RBC BlueBay Asset Management

Marketing communication

# Santa's little helper

**Markets are enjoying festive cheer as we head into year-end!**

**Key points:**

- A Fed cut as expected, but from here we see no real basis for additional rate cuts, unless data surprises, given upside risks to both US economic growth and inflation.
- 2025 has unfinished business, with UK and Japan central bank meetings still to come, with a rate cut and a rate hike, respectively, on the cards.
- European yields remained under upward pressure this week, but that may present a selective buying opportunity to add duration.
- We grow more constructive on the outlook for gilts, with increasing anecdotal evidence of weakness in UK spending and business sentiment.
- A look ahead to 2026, we see AI now probably the biggest concern preoccupying investors rather than the trajectory of policy coming from Washington DC.

**London, 12 Dec 2025:** US yields remained within their recent trading range in the wake of this week's rate cut by the Fed. Powell had been universally expected to lower the mid-point of the Fed Funds range to 3.625% and there were few surprises contained within the FOMC forecasts and the Fed Chair's subsequent comments.

Looking ahead, the path of monetary policy will be very much data dependent, with the Funds rate now not far from a neutral stance. In this context, doves cite growing downside risks to the labour markets in the year ahead. Meanwhile, hawks are much more focussed on the inflation trajectory, with the Fed now having missed this to the upside for the past five years.

From our point of view, we remain inclined to think that both economic growth and inflation will come in materially above current Fed forecasts, especially over the first half of 2026. Although growth data in the current quarter will be negatively skewed due to the government shutdown, we still see robust underlying momentum in demand.

This week's data highlighting firm job openings and an upturn in small business sentiment appear to support this thesis. Meanwhile, with the benefit of tax cut rebates soon to land, deregulation policies kicking in, and the lagged effect of past rate cuts also boosting economic activity, we see a number of tailwinds that should be beneficial at the start of the year, even without singling out the ongoing acceleration in AI-related business investment spending.

On this basis we look for US GDP to average 3.5% growth in the first half of the year ahead, which is more than 1% higher than current Fed projections for the year as a whole. Similarly, we see inflation lifting to 3.5% on CPI and lifting the core PCE measure, which the FOMC favours, to roughly 0.5% above the Committee's latest forecast. Consequently, we see no real basis for additional rate cuts in the US unless data surprises us to the downside in the course of the months ahead.

Yet, we doubt that perceptions that an incoming Fed Chair will take office with a clear bias to ease, if at all possible, are unlikely to shift on the back of Trump rhetoric. Therefore, with markets pricing one cut in US rates in the next six months and one further easing in the second half of the year, it is hard to disagree too much with what is discounted in yields.

As a result, we continue to look for US Treasuries to trade in a range, absent a more material data surprise, which may bring about a revision in thinking. We continue to maintain no active US rates position for now, though we are looking at inflation breakevens, which seem to embed more complacency with respect to inflation returning to its 2% target than we think is warranted.

Across the Atlantic, European yields have remained under some upward pressure. The upcoming shifts in Dutch pension regulation have led investors to be very wary with respect to owning long-dated duration and with heavy seasonal supply in January in European government bond markets, an absence of buyers has pushed up yields.

Relatively hawkish comments from ECB's Schnabel also contributed to bearish sentiment in euro fixed income over the past week. However, with European gas prices declining, we are more inclined to see Eurozone inflation decline below target rather than rise above it, over the course of the next several months.

From this point of view, we are now more inclined to think that the current rise in yields starts to present a buying opportunity to add duration in the parts of the market we favour the most. Here we would draw attention to Norwegian yields, where Norges Bank maintains cash rates at 4%, but rate cuts are expected as inflation across Scandinavian economies drops in the months ahead.

We also favour the short end of the Czech bond market. Currently the CNB is projected to raise interest rates by 75bps over the months ahead, but we think that these hikes are very unlikely to be delivered.

We have also been growing more constructive on the outlook for gilts. We think that Starmer and Reeves will remain in their jobs until May next year at the earliest, as it won't suit anyone to challenge as a successor now, knowing that the May local elections are likely to be pretty disastrous, whatever comes to pass between now and then.

Meanwhile, we pick up increasing anecdotal evidence of weakness in UK spending and business sentiment, which may see a more rapid slowing in inflation and more rate cuts from the Bank of England, than we had previously expected.

