



Market Commentary

A Roadrunner moment

Trump's moving at full pelt, but he's stepped back from the cliff edge...for now.

Key points:

- Volatility in financial markets has stabilised, with U.S. stocks recovering from earlier losses. However, renewed risk appetite deterioration is anticipated in the weeks ahead.
- The U.S.-China trade war remains a significant issue, and it remains to be seen who will eventually pick up the phone.
- The White House appears dismissive of potential economic risks from tariffs, believing that trade negotiations and inventory adjustments will mitigate impacts.
- In Canada, Trump inadvertently helped Mark Carney and the Liberals win the country's election. Observing how the government navigates the challenges ahead will be intriguing.
- Despite calmer markets of late, the broader macrobackground is concerning, and certainly much more so than we would have assumed at the start of the year.

2 May 2025 (London) – Financial market volatility continued to moderate during the past week and with US stocks having recovered from sharp losses at the start of the month, it would seem that many of the fears driving price action a few weeks ago have melted away for the time being.

However, meetings with policymakers in Washington during the past week leave us with a building sense of concern. We are inclined to believe that there will be a renewed deterioration in risk appetite in the weeks ahead and consequently it is appropriate to consider paring exposure to risk assets, which we added in the market drawdown in the two weeks following the Liberation Day announcements on April 2nd.

With respect to economic data, we have previously flagged distortions in Q1 GDP numbers and that underlying demand had been relatively robust. It also appears that numbers for April may continue to hold up okay. Although new orders appear to have collapsed, firms seem happy to draw down inventories and are seeking to try and calm their customer base, in the hope that by the time inventories are depleted, tariffs payable will have been materially reduced. There is little evidence, thus far, of firms laying off workers or announcing a rapid adjustment in prices.

However, this may give an initial impression that the impact of Trump's trade war won't be that dire. In our view, this runs the real risk of a cliff-edge type of adjustment, in a couple of months from now, if policy does not shift. In this regard, there appear to be similarities to the Roadrunner cartoon, in which Wile E. Coyote keeps on running, long after the ground has disappeared beneath his feet, ahead of the inevitable moment of realisation when gravity kicks in.

Yet on this point, in meetings with the administration, officials were blithely dismissive of these concerns. There is a belief that orders will have to pick up, as inventories are run down. A first trade deal has already been agreed and will shortly be announced. More great deals will follow in the weeks ahead, with a queue of countries desperate to get an agreement in place before the 90-day period reaches a close. It makes sense for the US to take a combative position, even with allies, during this process. This will maximise its leverage in the process. In this sense, creating uncertainty also strengthens the US's hand in these negotiations.

Away from China, there is a belief that countries are desperate to strike a bargain, in order to secure tariffs at 10%. Meanwhile, their views are that risks to inflation are overstated. After all, currencies often have 10% moves and it typically has limited spillover into the real economy, when this is the case. China is a separate issue, but carve-outs, where needed, can help mitigate US economic problems.

Anyway, there is a clear desire to diminish China dependency, meaning a reset is required. In the eyes of the administration, there will be some slowing of growth, but this is a price worth paying. Any move up in prices will be temporary, and so the administration sees the Fed cutting rates in the months ahead.

This position seems to reflect an alarming sense of complacency, in our view. Meetings with other analysts and advisors cited much greater downside risk and they shared a hope that Trump will be persuaded to back down.

However, this is not the impression we have taken from inside the White House. In this regard, we have a clearer sense that Trump has been intentional in triggering a trade war, and it would be wrong to assume that there will be a material change in the course ahead, given the deep-rooted sense that the US has been a loser in the wake of globalisation and has been abused and taken advantage of.

With China responsible for 30% of global manufacturing and also responsible for many of the critical inputs which contribute to the other 70%, there is a real sense that the US must become more self-sufficient. Trump appears to believe that with the US economy coming from a position of strength, at a time when China has been weak, this is exactly the right time to push the reset button. In any war, there will be casualties and economic pain, but there is also a sense that, as with Reagan in 1981, whose policies pushed the US into recession, history will end up vindicating the Trump agenda and will leave the country on a firmer footing in the years to follow.

In the near term, trade between the US and China seems set to continue to plummet. Beijing observes that its pain threshold is greater than that of the US. It remains to be seen who eventually will pick up the phone and, at least then, conversations can finally start.

This all suggests to us that the summer is likely to witness renewed upheaval and volatility. An adverse supply shock can't be averted, and the questions are how seriously this will impact growth and how materially it will push up inflation.

In this respect, there is plenty of uncertainty and many scenarios, though in speaking to ex-Fed Board members we sense that the only path for the FOMC right now is to adopt a cautious stance and wait and see. Certainly, there is no sense that rate cuts are set to be delivered any time soon and, with the yield curve already discounting material monetary easing to come in the year ahead, there is a sense that front end yields are already fully priced.

