



Market Commentary

Falling into line on Daddy's orders?

At some point, pushback seems likely to come

Key points

- Treasury yields fell as markets anticipate Fed rate cuts in the second half of 2025.
- Oil prices have returned to levels prior to the '12-day War' between Israel and Iran, reducing near-term inflation fears.
- Longer-dated yield concerns are also likely to persist, with the US Budget looking like it will be finalised ahead of the summer recess.
- NATO's demand for increased spending on defence and security could lead to the EU taking a stronger line on trade negotiations with the US.
- We continue to believe that markets are being complacent with respect to trade risks.
- There is no evidence of US asset sales yet, but marginal savings flows are shifting away from the dollar and US markets over time.

27 June 2025 (London) - Treasury yields moved lower over the past week as market participants became more confident of Fed rate cuts in the second half of 2025.

Having launched military strikes last weekend, Trump's forbearance appears to have ended the open conflict between Israel and Iran, helping oil prices return to levels prior to the '12-day War'. This has helped to alleviate some near-term inflation concerns.

Early modelling for June CPI also suggests that the next set of US price data may be relatively benign, with tariff price hikes only showing up in data released later in the summer.

In this context, Waller and Bowman have broken with the consensus within the Fed, in arguing for a possible cut in rates as early as the July FOMC. Although we think this is unlikely to occur, it seems inevitable that political pressure on Powell is going to build over the coming months, unless there is a material overshoot in inflation projections.

On this basis, discounting Fed cuts in September and December looks pretty reasonable to us and we remain relatively comfortable with what markets are pricing in terms of the forward path of US interest rates.

Meanwhile, longer-dated bonds have lagged the front-end rally, prompting a steepening of the yield curve, in line with our views. We think that this is a trend that has further to run over the coming weeks and we continue to favour a position in 2-year notes relative to 30-year maturities.

Chatter with respect to Trump making an early announcement on the next Fed Chair is growing, amidst the administration's mounting frustration at Powell's intransigence. As with other Trump appointees, it might be assumed that any nominee will be chosen on the basis of loyalty to the boss and a commitment to deliver what the administration wants.

Inasmuch as this points to lower interest rates, irrespective of near-term inflation numbers, markets may conclude that this could push short-dated yields lower, whilst pushing longer-dated bonds in the other direction.

Concerns with respect to longer-dated yields are also likely to persist, with the US Budget looking like it will be finalised during the coming month, ahead of the recess.

Pressure to get a deal done under reconciliation points to compromise within the Republican ranks over the coming few weeks. This is set to deliver a fiscal deficit around 7% of GDP, notwithstanding USD250-300 billion of tariff revenues.

In this light, worries around mounting US debt levels are unlikely to abate any time soon.

Despite Presidential claims that the deficit will fall, we just can't see this administration delivering tax hikes or material spending cuts. Therefore, the only factor likely to cut the deficit will be if borrowing costs can decline in a material way.

This speaks to Trump's desire for lower interest rates and plans to skew the maturity profile of debt towards the short end. Yet, the economic reality seems unlikely to permit a material easing of financial conditions, absent a much more adverse economic backdrop.

Elsewhere, the desire to lower borrowing costs has also been a factor in recent changes to the Supplementary Leverage Ratio (SLR), making it more attractive for banks to own Treasuries. However, banks may only be tempted to buy longer-dated bonds if the curve is steeper than it is currently.

Trump has also cast a large shadow over recent G7 and NATO summits. In the case of the latter, Secretary General Mark Rutte appeared to fawn over 'Daddy', full of praise and delighted to deliver Trump's agenda, pushing member states to raise their spending on defence and security to 5% of GDP by 2035.

In a sense, this acquiescence did not come as much of a surprise, given Germany's recent announcements with respect to its planned Budget easing. Yet, the optics of Europe grovelling before 'the king' in order to try and keep him within the tent and part of the NATO Alliance will have gone down uncomfortably in a number of European capitals.

This could feed back into upcoming trade negotiations, where it may appear that the EU will be prepared to take a stronger line. Although we expect a deferral of the July 9th US tariff deadline, given the lack of progress in negotiating trade deals, we think that trade tension is likely to mount in the next two weeks as this deadline approaches.

With Trump riding high, we think that he may be inclined to demonstrate a commitment to his Administration's agenda by announcing additional tariffs. In this respect, we think that EU pharma may be in the spotlight. Similarly, EU counter tariffs seem likely to go live as this deadline passes.

In this respect, we continue to believe that markets are being complacent with respect to trade risks. Although a repeat of April 2nd is unlikely, we think it's probable that we will witness bouts of volatility under Trump, interspersed with periods of calm. In that respect, a period of calm, which has prevailed since the second half of April, could be coming towards an end. This thinking infers that we should remain relatively cautious with respect to exposure in risk assets.

In the Eurozone, the substantive increase in fiscal spending linked to defence is already leading to an increase in government bond supply. From that standpoint, it is estimated that in the next 10 years Germany may issue an additional euro 1 trillion in bunds, adding over 50% to the outstanding debt stock. This represents a challenge to yields from a supply perspective.

This fiscal boost also infers a stronger outcome for regional growth, obviating the necessity for additional monetary easing. Consequently, we think that Eurozone government bonds will struggle to rally much from prevailing levels, though there is a sense that increased FX flows into the euro and European assets, could be a supportive factor.

With 10-year German yields around 2.5%, we see rates close to fair value. Similarly, for the time being, it is also difficult to get too excited with respect to regional spreads.

