RBC BlueBay
Asset Management

Marketing communication

Chain reactions

Hidden flashpoints could unsettle markets right now

Key points:

- In-line US CPI figures this week solidified expectations of a 25bps Fed rate cut in September, with more cuts likely to follow.
- With companies investing in AI and achieving efficiency gains, the underlying tone in the jobs market may remain relatively weak for some time.
- Leadership changes in France, Japan, and the UK reflect global political and economic challenges.
- Rising tensions, including Israeli military raids in Qatar and Russian drones in Poland, are heightening global uncertainty.
- US yield curve flattening and FX strength in the yen, euro, and Norwegian krone reflect shifting market dynamics.

London, 12 Sept 2025: An in-line US CPI release this week has cemented expectations that the Federal Reserve will resume cutting interest rates at its upcoming September FOMC meeting. Although some dissenting voices may call for a 50bps move, the mainstream within the Fed seems likely to endorse a 25bps reduction in cash rates, leaving the effective Fed Funds rate just above 4%, with the prospect of further moves at meetings to follow.

In this sense, it is widely understood that when central banks begin to cut rates there is an assumption that there will be more than one adjustment in a cycle of moves. From that standpoint, there will be plenty of focus on signs highlighting the trajectory and destination of policy, as we head into 2026.

With respect to labour market weakness, the downward revision of earlier NFP job estimates by a cumulative 911,000 workers was largely expected by markets, given prior comments from the BLS. However, a weaker picture with respect to jobs has been central to shifting Fed thinking.

This noted, a sharp downturn in immigration and a contraction in overseas workers means that the breakeven rate to sustain stable unemployment is lower than has been the case in the past, when the supply of available labour was growing more rapidly. In this context, monthly jobs readings of around 70,000 new jobs may look pretty normal, even if the total may appear soft, compared to what has been experienced historically in the past.

Yet with companies investing in AI and achieving efficiency gains, the underlying tone in the jobs market may remain relatively weak for some time. For example, it is interesting to observe a downturn in technology jobs as these jobs begin to be replaced by machines.

From that perspective, it is interesting to note for all the rapid earnings growth from the companies comprising the MAG-7, the number of individuals employed collectively by these companies actually shrunk during the course of the past year.

With respect to the race to succeed Powell as Fed Chair, it appears that President Trump has narrowed the field down to three remaining candidates, Kevin Hassett, Kevin Warsh and Christopher Waller.

Although Warsh is known to embrace a more radical doctrine, desiring to dramatically shrink the Fed balance sheet, markets appear somewhat reassured that the candidate is coming from the mainstream rather than someone much more unconventional, given some of the names circulating over the past few weeks. It is highly likely that the eventual pick will be someone very closely aligned to the administration's desired stance with respect to the institution and views on the economy and monetary policy.

In this context, we continue to look for a more dovishly-inclined Fed in 2026 and one which may be subject more to accusations of political interference. If inflation remains benign, then delivering rate cuts may not be a problem. However, the situation could become much more uncomfortable, should the momentum in prices show signs of an acceleration

In France, President Macron has installed Sébastien Lecornu as a new Prime Minister to replace the ousted Bayrou. As discussed last week, the political parties in the centre have been motivated from preventing new elections and handing a potential victory to National Rally on the far right.

However, it will still be very difficult to agree a budget with sufficient measures to satisfy Brussels, with respect to the deficit, without inflaming populist tensions. With a quest for some compromise leading to fewer Budget cuts, we see the deficit overshooting prior targets and continuing to add to long-term pressure on the trajectory of France's national debt. OATs may recoup some of their recent losses, but we think that there may be a limit on how far the spread can retrace.

Moreover, if the underlying political situation remains polarised, then this will continue to benefit extreme parties as investors begin to worry about the outcome of 2027 Presidential elections.

Compared to other countries such as Italy, whose population has long learned that the country cannot afford to live beyond its means, it seems that French society is stubbornly resistant to this fact. From that point of view, French creditworthiness and credit ratings are likely to continue to deteriorate over the medium term.

France wasn't alone in losing a Prime Minister in the last week. In Japan, Shigeru Ishiba stood down following protracted pressure within his party, since the poor showing at the recent Upper House elections. Initially JGBs and the yen weakened on the thought of a candidate such as Sanae Takaichi as a replacement, pushing for additional fiscal easing and for an end to BoJ rate hikes.

However, with the macro and economic backdrop different to that of 12 months ago, it appears that Shinjiro Koizumi could now be the frontrunner to catch. In this case, we would look for the yen and bond market to recover some of their recent underperformance.

Meanwhile, in the UK, it was the turn of the deputy Prime Minister to resign, following revelations with respect to underpaid taxes. There will now be a leadership election voted on by party members, who may push for an even more leftwing candidate than Rayner, given growing frustration at Starmer and his Chancellor, Reeves, within the broader Labour movement.

Although the likelihood of Starmer himself being pushed out in the near term may have fallen as a result of Rayner's departure, so in the medium term the situation could become even more difficult for him to control.

Meanwhile, with London Tube workers (again) on strike, the narrative of a country challenged both economically and politically will remain hard to shake. With this weighing on business and consumer sentiment, so it seems that UK assets and the pound may continue to be tested over the foreseeable future.

The US curve flattened during the past week. There may be some relief to hear that Trump isn't considering an outside maverick for the Fed job, which helps to stabilise long-dated yields. However, with respect to the curve, we have always thought that the next leg of the steepening trade would be led by cash rates coming down, more than long bonds selling off, and so we look for this to occur as the FOMC resumes its rate cutting cycle.

Elsewhere, in FX we have added exposure in the yen and euro, adding US dollar shorts. The Norwegian krone was a strong performer in the wake of elections, which saw right-wing parties perform better than many had expected.

Looking ahead

Pictures of Korean nationals employed by Hyundai placed in chains, following their arrest in the US in the past week, may play well with the Trump voting base. However, inasmuch that these are skilled workers involved in building new plants in the US that are planned to bring more jobs to the country, there is a risk that such an approach does more harm than good, if it ends up slowing or deterring investment in the economy from those overseas.

Foreign firms will be additionally cautious that a similar fate may befall their own employees and with visa backlogs making it difficult to fill skills gaps, there is a risk that policy could be damaging to US interests, given that it will take some years before the domestic pool of labour is able to fill some of these gaps in specialised areas.

From this point of view, we are left considering the chain reaction of event that may be triggered by changes and upheaval in policy and also in geopolitical circles. In a week where we have lost two Prime Ministers around the world (plus a deputy PM and an ambassador in the UK), it seems many countries are struggling to satisfy their increasingly restless societies at a time of ever-rising government debt. The US has seen fresh political violence, with the assassination of Charlie Kirk.

Meanwhile, with Israel conducting military raids inside Qatar, and Poland shooting down Russian drones, it would seem that there are a host of potential flashpoints that could puncture the sense of calm prevalent in global financial markets right now. Ultimately asset classes like credit can do just fine, as long as economies don't tip into recession. However, we remain inclined to maintain hedges where we sense any market complacency, or where implementing such hedges looks relatively cheap.

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