



Market Commentary

Travelling at the speed of light

AI boom...or bust?!

Key points:

- The Fed delivered a 0.25% rate cut this week, but with US growth remaining strong and inflation expected to rise, additional monetary easing in 2026 seems unlikely.
- European yields tracked US yields this week, with little new information coming from the ECB meeting. Although French GDP surprised to the upside, investors are waiting for evidence of German-led fiscal expansion to show up in broader economic data.
- Negative sentiment continues in the UK, with an anticipated downgrade of productivity estimates by the OBR and potential tax hikes on the horizon.
- Javier Milei's decisive victory in Argentina's midterm elections has sparked a rally in Argentine assets. Latin America's elections and a potential new political direction for the region will be watched closely in 2026.
- Overall, the macro backdrop is supportive of credit, with robust US growth and ongoing tech investment. However, stretched valuations and rising default rates warrant caution, and careful issuer selection is key.

31 October 2025 (London) – US yields rose in the wake of this week's FOMC rate cut, with Chair Powell seeking to downplay chances of a December easing. With growth remaining robust and inflation expected to move higher in the coming months, we have thought that the case for additional monetary easing in 2026 looks questionable.

However, we still think we will see one further easing at the end of the year, before the Fed moves back onto hold. Labour market concerns have been the principal justification for those calling for more aggressive Fed easing. In this light, Amazon's announcement this week that AI would lead to the company shedding 14,000 jobs added to those voices claiming that we could be on the cusp of a more seismic shift in the labour market as a whole.

However, we think an AI revolution in the economy at large will play out over a much more elongated time period. In the short term, lower jobs numbers are more a function of a sudden stop in population growth, as immigration flows reverse. Consequently, we think that the unemployment rate is likely to remain pretty stable, even with a subdued number of job adds.

Ongoing tech investment looks set to continue to keep driving GDP ahead into 2026, as companies race to build a lead in AI. The narrative that there will ultimately be a smaller handful of winners means that there is a strong desire not to be left behind and the rush to deploy cash represents a strong macro tailwind for the US economy as a whole. With benefits from lower rates, lower taxes and deregulation all ahead of us, so it seems that the macro narrative can help to sustain a bull market mindset, at least for the time being.

Yet valuations are stretched, and in credit it is hard to be too optimistic, not least with default rates trending higher across the market as a whole. Unlike equities, credit investors need to focus on left-tailed risks, rather than the right tail of the potential return distribution. In this context, it has also been notable how credit stories, which have flagged concerns, have recently been witnessing sharp falls in bond prices, with investors often happy to sell first and ask questions later.

From this standpoint, although the macro backdrop remains credit supportive, only a modest long beta position is justified. Meanwhile, issuer selection is becoming increasingly important. This is something of a global theme and, in this light, our analysts are expecting a doubling of default rates in EM corporates to

around 5% in 2026. This serves as a reminder that we need to be careful in selecting what we own. Data shows that in credit, you typically need to own around 15 good stories to compensate for losses from any one bad story in your portfolio.

Returning to the US, the government shutdown has continued to starve markets of economic data. However, a new weekly jobs number from ADP starting this week showed that private sector jobs added on average around 56,000 in the past month, which is perhaps a bit stronger than many had been looking for.

As for the shutdown itself, it may appear that the Democrats are closer to giving up the fight, as consensus in their ranks appears to fray. At the end of the month, payments under the Supplemental Nutrition Assistance Program (SNAP) will cease, unless there is a vote to protect these payments, and insurance premiums for the disadvantaged will see premiums jump, as subsidies disappear. In this case, the Democrats won't want to take the blame attached to this and may cite this as an excuse to agree a continuing resolution.

Looking at Treasuries, the rise in yields in the past week places them more in the middle of where we see the fair trading range. We had previously hoped that a continuation of the recent rally would give us the opportunity to add a short trade, but we failed to reach the levels where we had hoped to pull the trigger on this. Now with yields correcting higher, we would note that 3.75% on 2s and 4.80% on the long end could be levels where we may be tempted towards moving to a long duration stance.

European yields have tended to track the US over the past week, with little new information coming from Lagarde at this week's ECB meeting. European growth remains subdued, though French GDP surprised to the upside. However, it feels that in many respects we are continuing to wait for evidence of German-led fiscal expansion showing up in broader economic data and, in this respect, we are more hopeful for the second half of 2026 than H1.

Meanwhile in the UK, the market awaits the upcoming government Budget. An anticipated downgrade of productivity estimates by the OBR has seen Labour pushing stories of ever-large tax rises. Inasmuch as this hurts growth, it could open the door for lower rates. Also helping, this week's shop inflation numbers surprised to the low side as well.

From this point of view, painful tax rises may well be sold with the carrot of lower mortgage rates in return. However, the outlook for the UK economy appears depressed and we continue to think that the government is making the wrong policy choices. Indeed, there is a real risk that higher taxes won't deliver the desired revenues in return if growth goes into reverse. In this respect, political prospects for Labour and Starmer grow evermore grim.

At the same time, a deteriorating UK growth dynamic and prospects for further BoE rate cuts have been weighing on the pound over the past week in FX markets. Elsewhere in FX, the yen has also been under pressure, in the wake of the BoJ holding interest rates at 0.5% at its monetary policy meeting this week. This has seen the yen trade to a new lifetime low relative to the euro.

Meanwhile, renewed enthusiasm to use the yen as a funding currency continues to drive the dollar higher versus the Japanese currency. We remain some distance from levels above \$/¥160, where the MoF may seek to intervene.

Moreover, if policymakers in Japan wanted to avert yen weakness, then it is clear that what is needed is a return to monetary policy normalisation. In this respect, we may continue to hope that there will be such an adjustment in December or January. Otherwise, renewed weakening in the Japanese currency risks driving renewed inflation, at a time when Sanae Takaichi has vowed to bring this lower and end the squeeze on real incomes.

Elsewhere, last weekend saw a decisive victory for Javier Milei in the Argentine midterm elections. On the back of US support, maybe there is an argument that the country is 'too MAGA to fail' and certainly we have witnessed a strong rally in the price of Argentine assets over recent days. It will be interesting to observe whether we witness a shift towards the right from more left-leaning politics in upcoming elections across the continent of South America in the months ahead, mirroring the broader global trend in recent times.

Looking ahead

There continues to be plenty of chatter with respect to the identity of the next Fed Chair. This week saw the field notionally cut to five candidates, of whom the three frontrunners remain: Kevin Warsh, Keven Hassett and Chris Waller.

However, we continue to think there is a strong chance that Bessent will ultimately take the job for himself, with much of his work at Treasury already done by the time that the current administration moves towards a lame duck period later next year. Either way, we see a continuation of Fed orthodoxy as a reason to push back on projections that a new Chair will blindly do Trump's bidding. Although Trump wants lower interest rates, he absolutely must not allow inflation to push too much higher.

As for financial markets, the increasing skewness of the US equity market continues to lead to much head scratching from traditional fundamental equity investors. The valuation of Nvidia alone now comfortably exceeds Japan's GDP and accounts for 13% of the Nasdaq composite. At 60x earnings, a market cap of USD5 trillion is a very big number indeed!

In fact, 5 trillion is a number so large that it nearly represents the number of miles travelled in the space of one light year. Certainly, the ongoing rise of the company is truly out of this world. However, when you are travelling at the speed of light, physics will tell you it isn't possible to go any faster and, at some point, there could be plenty to fear if and when the AI boom does unravel. Yet that still doesn't seem on the cards just yet for the time being...or so the bulls will hope.

Notes to Editors

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