RBC BlueBay Asset Management

Market Commentary

Intervention time?

It’s all about Japan this week (and Chelsea)

Key points:

- Ongoing developments in Japan have been the centre of attention for investors over the past week.
- The large gap in interest rates between the US and Japan has served to undermine the value of the yen.
- The refrain of ‘higher for longer’ continues to be felt across financial markets.
- We think it is unlikely that we are at the start of a new inflation uptrend.
- European central bankers acknowledge that if the Fed is not cutting policy rates this year, then this will limit the room for them to cut.

26 April 2024 (London): Global yields have remained under upward pressure over the course of the past week, as the refrain of ‘higher for longer’ continues to be felt across financial markets. As we noted last week, we continue to see the bar to the Fed raising rates as relatively high, and especially so as we start to head towards November’s election.

Consequently, with monetary policy at levels we can deem as restrictive compared to neutral, we think that fair value for 2-year Treasuries, in a sideways rate environment, probably sits in a range between 4.75-5.0%, allowing for some optionality for lower rates and slower growth next year. On this basis, we have continued to add to front end exposure in order to mitigate short duration positions, which we continue to hold elsewhere.

US Q1 GDP data was a downside miss. However, these data are erratic and subject to revision. Nominal growth remained strong, but a surprisingly high deflator pulled real growth lower. Nevertheless the 3.4% print on Q1 prices compounded recent data disappointments on inflation, ahead of the March PCE Core data, which is due later today.

Seasonals on inflation in Q1 have been negative. However, we are hopeful that readings in Q2 will be somewhat softer as these seasonals improve. Therefore, we think it is unlikely that we are at the start of a new inflation uptrend, which would warrant additional monetary tightening. Yet, there similarly seems little requirement to suggest that the US economy needs to see lower rates any time soon. This notwithstanding any desire on the part of Jay Powell to do so, in order to help Biden’s cause.

Meetings with policymakers in Europe and the UK over the past week have focussed on the theme of policy divergence. There is an acknowledgment by both the BoE and ECB that if the Fed is not cutting policy rates this year, then this will likely limit the room for them to do the same. An ECB cut in June continues to look like a foregone conclusion but hopes for a follow-up cut shortly thereafter have been waning, as yields move higher.

We think that were the Fed to stay on hold, then the ECB is unlikely to cut by more than 50bps this year. In the UK, the most policy easing that the BoE seems able to deliver would be 25bps, if any rate cuts at all. There is a general sense that the economic outlook across the continent is somewhat improved relative to last year, labour markets remain tight, and in the case of the UK at least, underlying inflation pressures continue to look problematic.

Fiscal policy and debt levels are also topics for active discussion with the policy making community. In light of this, we have been reflecting on data, which highlight government interest expenditure as a percentage of GDP around 4% in the UK, not too far from double where this sat in the period between 2000-2020.

Meanwhile, in the US, this figure stands around a similar level, approaching the previous high recorded in 1991. With deficits remaining elevated, these levels continue to trend higher and represent a threat to fiscal sustainability, which should be reflected in increased term premia and steeper yield curves.

It is also striking to reflect that the US and UK now have higher interest expenses than is the case for Italy, notwithstanding how Italy is always held out as a candidate with a potential vulnerability. Italian interest expense as a share of GDP has been broadly stabilised in a 3-4% range, thanks to Rome frequently delivering a primary surplus in their fiscal accounts. This highlights the relatively benign backdrop for European sovereign spreads, at a time when risks elsewhere seem to be rising, with investors not adequately compensated for risks in longer-dated bonds.

Elsewhere, ongoing developments in Japan have been the centre of attention for investors over the past week. In the run-up to, and in the immediate aftermath of, today's Bank of Japan ("BoJ") policy meeting, there has been renewed pressure on the value of the yen. The large gap in interest rates between the US and Japan continues to undermine the currency. Consequently, with the US not in a position to cut rates, pressure has been on Japan to tighten its policy in order to mitigate ongoing yen weakness.

