Marketing communication

RBC BlueBay Asset Management

Christmas cheer on the way??

Markets are looking for an early Fed rate cut present under the Christmas tree!

Key points:

- A US Fed rate cut in view, but thereafter, increased speculation that Hassett could be the next Fed Chair, has seen inflationary risk concerns persist.
- UK fixed income sentiment is improving as risks of weaker growth suggests more interest rate cuts than currently anticipated by markets.
- A notably hawkish speech by BoJ Governor Ueda is buoying market expectations of a rate hike, allaying market worries around the inflation path ahead.
- European yield curves steepen on the back of improving PMI data, but divergences are seen in growth between Southern and Northern Europe, as German industry continues to struggle.
- In FX markets, a continuation of US growth exceptionalism leaves us sceptical that the dollar will extend its recent losing run.

London, 5 Dec 2025: Long-dated US yields moved higher during the past week, with the Treasury curve steepening, on increased speculation that Kevin Hassett will shortly be announced as the next Fed Chair. Market participants have viewed Hassett as potentially more dovish with respect to interest rate policy than the other contenders under consideration.

Although this narrative has anchored short-dated rate expectations, there has been some nervousness that Hassett's desire to please Trump could add to inflation risks, as we move through 2026. This has weighed on longer-dated government bonds.

Yet, in this respect, it is ironic to reflect that one of the key reasons that Trump has been calling for lower Fed rates is that he wants mortgage rates to decline. In this respect, he is eager that mortgage affordability improves and that this lifts activity in the property market.

However, there is the risk that Presidential interference actually pushes mortgage rates in the opposite direction, should fears for Fed independence build, or the Fed's commitment to deliver on its objective of price stability be called into question.

From this standpoint, we continue to believe that whoever is nominated as Fed Chair, will continue to preside over a more orthodox approach to Fed policy and will remain resistant to any pressure emanating from the White House.

On this basis, we are inclined to believe that on the back of a strong US economy, that the Fed will deliver fewer rate cuts than are currently discounted in markets in 2026. But we don't think that this is yet the time to move short duration, on the basis that the Fed is expected to cut at the December FOMC next week and given that November's economic data could contain downside surprises, linked to the recent US government shutdown.

However, moving short in US rates seems a favoured position heading into 2026. We also think that the US yield curve is unlikely to steepen too much further in the absence of deeper rate cuts and so have used the recent move in the US curve to close out existing curve steepening positions.

On the US economy, we continue to think that previously announced rate cuts, tax cuts and deregulation, all provide strong tailwinds for economic growth going into 2026. Furthermore, the ongoing acceleration of AI-related capital spending is also set to continue to boost economic activity in the first half of the year ahead.

Employment growth is set to remain subdued, but this reflects a contraction in labour supply given the turn in net US migration. Consequently, we don't see a material increase in the unemployment rate in the coming months and we continue to highlight keeping a close watch on US weekly jobless claims, on the basis that if there was a more concerning dynamic with respect to layoffs, then this total would accelerate above 300,000 per week. By contrast, the weekly claims series has continued to be very subdued in a stable range below 220,000, consistent with relatively healthy labour market conditions.

European yield curves have also steepened over the past week, mirroring moves across the Atlantic. PMI data were somewhat better than expected, with the regional composite figure rising to a 2-year high. However, underlying national data continues to highlight the divergence between relatively robust growth in Southern Europe, compared to weaker conditions in the North.

In Germany, pressure on Chancellor Merz has been building, with the German economy and German industry continuing to struggle. There is a risk of a collapse of the ruling coalition in the Bundestag, though there will be no appetite for new elections, which would only seem set to favour the right-wing AFD, versus other parties.

Meanwhile, moves to overrule Belgian objections to using frozen Russian assets to help Ukraine create some risk with respect to international precedent. Yet, if ratified, this may help mitigate a portion of the expected European costs with respect to supporting Ukraine at a time when further funding coming from the US is increasingly unlikely.

Within the Eurozone, sovereign spreads have continued to narrow with respect to German bunds and in the past week, 10-year Italian BTP spreads have dropped below 70bps for the first time since 2009.

We have continued to maintain an overweight stance on Italy and Euro sovereign spreads in general, on the view that there is scope for some further convergence, at a time when German bund supply is rising sharply, in response to a more expansive fiscal trajectory.

Our favoured European sovereign in 2025 has been Romania, which continues to trade well. Romania remains cheap in our eyes, with long-dated spreads still above 300bp over Germany, which appears too generous for an investment grade rated EU sovereign credit.

