RBC BlueBay
Asset Management

Market Commentary

Stormy conditions in the Middle East

And not just downpours in Dubai….

Key points:

- Geopolitical risks remain elevated.
- In the wake of robust economic data, market participants have continued to price out interest rate cuts.
- We continue to be more cautious on the outlook for longer-dated bonds.
- Core service price inflation and wage growth in the UK are not consistent with the BoE hitting its inflation mandate any time soon.
- Looking ahead, we continue to think that global inflation data will remain disproportionately more important than growth data.

19 April 2024 (London): Further strong economic data from the US continued to apply upward pressure to yields over the past week, despite ongoing geopolitical tensions. In the wake of robust retail sales, following upside surprises in recent inflation and employment data, market participants have continued to price out interest rate cuts, which had previously been discounted. This has seen 2-year Treasuries reach 5% yields and at this level, we believe that rates are fairly valued at the front end of the curve.

For the time being, we think it remains unlikely that we will tip towards a scenario where markets will discount a need for further rate hikes. In that case, in an environment where policy remains on hold for the time being, it is understandable that 2-year rates will sit somewhat below cash rates, reflecting optionality on further rate cuts to come, before 2026.

However, we continue to be more cautious on the outlook for longer-dated bonds. As we noted last week, we see inverted yield curves sending no signal to policymakers that fiscal responsibility needs to be taken seriously. From that point of view, elevated deficits may lead to escalating fiscal risks, and we believe that investors should look for more of a term premium.

Moreover, if rate cuts are not imminent, it is not clear that there is much merit in owning longer duration. Many long only investors have been positioned long and wrong since the start of the year, and we think that capitulation could see longer-dated yields rise and the curve dis-invert.

Meanwhile, the Iranian missile attack on Israel last week has seen a material escalation in risks in the Middle East region. In retaliation, US officials claimed Israel struck targets in western Iran overnight, although the conflicting parties are yet to claim responsibility or assign blame. Our hope is that any broader Israeli response will be contained, however its reaction function can be difficult to assess. We might infer that if Israel desists from attacking Iran, then this will allow it greater geopolitical leeway to pursue its aims in Gaza, without further pressure from the US and other key allies in the near term.

In that context, it may be the Palestinians in Gaza who pay the highest price for Iran’s recent intervention. Nevertheless, ongoing certainty that we could be on the cusp of a much broader and dangerous global conflict will be difficult to shake.

From that perspective, this has acted as something of a brake to sentiment for risk assets, with equities and credit softer over the past week. Yet the longer that time passes without a further serious escalation, so there may be an inclination to buy the recent dip. That said, it might seem somewhat foolhardy to be selling volatility in the form of Vix for the time being, and this may keep risk appetites in check, inferring that a break to new highs seems unlikely at present.

Inflation and wage data both surprised slightly above consensus in the UK over the past week. In line with the views we have been expressing, core service price inflation and wage growth in the UK both continue to sit at 6% and this is not consistent with the Bank of England ("BoE") hitting its inflation mandate any time soon.

In the next couple of months, a dip in energy prices on a year-over-year basis could see CPI get close to 2%, but this is likely to be short lived. It strikes us that price growth continues to trend between 4-5% and as this is borne out, we think that it will prove difficult for the BoE to cut rates, notwithstanding pressure being applied from its political masters.

Before the next round of inflation data, we will also see UK local authority elections take place at the start of May, in what could be seen as something of a dress rehearsal for the General Election, which is projected to take place later in November. A disastrous showing for the Tories could be a catalyst for in-fighting and recriminations within the Conservative Party, and it strikes us that political risks will only trend higher from this particular point.

In the EU, yields have tracked higher in the wake of US moves, albeit outperforming on a relative basis. Bunds discount a rate cut in June, followed by 25bps in each of the following quarters. However, it is interesting to question whether the actions of the ECB could be constrained, should the Fed continue to keep rates on hold. Certainly, the move in rate differentials between the US and Eurozone has been a factor in causing the euro to weaken versus the dollar, over recent weeks.

At the same time, dollar strength has been somewhat constrained by the greenback's strong relative valuation. Yet we think that there is scope for the US currency to push closer to parity to the euro. Meanwhile, should there be a risk-off event, which causes a spike in energy prices, then this is unlikely to be euro supportive.

Elsewhere, in Japan, there has been radio silence form the Bank of Japan ("BoJ") and Ministry of Finance over the past week. Despite earlier warnings of FX intervention, when the yen-dollar rate hovered around 152, it has subsequently broken up towards 155, without any policy action occurring. This has led to howls of protest in some quarters in Japan, and it is tempting to think that the market may soon force the hand of the MoF to intervene, in order to stymie weakness.

