



## Economic fears ease, as political worries bubble to the surface

**Will it be a calm end to an interesting year?**

### Key points:

- US yields moved higher over the past several days, in the wake of solid economic data, while European yields traded sideways on the lack of new impetus.
- An extended US government shutdown may have minor economic downside risks but likely won't affect the macro outlook.
- The UK faces a £30 billion fiscal gap, possibly leading to a raft of small tax hikes, based on recent reports.
- In Japan the LDP leadership election is imminent. Based on polls, we think Koizumi is well placed to win, and we look for the yen and JGBs to rally on a platform of policy orthodoxy.
- Credit markets have continued to be well supported by ongoing demand, with government supply over-abundant. In-line US CPI figures this week solidified expectations of a 25bps Fed rate cut in September, with more cuts likely to follow.

**London, 26 Sept 2025:** US yields moved higher over the past several days, in the wake of solid economic data. Q2 GDP was revised up to 3.8% on robust consumption, though it is worth recalling that Q1 GDP was very soft at -0.6%, and therefore growth in the first half of the year remained somewhat below trend. Meanwhile, a dip in initial jobless claims has helped assuage concerns that the labour market is continuing to slip, whilst durable goods orders demonstrate a robust pace of investment spending.

That said, we think that next week's US labour market reports will be more relevant in determining the trajectory of monetary policy. Confirmation of consensus estimates for a payrolls print around 50k additional jobs may keep markets guessing as to whether Powell will announce one or two 25bps rate cuts by the end of the year.

Meanwhile, a material surprise in either direction would tip the balance of probabilities. However, should there be an absolute contraction in the monthly jobless total, this could renew labour market concerns and prompt calls for a 50bps easing. Meanwhile, the next CPI report will also be closely watched and will be an important factor in policy considerations.

In our own assessment, we are not currently too concerned with respect to a deeper downturn in the labour market. Lower immigration has slowed the growth in the US labour force, meaning that job totals around 70k will keep the unemployment rate broadly stable.

We also think that the US economy is likely to improve in 2026 versus 2025, on the back of rate cuts, tax cuts, and deregulation. That said, we are already witnessing how AI is replacing some workers in tech, with Mag7 employment down in the past 12 months, notwithstanding spectacular growth in profits.

This could be an emerging trend to watch. From this standpoint, the move by the US on skilled worker visa fees, which have widely been used to bring in tech workers from overseas, has the dual benefit of helping prospects for domestic tech jobs, as well as poking the Indian administration in the eye, noting that the country has seen a dominant supply of such workers.

It also seems quite possible that there will be a US government shutdown next week, with Senate Democrats thus far unwilling to support a Budget extension until 21st November, which was agreed in the House.

The White House is threatening to implement a widespread reduction-in-force of Federal workers whom the administration considers unimportant in delivering its policy agenda, should a shutdown occur. As Democrats may feel they could be blamed should this occur, then this may suggest scope for an 11th hour compromise.

However, for now, Senate minority leader, Chuck Schumer, has been pretty robust, taking the view that Trump is looking to cut workers in these areas regardless, and reflecting that he considers the President to be lawless in his actions. An extended shutdown could have some modest economic downside risks, but we think it is unlikely to materially impact the macro outlook. From this point of view, the main area of concern for investors may be if there are widespread delays in economic data releases.

Elsewhere in the US, it was interesting to note Stephen Miran's articulation of his thinking behind placing his Fed dot, which was well below that of other FOMC participants. In many respects, such transparency is to be welcomed. Some may question his implied assumptions with respect to inflation, which supports an assumption of very low neutral interest rates.

That said, any assessment of neutral policy is always open to conjecture. Perhaps what is more relevant is that Miran's insights offer a clear view into the economic thinking from within the White House. These are views that Trump endorses, and one can only assume that the upcoming pick for Fed Chair will be an individual happy to get on board and embrace these ideas.

In terms of the identity of Trump's pick, we are still left guessing. That said, with Christopher Waller failing to call for a 25bps cut in September, in line with Powell, this may limit his chances of securing this role, and one may wonder if Miran's appeal to Trump has been reinforced by his own willingness to break from the crowd.

Ultimately, we think we will see a candidate chosen who may take the Fed in a more dovish direction. This seems likely to steepen the US yield curve and weaken the dollar somewhat, though neither outcome needs to be unduly problematic for the US economy.

Indeed, lower cash rates could start to help a stagnant housing market, should new mortgage borrowers become attracted towards floating rate (ARM) mortgages. A steeper curve could also tempt cash out of money market funds into the Treasury market at a time when overseas demand shows signs of waning. Meanwhile a softer dollar should help close current account imbalances, which have been a policy objective within the Trump administration.