On a cross-market basis, it is also interesting to reflect that in 2025, 10-year US Treasury yields have declined by 45bps, notwithstanding a relative strong US economy. UK 10-year yields are unchanged over the period, despite a much weaker economic performance, and so there could be scope for this relative performance to reverse in the year ahead, if only fears with respect to UK policy credibility can moderate.

Since lower inflation and lower yields can help the underlying UK fiscal position, it should also be noted that the negative feedback loop of higher yields making the deficit worse over the past couple of years could actually turn more towards a virtuous cycle of lower yields and deficit improvements, if such a trajectory can be established.

In this context, we have been adding duration across the curve in gilts over the past week. Meanwhile we have also seen value in long-dated yields in Australia after a recent sell-off pushed rates higher. Similar to the UK, the Australian curve is very steep and 30-year yields above 5.2% look appealing to us on a relative basis compared to US fixed income.

Further afield, we also see value in select emerging markets such as Colombia and Brazil, where rates are at more elevated extremes, and we think that subdued inflation should enable responsible central banks to ease policy in the months ahead.

In both countries, we are also hopeful that politics are moving towards candidates and policies that are more Trump-leaning. This is significant, inasmuch as we see the US administration seeking to put its firm imprint over all the countries sitting in the Western hemisphere, which Trump regards as the US' backyard.

This narrative was seen in the administration's extravagant support of the Milei government in Argentina a couple of months ago, and more recently in terms of some of the gunboat diplomacy occurring in Venezuela. In this regard, this is very much a live theme which can impact emerging markets in Latin America in the quarters ahead.

With the Fed FOMC meeting now behind us, attention will turn towards central bank meetings in the UK and Japan in the week ahead. It is very likely that we will see a 25bps rate cut and a 25bps rate hike respectively.

In Japan, it is clear that Takaichi is committed to reflection and growth maximisation and following meetings with her advisors in the past week, we also believe that she will seek to secure a stronger mandate in the Diet by calling elections relatively early in the new year. Takaichi remains popular with the electorate, and she wants to capitalise on this support before it possibly starts to fade.

Meanwhile, it seems clear that she is sensitive to yen weakness, knowing that a renewed slide in the value of the Japanese currency could risk her popular appeal. From this standpoint, it is understandable how she seems to have given the BoJ a green light on a December hike and we think that Ueda will take the opportunity to argue for a steady path towards monetary policy normalisation.

We project two further hikes in 2026 and one at the start of 2027, in order to lift Japanese cash rates to the bottom end of the BoJ neutral band at 1.5% by the start of the 2027 Japanese fiscal year.

10-year JGB yields have found some support close to 2% in the past week and we have reduced our own short duration stance around this level. Although we still see yields trending higher, the recent move has been relatively rapid by Japanese standards and so a period of some consolidation should be anticipated. Into 2026, we continue to think that 30-year JGBs can outperform other maturities, as supply and demand comes more into balance.

We also think we are reaching absolute yield levels which are intrinsically appealing to Japanese domestic investors. Although some commentators have highlighted that Japan could be a concern with respect to longer-term sovereign debt sustainability, we would note that this is very unlikely to be a problem that manifests, given extensive domestic savings and a strong external net asset position, which means net debt is close to 80% on a national basis, well below many other advanced economies.

With respect to the yen, we continue to see this attractive on a valuation basis, yet the fear that Takaichi will push for more dovish monetary policy if the yen is not under downward pressure is quite possibly a factor in encouraging carry trades, which will see the yen fail to recoup losses notwithstanding a relatively robust underlying economic performance.

In credit markets, spreads have remained relatively stable at an index level, and we think these conditions can persist into the first half of 2026. On a more granular basis, looking at high yielding credit, it has been interesting to witness the growing dispersion between stable B-rated euro loan credits at +4.7%, compared to returns of -3.4% for issuers in the CCC-rated bucket.

This decompression trend is only seen at the very weak end of the market, but this trend speaks to how dispersion is increasing, and markets will be quick to punish impaired credit stories with negative newsflow.

In this context, we see credit selection becoming increasingly important into 2026. This is a trend likely to be affirmed by building stress in private markets, where 20% of private debt is now in PIK (payment in kind) format, on the basis that these issuers increasingly can't remain current on coupon interest payments.

In FX, the euro has continued to push a bit higher versus the dollar as the spread between euro and US yields continues to narrow. 10-year bund yields are up 50bps in 2025, with the Treasury/bund spread converging by 100bps over the course of the past year.

This helps explain relative euro strength during 2025, noting that the underlying performance of the Eurozone economy has remained disappointing and that US growth exceptionalism seems set to persist into 2026.

