp', then we think that the ECB will also deliver a relatively hawkish assessment, as it takes rates up by 50bp next Thursday. Although lower energy prices are clearly helping the inflation outlook (as well as government deficit positions), core inflation remains elevated and may require restrictive monetary policy for a number of quarters, in the eyes of many policymakers who we meet.

In the short term, the fact that the economy continues to hold up pretty well may actually give central banks, like the ECB, more cover to be more aggressive in the short term, so that they can then pause at an earlier point. In this context, we still look for Fed Funds to peak just above 5% and the ECB deposit rate to reach 3.5% in the spring, before policy pauses for the following six months.

We think that rate cuts will only be a story later in Q4, if growth has slowed, the labour market cooled and core inflation come much closer to the 2% objective.

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From this standpoint, we have approached next week's central bank meetings by reducing exposure on long positions, which have rallied during the past month and generated positive returns. This is true in the context of corporate and sovereign credit where new issues have performed relatively well.

We have also reduced exposure in EM, particularly positions in Brazil real FX and Mexico rates which have performed well, while allowing the overall strategy duration profile to move to a more material short position. In this context, we have adopted a relatively conservative stance, as we think that the January rally may be losing momentum and we are very sceptical that central bankers will do anything to give valuations a further push to the upside.

Elsewhere, the Bank of England seems to be the central bank most prone to delivering a policy surprise. Here, market participants are expecting a 50bp hike taking rates to 4%. Although this would certainly be justified by inflation and wage data, we are concerned at spreading signs of economic weakness.

Meanwhile, house prices are looking very vulnerable and we think that it will be very difficult for UK rates to exceed a 4% ceiling without the risk of crashing the UK housing market and the UK economy along with it. On this basis we continue to maintain a bearish view on the pound and are structurally inclined to adopt a more bearish stance on gilts, though we do not have a position in UK rates for the time being.

Looking ahead

Next week certainly looks to offer plenty for markets to get their teeth into. Meanwhile, the war in the Ukraine has also seemed to drop off the front pages in recent weeks, with the conflict in something of a stalemate during the winter.

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However the decisions of the US, Germany and Poland to follow the lead of the UK in supplying battle tanks to their ally could help shift the balance of power in the weeks to come, and we would continue to be hopeful that war will be over at some point in the coming months. The past week has been a quiet one, but it is possible that we have seen the calm before the storm.

Portfolio Manager Perspectives

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RBC Global Asset Management (U.S.) Inc.
Minneapolis | Boston | Chicago
800.553.2143 | **rbcgam.com**