In the UK, fixed income market sentiment has managed to improve somewhat since last week's Budget. Prospects for weaker UK growth suggest scope for the Bank of England to surprise with more interest rate cuts than markets currently discount, which stands in contrast to how we view the outlook for the Fed in the US.

In addition, a reduction in long-dated gilt supply and a wind-down of long-dated gilt QT sales also suggests a somewhat better technical backdrop for gilts in 2026, than has been the case for much of 2025. Meanwhile, there is a sense that although a UK risk premium will continue to persist, as markets question the credibility of a policy mix which prioritises welfare spending through ever higher taxation, the element of the UK risk premium relating to political risk, could be a little lower in the near term.

Over the past several months, there had been a concern that Reeves and Starmer were isolated within their own Party and that their positions were increasingly vulnerable. A school of thought had consequently concluded that Starmer would jettison his beleaguered Chancellor soon after the Budget, in order to buy himself more time.

Yet over the past few days, this may be becoming a less likely outcome, with Reeves seeming to have weathered the worst of the storm. Any political change in the UK is likely to be taken negatively by financial markets on the assumption that this will see Labour pivot in a more left-leaning direction.

Consequently, as unpopular as she may be, Reeves's survival for the time being is largely seen as a good thing by the gilt market. Reflecting on these developments, we have moved to a modest overweight position in gilts, though we continue to remain positioned short in the pound, based on the view that the UK's growth prospects will continue to be depressed, and this should lead to monetary easing as an offset.

In Japan, a notably hawkish speech by BOJ Governor Ueda has seen markets attach a 90% probability of a hike from the BOJ at its meeting this month. The understanding is that Prime Minister Takaichi will have seen and agreed the content of this speech prior to Ueda's delivery.

Consequently, this has helped to allay building fears that the LDP leader would cause the BOJ to fall further behind the curve with respect to normalising its policy rate. This move has helped to stabilise the yen and also benefitted longer-dated bonds on a relative basis on the yield curve, as this suggests a more responsible attitude in ensuring that inflation is not allowed to run away to the upside.

Meanwhile, 10-year JGB yields have continued to climb towards 2% on an outright basis. There is a sense from Japanese domestic investors, that 10-year yields in a 2-2.25% range are more a reflection of fair value, on the notion that BOJ policy can reach the bottom end of its neutral rate band at 1.5%, by the start to the fiscal year in April 2027.

In FX markets, the dollar has traded softer over the past week, influenced by thinking in respect to a more dovish policy under a possible Hassett Chair. However, we continue to see a continuation of US growth exceptionalism for the foreseeable future and from this point of view, we are sceptical that the dollar is set to extend its recent losing run.

Looking ahead

The FOMC meeting decision next Wednesday is set to be the dominant event. It seems likely to us that a formal announcement on the next Fed Chair will wait until after this time and once the Fed blackout period around the FOMC is completed.

Thereafter, important BOE and BOJ meetings will also be a focus before the wind-down to Christmas can properly get underway. This year end there is also uncertainty around Dutch pension fund flow, with changes to portfolio hedging effective at the start of 2026. This could keep euro rates markets a bit busier than is usual at this point on the calendar. However, liquidity will start to tail off progressively after the end of next week, and this hopefully points to a quiet end of the year.

Against this backdrop, carry may be an important theme to position for, as we move into quieter Christmas markets. Seasonally speaking, markets tend to trade with a degree of Christmas cheer around this time of the year, and with a sense of hope and optimism at the start of January.

Inevitably, some of the January optimism can begin to fade as the month progresses. On the whole, we are inclined to think that this is a favourable time to be adding risk now, with a view to be taking risk off in the New Year, in anticipation of these trends. We still inhabit a world where human decisions drive markets more than machines. In this case, for the next few weeks at least, nobody wants to be seen as too much of a grinch….do they?

Contact:
Lydia Cambata
lcambata@bluebay.com

About RBC BlueBay Asset Management
RBC BlueBay Asset Management ("RBC BlueBay") represents RBC Global Asset Management outside of North America and is an active asset manager with expertise across fixed income, equities and alternatives.

RBC BlueBay's solutions-driven approach means it endeavours to empower clients with the knowledge they need to help shape their investment decisions. It works and evolves with clients, creating and customising investment products that meet their needs.

Responsible investment is embedded across RBC BlueBay's business. This means it is not just an investment focus but is also ingrained in its client service experience and work to deliver solutions that support real-world impact.