Looking ahead we doubt that there will be additional further outperformance of Treasuries versus bunds in the months ahead. Part of the bund move in 2025 was driven by German fiscal expansion, though we would note that on a net Eurozone basis, the overall fiscal impulse in the year ahead is expected to be negligible.

We are also more inclined to see Eurozone inflation move lower, even as it ticks upwards on the other side of the Atlantic during the coming six months. Consequently, we are more biased to look for a firmer dollar in the first half of the coming year, though given the other factors driving FX as an asset class, this is not a view we currently express with any real conviction.

**Looking ahead into 2026**

It is interesting to reflect that perhaps we are all starting to speak about and worry about Donald Trump just a little bit less than we were this time last year. In many respects, we don't see any big new policy changes or initiatives being unveiled in the months ahead, and although the US President will retain the capacity to unsettle and unnerve financial markets, there is also a sense that we have become somewhat desensitised to his incendiary comments and bluster, to a degree.

Global financial markets have been relatively settled over the past six months, and it is tempting to extrapolate these conditions into the first half of 2026. In this context, it is also interesting that AI is now probably the biggest concern preoccupying investors into the year ahead, rather than the trajectory of policy coming from Washington DC.

Over the next few months, as AI-related investment spending continues to accelerate, a more upbeat narrative may remain in place. However, in the second half of the year, we think that risks to valuations may build, if there is a sense that the pace of investment starts to level off. Momentum is a huge factor driving markets, particularly so in more speculative stocks heavily populated by retail investors.

That said, there may be no shortage of upcoming macro events that also come to the fore and we have also learned on many occasions that it is the unexpected events and under-considered drivers that can end up having the most profound market impacts. On this basis, we doubt that volatility will remain subdued over the coming year and there certainly will be trends to capitalise on, within the context of actively managed strategies.

On this note, this is the last weekly macro commentary of 2025 and distribution will resume in the New Year. I hope those reading have found the content shared this year both interesting and useful and I would like to extend my very best wishes for a Merry Christmas and Happy New Year. But before signing off, as with prior years, it is time to share a few bold predictions for the year ahead!

- 1. Next Christmas we will be discussing rate hikes in the US into the year ahead, not rate cuts
- 2. Political leaders in Europe will be clinging on, but only in the absence of better near-term alternatives
- 3. Trump will already have fallen out with the new Fed Chair
- 4. There will be plenty of discussion and analysis relating to Japan's ongoing economic outperformance of the Eurozone
- 5. 2026 will have been a year when European yields outperform US yields
- 6. We will continue to reflect on US growth exceptionalism, and the dollar will outperform over the year as a whole
- 7. Stress will continue to build in a 'year of the cockroach' for private markets
- 8. Stocks will do much better in H1 than H2, with 2026 marking a year when active equity managers start to outperform benchmarks, after a tough recent run
- 9. England to be knocked out of the FIFA World Cup in the Group stages ☹ (OK – I'm certainly hoping that one is wrong!)

For the sake of some fun – these were the set of predictions 12 months ago:

- **1.** 2025 will be another year of US growth exceptionalism, but will 2026 be the year we finally need to fear recession?  **MOSTLY CORRECT**
- **2.** Fed and BoE policy on hold in H1, as the BoJ hikes, and the ECB continues to cut rates **MOSTLY CORRECT**
- 3. A year of curve steepening everywhere, with the exception of long end flattening 10/30 in Japan  **MOSTLY CORRECT – but wrong on Japan**
- 4. US dollar set to outperform at the start of 2025, but the yen to be the strongest G10 currency over the year as a whole  **WRONG!!**
- 5. A year of clipping coupon in credit, as spread narrowing runs out of steam and credit compression trades start to reverse  **MOSTLY CORRECT**
- 6. A year of mounting problems in private market assets as rates staying higher for longer proves toxic for business models reliant on leverage and cheap borrowing **CORRECT**
- 7. National Rally to be victorious in French Parliamentary elections, but AFD in Germany remains largely sidelined in the Bundestag  **WRONG – though National Rally would have won if elections had been held!**
- 8. Trudeau will leave office by the end of March, Musk won't last in the DOGE beyond June and Starmer may be gone next October **NEARLY CORRECT – Starmer was the outperformer!**
- 9. Chelsea to win 2 trophies but miss out on the League title this year…**CORRECT – kudos to the Champions of the World!!**

**Contact:**
Lydia Cambata
lcambata@bluebay.com

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