For the UK, Starmer's commitment to NATO demands only adds to his fiscal headache. A rebellion with respect to welfare reforms could pressure the government into a U-turn in the coming week, and it seems that the national mood would desire more spending on government handouts. In this case, it is hard to show fiscal discipline elsewhere when more money is being thrown at defence.

In many respects, Starmer is something of a hostage to fortune. In the same way that that Tony Blair felt it was impossible for a Labour leader to turn his back on the US and the 'Special Relationship' with respect to Iraq, Starmer has had no choice but to go along with increased defence spending plans.

However, he will hope that this can be back loaded, so that it does not pressure the government into raising taxes or cutting spending elsewhere in the near term.

From this point of view, Reeves and Starmer continue to walk a bit of a fiscal tightrope. For example, difficult choices may point to an abandonment of prior net-zero commitments, but evidence still suggests that the direction of travel will be towards greater fiscal relaxation.

In that context, policymakers hope that the gilt market doesn't decide to throw a tantrum. In our eyes, ongoing concerns with respect to UK inflation, as well as the fiscal position, mean that we are inclined towards a more bearish outlook for both gilts and sterling.

For now, we maintain no positions in the UK. However, if 10-year yields rally below 4.40%, then this may be an attractive entry point, to move to an explicit short stance.

A US trade deal with Japan looks some way off, with Tokyo also pushing back on US demands for increased defence spending.

The political optics are challenging in Japan, with Upper House elections on 20th July. However, in speaking with policymakers, we sense that Japan continues to feel a sense of betrayal from the US, with respect to what was announced on April 2nd and we feel that it merits, and deserves, better treatment from its long-standing ally.

From a financial market perspective, a lack of progress on trade has meant that the BoJ is more likely to maintain a dovish stance for the time being. This being the case, we think that the yield curve will continue to trade close to current levels for a time.

However, we believe that higher inflation prints will renew pressure for interest-rate policy normalisation in the months ahead, with this helping to flatten the 10/30 spread in JGBs, in addition to raising shorter-term yields.

In FX, prospects for US rate cuts have helped feed the weaker dollar narrative, sending the DXY index to a 3-year low. Analysis of flow data suggests that much of the move in the past couple of months has come from Asian investors increasing their hedge ratios.

To this point, there is no evidence of US asset sales by overseas investors. However, we see asset allocation flows away from US assets and even if this does not trigger sales of existing holdings, it does seem likely that marginal flow in savings will flow away from the dollar and US markets on a forward-looking basis. We also note that many investors we speak with confess to being over-allocated to US securities.

From this perspective, a weaker dollar trend may have much further to run over coming months, but we are also a bit wary of a build-up in short-term speculative positions. For example, this could mean that a volatility shock, such as what we saw on April 2nd, could end up strengthening the dollar, if this leads to a more broad-based de-risking and cutting positions.

From this standpoint, the reaction in FX markets in a risk-off move could end up looking quite different to what we saw on April 2nd. Within FX we continue to favour the Korean won. We have also added a long in Chinese renminbi, which has lagged other currencies. In Europe, we have also added Norwegian krone, which has underperformed as oil prices have retraced this week.

Credit markets have been firm in the past week, as Middle East tensions have abated. One of the topics we have been focussed on is how annual coupon payments in a number of credit asset classes are helping to negate net supply.

A few years back, coupon payments were much more modest, meaning that new money needed to be allocated into credit in order to match supply to demand. However, technicals in credit are now in a stronger position.

We also see European fiscal spending diminishing recession risks in continental Europe. Inasmuch that recession is the driving risk to credit impairment, we can infer that credit should outperform government bonds as long as recession risks are low or declining.

Although we remain concerned with respect to complacency in risk assets more broadly, we lifted some hedges we had added as Middle East tensions were building. Yet, we think that it makes sense to maintain a

relatively cautious stance as valuations are not compelling. From that point of view, we would favour being in a position where we are placed to add on any market weakness.

We have continued to favour Romanian euro debt as our top pick within the investment grade sovereign universe. Since the elections in the middle of last month, spreads in the country have recovered back to levels that were prevailing at the start of this year, as political risks diminish. Although fiscal and current account deficits remain an ongoing source of concern in the country, prevailing spreads at 350bps above bunds offer material compensation for these risks in our eyes, noting that outstanding debt levels remain modest in an international context.

Looking ahead

Next week's Independence Day holiday in the US means that the monthly jobs report will be released a day early, next Thursday.

We have seen some softening in US economic data trends over recent weeks. Softer activity numbers may add to enthusiasm for rate cuts, which we think can help curve steepening positions and can help continue to push the dollar somewhat softer. However, we think that it will more likely be the inflation print in the middle of the month that could prove more pivotal in terms of Fed thinking and any move in yields.

This said, it may well be that trade headlines are a much more dominant driver of price action, rather than economic data releases, over the course of the next few weeks.

Big Daddy is riding high, and his arguments seem to be winning the day. Indeed, the win for left-winger Zohran Mamdani in the recent New York mayoral election continues to suggest to us a Democrat Party that remains in disarray since last November's elections.

Perhaps the risk to markets here is that with Trump feeling bullish, there may not be much of a restraining force should he decide to double down on plans to Make America Great Again.

The question for investors will be whether this may lead to a renewed period of volatility, or whether public opinion, the Fed, overseas governments and financial markets all meekly fall into line behind Daddy's instruction.

Reflecting on this question sees us thinking a cautious outlook remains warranted. At some point, pushback seems likely to come.

Notes to Editors

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