RBC BlueBay
Asset Management

Market Commentary

Trump 2.0, a song of fire and ice

Is the President-elect on a quest to Make Greenland Great Again?!

Key points:

- With the US economy retaining strong momentum and with potential volatility due to the policies of the incoming Trump administration, risks on inflation remain two-way, in our view.
- In Europe, we continue to see the ECB cutting rates in response to a soft economic growth backdrop.
- In the UK, better inflation data may be as good as it gets, for the time being. However, it's clear that the BoE has a dovish bias and would like to ease policy.
- Looking ahead, overall risk levels remain low and the principal opportunities where we have strong conviction are currently expressed in FX, more than rates or credit.

17 January 2025 (London) – US Treasury yields declined over the past week, in the wake of a benign CPI report showing core price growth easing slightly, to 3.2% in December. Yet, taking a step back, we would observe that inflation has been broadly stable around this level for the past six months. In our view, a renewed downtrend in inflation will be needed in order for the Fed to resume policy easing in the coming months.

This suggests that the Fed will be on hold during H1 this year, as we don't have too much confidence in such a downtrend re-emerging for the time being. With the economy retaining strong momentum and with upside risks to prices in the trade, immigration and fiscal policies of the incoming Trump administration, risks on inflation remain two-way, in our eyes.

Yet, we continue to see the FOMC as more inclined to cut, rather than hike rates in the coming months, given Powell's assessment that monetary policy remains relatively restrictive. Conversely, in order for the Fed to return to policy tightening in the months ahead, we think that inflation would need to approach 4% on core CPI and 3.5% on core PCE.

However, this does not seem too likely, in our opinion. With the US dollar strengthening, it seems unlikely that tariffs will have a material inflationary impact in the near term. Similarly, we think that there may be some net fiscal easing, yet not a particularly material amount in 2025, as long as the economy remains firm and tax receipts hold up.

From this perspective, we continue to argue that 2-year yields are fairly priced around 4.25%. Further out the yield curve, the past two months have witnessed a bear steepening movement with long dated yields breaching 5.00% earlier this week.

However, having reached this level, we think this move may pause for the time being. Further curve steepening is likely in the medium term, but we think this is more likely to occur as and when short dated yields are able to rally.

Consequently, we believe that we have reached a point wherethere is not much opportunity with respect to US rates or the Treasury curve, and this has seen us flatten risk in this space over the past week.

In Europe, we continue to see the ECB cutting rates in the coming months, in response to a soft economic growth backdrop. As in the US, core inflation remains above target, with core prices trending sideways around 2.7%.

However, downside risks are more prevalent in the Eurozone and although inflation is proving sticky in the last 'half-mile', there seems little for the ECB to fear, with respect to a re-acceleration in inflation pressures. Consequently, we see Lagarde easing rates by 25bps in each of the next three calendar quarters.

French spreads have rallied slightly over the past week, thanks to some perceived progress with respect to the budget. Nevertheless, we only expect the current Bayrou government to last up until this summer. At this point we think it will become politically expedient for Le Pen to withdraw the support of National Rally, triggering new elections once 12 months has passed from last summer's vote.

From this perspective, spreads may be rangebound over the next few months, but if OATs tighten below 70bps versus bunds, then this may represent a good entry point to move short ahead of expected pressure on spreads to widen, later in the year.

In the UK, a better inflation print also helped gilts to rally this week. Core CPI dropped to 3.2% in December, with services inflation cooling from 5.0% to 4.4%. However, we would caution that part of this drop relates to the behaviour of a few volatile items in the CPI basket. Notably airfares were -26% year-on-year in December, partly due to an early sampling date, which did not fully capture the move up in Christmas pricing. This move (and the associated reading in hotel prices) will reverse next month, biasing numbers higher.

Moreover, in the months ahead, the UK is braced for higher utility bills, elevated council tax charges, rising food inflation, and increased prices linked to firms passing on higher employment tax charges. In this way, we think the December data for UK inflation may be as good as it gets, for the time being.

It is clear that the BoE has a dovish bias and would like to ease policy. Therefore, it won't be too surprising if Bailey cuts rates to 4.5% at the February meeting. Yet, inflation remains above target and we see limited scope for any further easing. Similarly on the fiscal side, the government's fiscal rules may be challenged by higher yields feeding into elevated borrowing costs. This could put Reeves under pressure to raise taxes or cut spending in a spring Budget.

Yet, core to the UK's problems on a medium-term view is the lack of growth, at a juncture when sentiment is depressed and the government seems lacking in ideas. Indeed, for all the talk of wanting to champion growth, often it seems the government's actions are designed to have the opposite effect.

