



Market Commentary

Are temperatures set to rise into the summer?

Markets have tended to assume that trade worries will melt away....

Key points:

- US Treasury yields fell this week, as labour data hinted at the jobs market softening. No decisive change in the economic trajectory is expected, with unemployment unlikely to rise significantly.
- Eurozone inflation eased in May, which supported euro yields. Defence spending in the region was also back in the spotlight again.
- Market momentum may be fading, as lower volatility has reduced hedging costs and trade negotiations could reignite market risks.
- Tensions could also resurface ahead of the G7 meetings in Canada, potentially pressuring risk assets, as investors focus on Trump's 9th July tariff deadline.
- Although those close to the administration believe that the US economy is stable with stocks near their highs and tariff revenues increasing, we believe caution is warranted.

6 June 2025 (London) – US Treasuries led global yields lower during the past week, as labour market data suggested some softening in the jobs market ahead of payrolls data, which is released later today. Some slowing in economic activity has been expected in the wake of US trade policies, though we don't see a decisive change in the economic trajectory at this time.

With the US administration tightening the labour market as it clamps down on immigration, we doubt that the unemployment rate will rise in a way that prompts a return of recessionary fears. In this context, the overall direction of yields remains relatively unclear, in our eyes.

In the absence of greater clarity and new and decisive information, it appears to us that the Fed will maintain policy on hold for the foreseeable future. In this respect, the FOMC will be just as focussed on emerging trends in prices as it is on indicators of economic activity. Recent core PCE data helped mitigate immediate upside concerns with respect to inflation.

However, with tariffs set to stay, so we think there will inevitably be a period of adjustment that shows up in higher prices in the months ahead. OPEC announced further supply hikes at last weekend's meeting, but a softening dollar has ensured oil prices remain resilient above USD60 per barrel.

We continue to favour a 2/30 curve steepening stance in US Treasuries. The Budget is currently being negotiated within the Senate, and here there is a risk that there is some pushback on planned cuts to Medicaid spending. There seems little evidence that the US fiscal deficit will be coming down any time soon.

In this respect, it has been interesting to note the relatively critical take on the Budget's spending provisions coming from Elon Musk, who has only recently quit the DOGE. Administration officials seem to be counting on a combination of strong growth, material tariff revenues and lower borrowing costs, in order to bring the US Budget back towards balance.

However, much of this appears wishful thinking in our eyes. It seems appropriate to reflect that Trump is a President who wants to cut taxes and add to spending and who has little appetite for any real austerity. It strikes us that, unless or until, the bond market forces a change in tack, then from a political standpoint, this narrative is unlikely to change.

Eurozone inflation was a little lower than expected in May and this has helped support Euro yields. In politics, gains by Polish populists in the latest election and the collapse of the Dutch government, as Gert Wilders withdraws his party's support from the ruling coalition, serve as a reminder of underlying populist sentiments across the continent.

Meanwhile, an ongoing focus of attention has been back on the topic of defence spending, as EU policymakers, led by Germany, ramp up their planned commitments. The notion that German outlays could reach 5% of GDP annually is significant. Here we think that the forthcoming increase in government deficits and German bund supply may be overlooked in markets, at present.

In the short term, European assets have benefitted from increased flows, which has prompted some regional outperformance in recent weeks. However, we would be wary of yields falling too far, given that fiscal risks could be underpriced.

Meanwhile, the UK remains rather non-committal in its timeline to raise defence spending to just 3% of GDP. This means UK defence spending will be well below European levels over the next few years, even if it is coming from a stronger starting point relative to many of its peers across the channel.

In this respect, it might be that geographical proximity to Russia and Ukraine is sharpening the minds of those countries closer to Moscow. Indeed, it may seem that UK voters have little enthusiasm for greater military spending at a time when the country faces difficult fiscal choices, and society would rather see cash diverted towards improving other public services, notably healthcare.

From this perspective, the Starmer government remains boxed in by the fiscal framework on one side and the bond market on the other. For the foreseeable future, it seems there is limited scope for this to change. Consequently, Starmer and others can make grand sounding comments and gestures and even engage in a degree of sabre rattling.

Yet this contrasts with the lack of appetite for a fight in the country, with over half of the population noting they would never take up arms, regardless of the circumstances. On this basis, it is likely that adversaries will look towards the UK as even more of a paper tiger going forwards than is already the case today.

Until now, investors in equities and other risk assets have been rewarded to keep buying, as markets rally into a wall of worry. However, we think that this price action may be losing momentum and so this is a moment to adopt a more cautious stance. The cost of implementing hedges has fallen materially over the past month as volatility has dropped. Following a period when complacency appears to have risen, we would not be surprised if volatility doesn't pick up materially again over the course of the coming month, with trade negotiations coming back to centre stage.

In FX, the trade weighted dollar has slipped back towards a 3-year low, notwithstanding the recent rally in stocks. We continue to hear of asset allocation shifts taking demand away from the US dollar and so this trend can continue. Indeed, if there is a renewed period of volatility then we could envision a more rapid move weaker for the greenback, given fears that the dollar itself has tended to trade like a risk asset over the past couple of months.

Looking ahead

Payrolls will be a focus for markets today. However, we think that trade will be the bigger focus for markets over the course of June. As the calendar moves into summer, we see a risk that the temperature in financial markets also starts to heat up.

While May was characterised by a moderation of trade concerns, so it appears that tensions may be set to escalate once more, with the US trading barbs with the EU and China over recent days. Markets have tended to assume that trade worries will melt away. But as we head towards the G7 meetings held in Canada in the middle of this month, we see a risk that these resurface and put more pressure on risk assets, with market participants looking towards Trump's July 9th tariff deadline date.

It is interesting to speak to those close to the US administration who feel that, with the economy holding up OK for now, no upward move on inflation (yet), stocks near their highs and tariff revenue already rolling in, things are going quite well for the USA. Yet a hubristic view seems to overlook the increasing risks and from this standpoint, we think that it is appropriate to adopt a cautious stance.

There is a saying that pride can come before a fall and although it is challenging to determine the timing of such moves in financial markets, our sense at the moment is that investors are under-compensated, relatively speaking, for running much risk. Therefore, it may appear much more attractive to maintain some dry powder to deploy at moments of weakness, should valuations become more attractive in periods of dislocation.

Of course, the stock market may continue to prove the haters wrong and continue to power ahead, led by retail buying. Yet the idea that tensions may rise, as trade deadlines approach, has a logical sounding appeal.

In this way, it almost seems as rational to expect the thermometer to climb as we head into the summer. Extracting performance from the market volatility seen during April seems to have been challenging for many. However, we have confidence that there are further such episodes and opportunities ahead. Under Trump, we can't see macro volatility disappearing any time soon.

Notes to Editors

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