RBC Global Asset Management

Portfolio Manager Perspectives
Mark Dowding's Global Macro Update

June 23, 2023

Future for UK housing could be 'intents'

Not going to Glastonbury? There may be other options...

Key points

- Market volatility has been subdued in the wake of the recent Fed and ECB meetings.
- While the Fed isn't committed to a 'pause', the data may confirm that we are near the rate cycle peak.
- With Eurozone activity also moderating, we think that we are close to the top of the rate cycle for Euro rates as well.
- The BoE surprised markets by raising the bank rate 50 bps, in light of another shocking CPI figure.
- Looking ahead, we think the risk rally can run a bit, especially if macro volatility remains subdued.

Government bond yields chopped sideways over the past week. With the June Fed and ECB meetings out of the way, market volatility was more subdued, with policymakers largely reiterating recent communication. Overall, the macro backdrop remains challenging, and being patient in an ageing policy cycle still seems the most prudent approach to markets.

Fed chair, Powell, testifying to senators, echoed the Fed's aim to moderate the pace of tightening as we near the rate cycle peak, but stated that reaching 2% inflation on a sustained basis still has 'some way to go'.

> **"We think the Fed is unlikely to raise rates again thereafter, unless inflation delivers a surprise to the upside."**

Despite avoiding the use of the word 'pause' in his testimony, we think that softer data in the form of moderating growth and inflation could easily see July's Fed meeting confirm a more concrete pause. If this were to transpire, we think the Fed is unlikely to raise rates again thereafter, unless inflation delivers a surprise to the upside.

In this context, it is plausible that we have now reached the top of the US rates cycle. With US 10-year yields at around 3.75%, we believe there are far more outcomes that result in materially lower US rates over the coming months, and one wonders if the Fed's messaging has been managed to ensure that markets don't project a pivot to lower interest rates any time soon.

Should softer data confirm a pause in July, then 10-year rates could easily fall back lower. On the flipside, should data come in firmer and yields climb further, then this may offer an opportunity to add to conviction, given risks are skewed heavily towards slower economic activity in the second half of the year.

Although the inflation outlook is more uncertain, especially in the core services sector, we are confident that the back end of the US curve is well supported, even in the scenario where inflation is somewhat stickier.

In Europe, ECB board members, Schnabel and Nagel, presented the 'hawkish camp' view at an economic conference in Germany, favouring raising rates sufficiently past restrictive, but qualifying comments with close monitoring of wages and company profits on domestic inflation.

However, with Eurozone activity also moderating, we also think that we are now close to the top of the rate cycle for Euro rates. Recent discussions with the ECB have focussed on downside economic risks, particularly through the bank lending channel, and although we expect a hike to 3.75% in July, this may end up being the last hike in the cycle.

More moderation in price pressures over the summer, and with inflation expectations remaining well anchored, should also mean that yields stabilise around current levels. With a top in policy rates on the horizon, attention will turn to reducing the ECB's bloated balance sheet, with the possibility that PEPP re-investments could cease before the end of 2024, although any active selling of securities seems unlikely for now.

Despite muted action in other global bond markets, it was another chaotic week in the UK. The BoE surprised markets by raising the bank rate 50bps to 5%, in light of recent data prints.

Earlier in the week, another shocking CPI print, with core CPI at an eye-watering 7%, meant markets were quick to price the possibility that the BoE would have to take larger policy steps again, possibly taking the bank rate to above 6% by year end, adding to fears that inflation expectations have de-anchored.

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Despite the re-pricing in rate expectations, we believe that the market is now over-extrapolating forthcoming monetary tightening. Although UK economic activity has surprised to the upside in recent months, we see increased fragility, as policy continues to tighten in earnest.

In particular, we see how dynamics in the mortgage market are only now being felt more broadly, a full 18 months since the BoE started to hike rates. This is likely to keep the BoE on its toes regarding any further tightening in policy – with the growing risk of cratering the UK housing market and the economy along with it.

However, with hard labour and inflation data now front and centre of policy decisions, one suspects we are now entering a period of heightened uncertainty regarding the UK economy, around high inflation and mediocre growth, one which we think is an ugly cocktail for the pound.

It's been a quieter week in credit, with supply dropping meaningfully after a very busy May and start to June. Corporate spreads are starting to hit more resistance having moved tighter, which has coincided with accounts increasing their credit positions in the primary market.

Asset class inflows also seem to have picked up, particularly into ETF funds which has helped the market feel in good shape, however we are starting to see signs of some fatigue, likely not helped by ongoing fears over growth.

Looking ahead

We think that the risk rally can run a bit further, especially if macro volatility remains subdued. We may well see some further hawkish comments from central bankers, as exemplified by the BoE and Norges Bank this week, however it feels that markets are running ahead of themselves once again in pricing rate hike expectations.

While we have noted before how uncomfortable policymakers have been at markets prematurely discounting rate cuts, once markets become convinced that we have passed the peak in US rates, price action in 2023 to date has shown that there is an underlying enthusiasm to own duration, notwithstanding inverted yield curves.

However, ultimately the dynamic between those looking at the glass half full versus those who see it half empty may hinge on whether economic activity or inflation falls more quickly.

One area where volatility has clearly returned is in the UK, where rates have been steadily de-anchoring from other global bond markets. It seems investors are bracing themselves for a second act following on from last autumn's budget debacle.

As a result, the UK press is full of what could happen to the housing market in coming months, and as revellers gather for the Glastonbury festival this weekend, one wonders whether the accommodation that awaits them may become a more permanent feature for some – 'intent' times ahead!

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