However, it continues to be the case that the yen will weaken, for as long as BoJ policy remains over-accommodative. In this context, we see building pressure on the BoJ, in the run-up to its upcoming policy meeting. Consequently, we continue to believe that the BoJ will revise up its 2024 inflation forecast once again and will then move to communicate that it will cease its policy of balance sheet expansion via bond purchases.

Although we doubt that we will see the BoJ shrink its balance sheet any time soon, it has become important that it stops adding to existing stimulus. In addition, we also look for Ueda to tee up a rate hike to 0.25% at its July meeting. Even this may not be enough to turn the tide on the yen. However, if markets can see that the BoJ is committed to a path of policy normalisation, then this will take away an incentive for traders to stop selling the Japanese currency and could help promote more stability, at the very least.
In emerging markets, the move up in US rate expectations has been particularly negative in terms of EM local currency yields and FX. We have looked for EM central banks to cut rates this year, having brought inflation down ahead of moves in developed markets.

Yet, if US rates remain elevated then it becomes psychologically more difficult for these central banks to ease, and this has been a catalyst for disappointment in EM rates, leading to some position capitulation. This has taken real yields in a number of markets to very elevated levels, and we would question whether this degree of risk premium is really warranted. On this basis, we are more inclined to add to EM rate risk than to cut positions.

In light of that, we remain constructive on Mexico, South Africa and Brazil. In contrast, we remain more circumspect in EM FX, taking risk on the short side in both Mexico and South Africa, as well as China. In this case, the policy action, which we expect to lead to a rise in bond prices, is likely to have the opposite effect on EM FX, in our eyes.

Credit spreads widened as markets demanded increased risk premia. After a strong rally, credit was vulnerable to some retracement. However, we continue to cite that market technicals remain supportive. Net corporate supply has turned negative, and this is a catalyst for tighter spreads on cash corporate bonds.

CDS indices have underperformed as spreads have widened, with investors adding hedges. In the short term, if these hedges are lifted, then CDS could outperform. Yet the arguments for a tightening on the bond/CDS basis remain intact, as long as the demand versus supply technical in corporate bonds continues to be supportive of spreads.

In terms of investment themes, we have been adding some duration in 2-year US Treasuries at around 5%, in order to start to reduce a net short duration bias at an aggregated strategy level. We have topped up long dollar positions, whilst also adding in EM rates in Brazil, Mexico and South Africa.

Elsewhere, we continue to maintain hedges against the majority of our corporate credit exposure, retaining a relatively modest beta in terms of overall market directionality. We had reduced sovereign credit in the second half of March but continue to favour long-held names such as Mexico and Romania.

Looking ahead

There is not much economic data to drive markets in the coming week. In the absence of new geopolitical headlines, we would be inclined to think that volatility can drop, and this can encourage buyers of risk assets. We could see that the 5% level on 2-year Treasuries acts as an anchor for the time being, as we continue to see the bar on Powell voting to move to raise interest rates prior to the election as reasonably high.

In that sense, new information may be needed to extend the sell-off, and we continue to think that inflation data will remain disproportionately more important than growth data for the time being. From that point of view, the next CPI data remains a few weeks away, and it will be interesting to see if somewhat better seasonals could herald a return to more benign prints in Q2.

Ultimately, we have stated that Powell would like to cut interest rates, if only data gives him half a chance. However, in the short term, even the Fed Chair has been forced to admit that incoming data in 2024 have failed to support the thesis of a return to the inflation target any time soon.

Elsewhere, at a time of geopolitical volatility and stormy skies across the Middle East region, it was striking to observe the freak weather event of flooding in the UAE, in the wake of almost twice the expected annual rainfall in the space of a day. It is convenient to point to climate change, though more astute observers will notice a more deliberate pattern to maximise rainfall in a country which is threatened by water security, as its population continues to grow. This has led to regular cloud seeding, which is making rainy conditions much more common and is also acting to lower temperatures, almost seeking to demonstrate how it is possible to engineer micro level solutions to the problem of climate warming.

In the UK, we might only wish sometimes that there was a reverse technology to give us a few more warm, sunny days instead of cold and wet ones! That said, in the wake of 20 deaths in storms in the UAE this week, one wonders whether these measures may have been taken a bit too far….it won't be the first or last time that Mother Nature hits back….

Notes to Editors
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