



Making all of her own problems

There's trouble in Japan and trouble in the UK!

Key points:

- FOMC minutes and an inconclusive September jobs report suggest a December rate cut is less likely, though one more cut is expected before policy holds. We do not anticipate further cuts in 2026 due to a positive economic outlook.
- Strong GDP growth, rate cuts, tax cuts, and deregulation point to accelerated economic activity in the U.S. AI investments of USD300 billion could boost real GDP to 3.5% in 2026, with CPI potentially reaching 3.5%.
- Prime Minister Takaichi's reflationary policies are unsettling markets. Unlike during Abenomics, Japan's current issue is high inflation, not low. This has led to concerns about sovereign debt sustainability and bond market volatility.
- Chancellor Rachel Reeves' credibility is damaged by policy flip-flops, leading to rising gilt yields and fears of political instability. A short stance in the pound is maintained due to limited scenarios for sterling's rally.
- The EU remains stable but faces long-term malaise, with elevated energy costs and declining competitiveness. Fiscal stimulus is expected to lift GDP in 2026, but consumer and business confidence remain low.
- Policy-induced volatility continues to shape markets, especially with high government debt levels and voter discontent. The potential bursting of an AI bubble remains an investor concern, but Nvidia's strong earnings results helped ease bearish sentiment.

London, 21 Nov 2025: Ongoing volatility in tech stocks was the dominant narrative for global markets over the past week. Despite a strong set of earnings results from Nvidia, bearish sentiment prevailed threatening to gain a head of steam. In US fixed income, minutes from the last FOMC meeting appeared to downplay prospects for a December rate cut from the Fed, and this was backed by an inconclusive September jobs report.

However, we have thought that one further rate cut may be delivered, before policy goes on hold. At this stage we are not anticipating further rate cuts in 2026, on the presumption of a relatively upbeat economic outlook.

Weekly jobless claims data this week helped to downplay fears related to weakness in the US labour market, and although we anticipate softness in payroll growth over the coming months, a contraction in foreign born individuals residing in the US, means that we think that this weakness is unlikely to bring about a material increase in the rate of unemployment.

With US GDP growth already solid, the additional tailwinds from rate cuts, tax cuts and deregulation all point to an acceleration in economic activity ahead. Meanwhile, with companies announcing plans to invest USD300 billion in AI-related projects in the US in the course of the year ahead, we would not be surprised to

see an expansion in real GDP of 3.5% in 2026. With price risks also on the upside, we think that CPI can also accelerate to 3.5%, inferring a 7% growth rate in nominal GDP.

This is a constructive backdrop for corporate earnings, even if it masks a 'K'-shaped economic trajectory. Consequently, lower rates don't appear to be warranted and in the White House, there appears growing appreciation that inflation represents one of the biggest challenges for the Republican Party at next year's mid-term election.

Away from the US, Japanese assets came under increasing pressure over the past week, as Prime Minister Sanae Takaichi continues to unsettle markets. In seeking to embrace the mantra of Abenomics, Takaichi has been pushing for easier monetary and fiscal policy in Japan in an effort to boost nominal GDP growth.

However, the problem with this reflationary stance is that, unlike during the tenure of former Prime Minister Abe, the main economic issue today is not that Japanese inflation is too weak but too strong. Consequently, a policy stance that seeks to push inflation higher when CPI has been above target at 3% for the past three years, appears badly misguided.

Moreover, in linking a desire for nominal growth to outpace bond yields, in order to lower the debt-to-GDP ratio, so there is a sense that Takaichi may effectively be signaling a desire to inflate away Japan's sovereign debt. Unsurprisingly, this is not going down well in the bond market, which is undergoing renewed bear steepening and pushing long-dated yields to new highs.

Meeting with a large number of Japan's largest investors during the past week, there is widespread concern at the Takaichi agenda and a concern that a sell Japan trade could build in the days and weeks ahead, if there is no course correction.

At the BoJ, it could appear that Ueda has been placed in a subservient position, with his political master now calling the shots. There is a sense that many within the BoJ would like to see rates hiked in December, but unless markets force the issue, even a January hike now appears to be in doubt.

Meanwhile, some have suggested that Takaichi could direct the BoJ to resume Yield Curve Control, using QE to stabilise the bond market if yields continue to sell-off. However, easing monetary policy further when a tightening is what is really required, only risks exacerbating an inflationary overshoot.