An example of the UK government's muddled thinking on growth is highlighted with respect to its attitude towards the oil and gas industry. The UK is a country with the reserves in the North Sea to be self-sufficient in gas for many years to come. Yet oil companies are being stymied in developing new fields due to a nihilistic climate agenda. Nihilistic, in that such obstruction means that the UK is forced to import LNG from far afield – only adding to Scope 3 emissions in the process.

Meanwhile, it means that jobs and investment are lost to the UK, and climate policies are just delivering a transfer of wealth from countries like the UK (and others in Western Europe) to other oil producing states, elsewhere in the world. It is also interesting to think that when many 'liberals' head to their favoured coffee shop, they will be passionate in considering whether their beans have been ethically sourced.

Yet when it comes to hydrocarbons, this thinking goes out of the window. Anyway, it is not surprising that the UK and Europe are paying far too much for their energy, and policymakers might as well be telling oil majors to quit the UK and move listings to New York, where these companies are made more welcome.

In FX markets, sterling has continued to underperform over the past week, and we continue to eye further downside for the pound. Meanwhile, the yen has been a recent outperformer, ahead of the BoJ meeting next Friday.

Comments from BoJ officials have suggested confidence in the economy and wage growth, and a rate hike is now discounted with a probability of around 80%. We have been looking for BoJ tightening to be a catalyst for the yen to outperform this year and we retain a bullish view, which we favour expressing versus sterling and the euro.

In terms of the USD, markets await next week's inauguration of Donald Trump and policy pronouncements to follow, with respect to tariffs. Based on comments from incoming Treasury Secretary Scott Bessent, the Trump team continues to encourage a strong dollar, with the greenback retaining its role as the world's reserve currency.

By this time next week, we may have seen Trump announce several Executive Orders, given the desire to hit the ground running. From this standpoint, it may be easier to project what this means for the dollar at this time. Yet for now, we think it makes sense to stay long risk in the US currency.

On balance, we are inclined to think that Trump may surprise markets by sounding more assertive, not less assertive, than is currently discounted. At the same time, strong data continuing to affirm US growth exceptionalism continues to be of ongoing benefit to the dollar.

IG credit index spreads are broadly unchanged since the start of the year, with CDS indices also trading sideways. January is always a heavy month of issuance, though this has seen solid demand, with new deals priced at only small concessions relative to existing bonds.

In EM, Romania has seen some underperformance on budgetary concerns. Romania remains a favoured holding for us, based on attractive valuations relative to other European assets. Indeed, we are hopeful that some recent pressure on spreads and credit ratings may ultimately help to ensure policymakers seek to consolidate the budget position, noting endemic weakness in tax collection, which should not be too hard to address.

In Japan, we think there is now more potential performance to be earned in FX rather than Japanese rates. Consequently, we have moved to a maximum conviction view in yen versus the euro earlier this week, in anticipation of policy change at next week's BoJ meeting. In the months ahead, we think EUR/JPY can trade down to 145, from levels above 160 today.

Looking ahead

Next week is a holiday-shortened week in the US, but we don't expect it to be a quiet one. There will be plenty of noise coming from Washington in the coming days, and it will be interesting to see how this impacts markets, both domestically and overseas.

At the current point in time, we have flattened much of the risk in global rates across strategies – with a reduced JGB short offsetting small long rates positions in markets including Norway, Iceland and Hungary. Directional credit risk also remains close to its lowest positioning for the past three years.

Consequently, overall risk levels remain low and the principal opportunities where we have strong conviction are currently expressed in FX, more than rates or credit. We think this leaves us well positioned to react to market volatility, should any dislocation occur in the coming weeks.

Moreover, at a point of policy uncertainty, prior to Trump's ascendancy, it strikes us that there will be other moments this year, when it is possible to invest with greater conviction and a stronger sense of certainty.

Meanwhile, it has been encouraging to hear news of the ceasefire in Gaza in the past few days, which hopefully ushers an end to a distressing period of conflict. In many respects, Trump is already taking credit for the peace, and it might seem likely that Ukraine will be a rapid area of foreign policy focus. Here, a 'messy peace' appears a plausible outcome in the next couple of months, as Trump seeks to wield his influence.

Elsewhere, it will be interesting to see how things play out in Greenland. It may seem that the incoming administration cares little about climate change (as is the case for China and India) and so assumes that we are on a path to a 2.5° warmer world (forget the 1.5° rhetoric – that ship sailed long ago).

This being the case, the US is assuming the Artic icecap melts (with apologies to a few polar bears) and so Greenland is strategically a battleground in terms of control for the Artic and the resources in the region, with China likely to eye opportunistic expansion.

Meanwhile, Denmark may protest that Greenland is not for sale, but in Trump's world, what he wants, he will plan to get. Maybe just a shame he doesn't want to buy the poor UK instead….

Notes to Editors

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