European yields have also traded sideways recently, on the lack of new impetus. French OATs continue to hover around 80bps as Lecornu struggles to make headway with respect to Budget compromises. Meanwhile, the prospect of the Italian deficit moving below 3% this year continues to underline a backdrop of two sovereigns heading in different directions.

Elsewhere, there has been increased focus on Russian malfeasance with recent incidents relating to drones and military aircraft incursions in European airspace. With Trump stating that NATO should down Russian jets should these events be repeated, there is a clear risk of a geopolitical flashpoint. Moreover, all of this will continue to reinforce the need for the EU to redouble its own efforts with respect to its defence spending.

Fiscal expansion should help Eurozone growth in the months ahead, though for now activity remains pretty muted around 1-1.5%. We are also inclined to see EU inflation risks more to the downside based on Chinese imports deflating goods prices. This could mean scope for the ECB to ease again next year, but for now, we think that Lagarde will maintain policy on hold through the end of this year.

In the UK, adjustments to OBR assumptions appear likely to result in a GBP30 billion black hole in government finances to be covered by a raft of small tax increases, based on latest reports. In many ways it seems crazy to think that current year fiscal policy is being influenced so much by the long-term assessments of a few statisticians, and it is worth reflecting that this was surely never the intention when the OBR was established.

In fact, one increasingly wonders whether the OBR has outlived any usefulness it has. After all, long-dated gilt yields, swap spread and CDS markets already offer plenty enough information relating to debt sustainability. That said, we would note that the UK government is something of a hostage to moves in global yields at the moment. Should these decline, this will take pressure off Starmer and Reeves. Conversely, should long-dated yields elsewhere move higher, the UK's problems will continue to be magnified.

Meanwhile, were Starmer ousted and Labour to move to the left, matters could be even worse. A case in point is the front-runner to replace Starmer, former MP Andy Burnham, who provided a clearer picture of his policy agenda in an interview with the UK media this week, in which the current mayor of Manchester lambasted bond markets and called for £40 billion of additional borrowing to aid social housing.

In Japan we await the LDP leadership election next weekend. Based on polls, we think that Koizumi is well placed to become Japan's next Prime Minister, and we look for the yen and JGBs to rally on his platform of policy orthodoxy, which we see leading to the BoJ hiking cash rates to 0.75% at the end of October.

With inflation still running well above 2% and a tight labour market keeping wages elevated, we wouldn't be surprised if the BoJ also provides more clarity on where it views the nominal neutral policy rate. However, should Sanae Takaichi prevail, this could benefit equities, but it is likely to harm prospects for the bond market and yen, given her desire to implement tax cuts.

In FX, stronger data benefitted the dollar this week. On a trade weighted basis, it had appeared that the greenback was breaking out of a trading range, which has lasted since the beginning of the summer on the weaker side in the middle of September.

However, dollar crosses are now back in the middle of this range, and this could infer further sideways price action in the short term. However, should next week's jobs report disappoint, then this could give a renewed impetus towards a weaker dollar, in line with our medium-term view. Elsewhere the yen and sterling both came under pressure due to domestic political concerns described above.

We think that it may be attractive to add to a yen long position, but only after the LDP Leadership contest is behind us. In the UK, we have been short in the pound, and this is a position we have been adding to as our concerns with respect to the Labour government continue to grow.

Credit market have continued to be well supported by ongoing credit demand. Although spreads are historically tight, it is worth contemplating whether it has become understood more widely that investors tend to be overcompensated for the risk of defaults in a diversified portfolio and that theoretical spreads should reach tighter levels. This could be compounded at a time when government supply is over-abundant.

In conjunction with rising concerns with respect to government creditworthiness, this has seen swap rates trade well below many government bond curves. From this perspective, corporate bonds may appear rich relative to government bonds, yet are much more reasonably priced relative to the true risk free rate.

From a trading perspective, we have added exposure in Norwegian rates relative to Sweden on a relative value basis. We think the Norwegian central bank will lower rates, yet we are still hopeful that the krone can continue to perform from depressed levels.

## **Looking ahead**

We expect a preliminary finding of the Supreme Court to deny Trump's attempts to remove Lisa Cook, in the coming days. Meanwhile we may witness a shutdown blame game, an announcement on the next Fed Chair, and a host of international political and geopolitical issues impacting markets in the period just ahead of us.

The past week started as a quiet one. It was even striking how quiet the UN chamber was when Trump gave his address this week, in stark contrast to the mocking and laughter six years ago. With the final quarter of a tumultuous year about to be upon us, we doubt that the quiet will last too long. But for now, it is a good moment to pause (unlike the UN escalator) and reassess what lies ahead.

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