Similarly, Takaichi's talk of using fiscal easing to offset inflation pain has distinct echoes of the policy failures witnessed in a number of developed economies during the 1970s.

In response to these developments, we have increased a short duration stance in JGBs and added short yen FX exposure. We continue to maintain a curve flattening position on the 10/30 curve, which has been challenged against a backdrop of a bear steepening of the curve. However, we stand by the notion that valuations in this space remain compelling and will normalise as soon as the MoF can address an imbalance between bond supply and demand.

This extreme valuation is best demonstrated in forward yield curves, where long-dated yen forwards now exceed 5% and at some points exceed the equivalent forward rate in US Treasuries, notwithstanding a gap of 240bps between current respective 10-year yields.

At this point we don't think Japan should issue any long-dated bonds until spreads normalise and it strikes us as misguided that policymakers should allow pressure at the long end of the curve to be a driving force with respect to concerns relating to Japan's sovereign debt sustainability.

Elsewhere, if Sanae Takaichi seems to be making her own problems, the same would also appear to be true of Rachel Reeves in the UK. Last weekend's leaks that income tax hikes would be excluded from next week's Budget were greeted with cynicism in financial markets in the wake of the constant flip-flopping by the UK Chancellor, which has served to badly damage her (remaining) credibility.

Gilt yields rose sharply at the start of the week, with markets also growing nervous that political failure could see the Labour party move to replace Reeves, and quite possibly Starmer alongside her, in the weeks ahead. Fears that Labour would lean left is a live concern in such a scenario and could be the catalyst for more dramatic weakness in UK financial assets.

Short-dated gilt yields may be supported by stalling UK growth, which may help serve to lower inflation and wages, allowing the BoE to lower rates further. However, it is not at all clear that this will benefit longer maturities if the fiscal position fails to improve and fears with respect to policy credibility or political stability come to the fore.

We don't see a clear risk-reward for an active position in gilts at the current time and risks to yields may be two-way in nature. However, we remain convicted in running a short stance in the pound. At this juncture, it feels hard to see many scenarios which seem likely to bring about a rally in sterling, with risks seemingly skewed very much in a weaker direction.

In the EU, markets remain more stable for the time being. However, recent meetings with policymakers give a relatively downbeat assessment of prospects across the continent. Although fiscal stimulus is set to lift GDP in 2026, the EU is mired by elevated energy costs making industry uncompetitive.

The German auto industry is suffering loss in market share. Meanwhile there is a sense of long-term malaise and against this backdrop, consumers are reluctant to spend, and businesses disinclined to invest. In that sense there is worrying talk of Europe turning itself into a museum; a place that is nice to visit and pleasant to look at, but a place where very little actually happens.

Against this backdrop we continue to see Eurozone yields trading in a range but we continue to lean towards favouring the US\$ in FX, noting that US growth exceptionalism appears very much live and well.

Looking ahead

We should soon start to see more economic data shaping thoughts around the evolving US economic outlook. However, the last week has been another reminder of how changes in policy and politics can move markets.

At a time when government debt levels are elevated globally and when voter discontent with established political parties has been rising around the world, so we are reminded that political and policy-induced volatility is set to continue to shape the global landscape.

A bursting of an AI bubble in the year ahead will likely remain a key investor concern, yet timing a call on this will be very challenging. In bubble markets, it can be as risky to be short as it is long as the doubling of the Nasdaq index at the end of the dot-com boom in 1999 reminds us.

From this standpoint we are not in an environment where there are too many rewards for taking too much risk. However, on a macro basis, idiosyncratic stories at a country level may provide significant opportunities, which can be pronounced, should policy errors occur.

In this respect, we would reflect that the Japanese economy has been performing relatively well in the past few years. Growth has been positive and has been supported by rising productivity as the supply of labour contract. The country has left a period of deflation and stagnation behind and even debt-to-GDP is on a declining trajectory.

This being the case we certainly hope that Takaichi doesn't enact policies which manage to steal defeat from the jaws of victory, having failed to fully grasp some of the potential consequences of her actions. Time will tell if this lady is for turning. However, thus far she may seem pretty immune to any criticism.

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