As for trade policy itself, it is becoming more apparent that our previous hopes that tariffs would be legislated via Congress are unlikely to be realised. We had assumed that legislation would be required in order to utilise tariff revenue in the US Budget.

However, there is no appetite in Congress to assume responsibility for this. Instead, it appears that it will be easier to change the way that the Budget rules are implemented, meaning an amount of duty revenue can be assumed within the reconciliation process.

Given the tight balance in the House and divisions within the Republican ranks, it seems that the passage of the Budget itself may not be concluded until close to the end of this year, despite desires in the administration to make more rapid progress.

In the interim, it may seem conceivable that there could be renewed concern over a government shutdown around October, noting the dearth of bipartisan agreement on many topics. Unlike past shutdowns, which have been quickly resolved and done little damage, there is a worry that this time around a more protracted stalemate could exacerbate downside risks and add to risk premia.

More broadly on the US fiscal position, it's clear that the country's finances are in poor shape with a deficit way too high, at a point in the economic cycle when one would normally have thought the Federal Government would print a surplus. There is a real risk that a material growth slowdown, triggering a fall in tax receipts and additional spending requirements, could push the US deficit towards double digits.

Historically speaking, past recessions have added 4% to the deficit on an annual basis, compared to the position prior to entering a slowdown. DOGE actions have eradicated some Democrat-leaning agencies, though total assumed job cuts of around 120k are not seen as having a material impact from a debt or GDP perspective. Moreover, with many of these cuts in the IRS, it may actually end up weakening the fiscal position if revenue-gathering is adversely impacted.

With respect to the Fed, it is assumed that President Trump will renew his personal attacks on Jay Powell, as the economic backdrop deteriorates. It is unlikely this will result in the removal of the Fed Chair, but it seems likely in the fall that we could see moves to nominate Powell's successor.

In this context, Kevin Warsh seems a clear frontrunner for the time being, yet when it comes to Trump, we have seen how he can be fickle and, in this regard, it may be challenging to pre-judge. That said, it seems ironic to us inasmuch that Warsh would hardly describe himself as a 'low interest rates guy'. Moreover, his playbook would suggest a robust desire to bring inflation to target. That said, were he to inherit a role in the wake of inflation heading up to 4% in the months ahead, so it may be that Warsh is the right person to actually deliver on Trump's promise of lower prices.

In summary, the economic and policy backdrop in the US is a clear sense of concern as we look ahead. We would also reflect that our meetings have very largely been with those from Republican ranks on this particular trip, and one can only imagine concerns from Democrat circles would be even more pronounced.

Our former hopes that Trump would be a pragmatist, interested in doing deals, and seeking policy wins to boost his own popularity, appear to be giving way to a concern that there is a deeper psychological and ideological desire to effect change and a sense of urgency in which to do so. This has conveyed an impression that Trump has triggered a trade war, which the country is not well prepared for. However Trump, in his zeal, seems less worried about the collateral damage than we would have thought he would have been.

A stagflationary environment may be challenging to equity and fixed income assets and although overseas markets are likely to be more robust, should risk assets come under renewed pressure in the US, then this will set the tone across global markets. In the very short term, it is possible that recent market volatility may continue to abate, especially if hard economic data do not deteriorate too much for the time being, as appears likely in our assessment.

However, a move to a more cautious stance appears warranted and notwithstanding the landscape of elevated uncertainty, adding hedges and downside protection is likely appropriate to consider. Meanwhile, duration is not an effective risk hedge, and we are more inclined to think that the US yield curve may bear steepen on concerns around inflation and the Budget position.

Looking ahead

With our focus very much on the US this week, perhaps the most notable external development was the election of the Liberals and Mark Carney in Canada, on a platform promising to stand up to the US and to Donald Trump. Arguably it was Trump's stance that has helped gift the Liberals a win, given how badly they trailed in the polls just a short time ago.

Having fallen short of an absolute majority, it will be interesting to see how the incoming government navigates the challenges ahead. In this respect, Canada is in a challenged macro position and trends towards separatist movements in Quebec and Alberta represent a risk in the quarters ahead, should the economy continue to struggle.

Yet returning to US markets once more, we are struck by the sense that markets currently want to believe in a narrative that all will be well. There is a deep-seated desire to look at a glass which is much more half-full than half-empty. However, surveying where we stand at the start of May, the backdrop appears much more concerning than we would have assumed in Q1 this year.

We have seen that if volatility in markets spikes, then Trump may take a temporary step backwards. However, it has been observed in the administration that markets have tended to recoup short-term losses, and in this respect, there is little need to turn their course.

In this respect, it seems likely there will need to be a recalibration of understanding in the weeks and months ahead. As with Roadrunner, eventually reality will kick in. Consequently, it is hard to spend time in meetings in Washington DC, without building a sense of looming concern....

Notes to Editors

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