To date, the BoJ has acted very cautiously since Ueda took office 12 months ago. However, it is becoming ever more clear that Japanese policymakers cannot simultaneously control the level of the yen and the levels of interest rates and bond yields at the same time. If they want the yen to stop sliding, then Japanese rates will need to rise. Otherwise, FX weakness will anyway drive a significant acceleration in imported inflation, which could be problematic in a country where real interest rates are already very negative, with policy highly stimulative.

There has been plenty of talk of FX intervention, though none delivered as at the time of writing this mail today. This could well occur today based on recent comments. In a sense, the Japanese Ministry of Finance ("MoF") knows that it can drive the value of the yen stronger in the short term, by jumping into the FX market.

However, without a change in the underlying policy stance from the BoJ, then this seems doomed to only have a very temporary effect. Hence, intervention by the MoF can be viewed as effectively letting the BoJ off the hook when it is the latter that really needs to deliver. Nevertheless, more policy action will be needed from Tokyo in terms of higher rates, in order for the trend to ultimately turn.

In this context, we continue to retain strong conviction with respect to a short JGB stance and see a range of 1.25-1.5% on 10-year bonds as realistic in the coming months. At some point, we also know that the yen is extremely undervalued and should rally.

Yet policy delivery is required first, and from this point of view we continue to express much more conviction in yen rates than FX – especially as a short position in JGBs looks like a very one-sided trade. Certainly, we would be very surprised to see JGB yields fall at this point, absent a very sudden move lower in global yields on a major negative economic surprise.

Away from rates and FX, the past week has seen some further volatility in stock prices as the quarterly earnings season gets underway. We have also seen this weigh somewhat on credit spreads.

However, we would continue to reiterate a view that risk appetite can withstand current rates and yield levels for the time being. This may hold as long as growth remains robust, and absent a change in sentiment, that leads markets to price in risks of further rate hikes, which would also raise the prospect of recession risk during 2025/6.

Nevertheless, in a world where rates do stay higher for longer, as is now looking likely, we would not be surprised to see this expose balance sheet weakness on the part of some vulnerable borrowers. In private markets, leverage is greater and so the need for lower rates will be more pressing. Ultimately, this is a space where we may witness some more signs of distress.

Meanwhile, in emerging markets, we have seen local yields and FX under pressure. Yet, with local inflation undershooting, we think that rate cuts can support the case for the former, whilst leaving currencies such as the Mexican peso, Colombian peso and South African rand more vulnerable. Elsewhere, we are more constructive on the Brazilian real and Turkish lira, though remain short beta in EM FX as a whole.

In the US, we are relatively more constructive on 2-year Treasuries and more bearish on 30-year notes. Simplistically speaking, we think if there is a major bond market rally this year, it will come on a sudden data slowing or an exogenous risk-off event. In both cases, 2s should lead the rally.

Meanwhile, if yields sell off, then we see this linked to concerns over US debt and this would be led by the long end of the curve. By contrast, the main scenario, which would produce further curve flattening, would be one where the Fed announced plans to adopt a more hawkish stance to drive down inflation, by pushing up rates. Yet we feel that Powell won't want to do that before the November vote, if ever.

Looking ahead

There is not too much coming from data nor central banks and that could make for a quieter week on paper, especially with Europe heading into the May Day weekend and Japan heading out on Golden Week holidays.

However, ongoing events in somewhere like Japan could drive market volatility. In this world of macro divergence between the major developed economies, so there is a sense that something has got to give, and this could easily manifest itself in much larger market moves.

Positioning for this could be tricky. However, one thought is to note that commonly investors seek to hedge long exposures in risk assets by adding interest rate duration to their portfolios. Yet in the current environment, it is higher yields – be they in Japan or elsewhere – which could act as more of a catalyst for a risk-off event. Hence adding duration shorts, rather than longs, could be a better way to balance portfolios at the current time, as are curve steepening trades.

Meanwhile, we think the coming day or two is likely to see intervention unsettle FX markets. It could make for an interesting Friday afternoon. At least, as a Chelsea fan, thinking and writing on this is providing a happy distraction from dwelling on my side's thumping at the hands of Arsenal earlier this week! It seems like Chelsea manager Mauricio Pochettino may be under as much pressure as Governor Ueda is, over the next few weeks.

Notes to Editors
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