RBC BlueBay
Asset Management

Market Commentary

Fight or flight?

All that glitters is not gold.

Key points:

- Donald Trump took office and on the crucial issue of trade tariffs, there has been no additional substance to drive markets. Nevertheless, we have heard enough now to know that tariffs are coming.
- Canada and Mexico have been the initial areas of focus, and we could see the EU challenged in the near future.
- While US economic growth seems set to keep powering ahead, Europe continues to languish.
- In the UK, a weakening of the labour market and deteriorating sentiment suggest the UK economy has stalled, with GDP data likely to show 0% growth over Q4 2024.
- In Japan, the BoJ hiked interest rates to 0.50%. We expect further normalisation in Japanese monetary policy to follow in 2025.
- As we look forward, we feel that the start of 2025 has already been relatively breathless and there is still plenty of uncertainty in the macro backdrop.

24 January 2025 (London) – The inauguration of Donald Trump stole the attention at the start of this week, with the 47th President of the US wasting no time in signing a wide-ranging set of Executive Orders on arrival at the Oval Office.

That said, many of these measures had been well flagged in advance and on the crucial issue of trade tariffs, there was no additional substance to drive markets, save for comments suggesting a 25% tariff on Mexican and Canadian imports come the end of next week, noting concerns around illegal migration and drug trafficking.

This being the case, the dollar traded slightly softer over the past several days, with risk assets continuing to trade relatively well, with fears of greater economic disruption coming from tariffs not realised to this point. Nevertheless, we think that it would be wrong to be complacent on this topic. We feel we have heard enough now to know that tariffs are coming, and it is more a question of how and when.

In many respects, there is a desire in the new administration to push tariffs through legislation, enabling revenues raised to help reduce the budget deficit. However, a legislative route will likely take a number of months to expedite, and there can be no doubt that Trump and his team are in a hurry to make headway as quickly as they can.

In addition, a legislated path for tariffs will limit the room Trump has to make deals or engineer bilateral outcomes seen in the US national interest. In this context, it can be seen how Trump is already using the threat of tariffs to effect aims with wide-ranging goals in foreign policy, energy policy and immigration policy with respect to specific countries. Herein, it won't be surprising to us if the dealmaker in Trump will want to retain this leverage going forward.

Consequently, analysing how Trump's threats to Canada and Mexico for 1st February may be instructive to understanding the wider implications for trade policy may evolve in the weeks to come. In this case, we might guess a compromise at a lower tariff rate gets applied, though implementation could be deferred until the end of the quarter, contingent on Canadian and Mexican actions in the interim.

That said, there is much short-term uncertainty around this and there are a wide range of outcomes, which could be viewed as materially better and materially worse in terms of their impact on the global economy, away from the United States.

It has also been noteworthy that Trump and his team have been relatively silent with respect to tariffs on EU member countries, over recent weeks. One might wonder if Trump is looking at the Eurozone economy right now, inclined to show some pity on it. But in all reality, we think it would be wrong to conclude that the EU won't soon be in the firing line of the incoming administration.

Our understanding has been that Canada and Mexico have been the initial area of focus, as these are the two countries accounting for the largest share of US trade. However, Trump's ire will soon be directed across the Atlantic.

We could see the EU challenged by US threats to withdraw from NATO or the Basel banking rules. Washington will demand the EU makes commitments to increase spending on defence and spends more on US energy and agricultural exports. However, this alone won't avert the imposition of tariffs, and we see this representing a material challenge to EU policymakers in the months ahead.

Whereas US economic growth seems set to keep powering ahead for the foreseeable future, with investment spending accelerating as US inbound FDI increases, Europe continues to languish with energy costs too high, sentiment too depressed and an economy that is over-taxed and over-regulated. In this context, we see the ECB cutting rates by 25bps per quarter, whilst the Federal Reserve holds them unchanged in the months ahead.

At the same time, we continue to think that the euro may trade below parity versus the dollar in the weeks and months ahead. On rates, our views are not too far from what is embedded in market pricing and from this standpoint, we are still inclined to skew our risk budget towards FX opportunities.

European spreads have been rallying since the start of the year as near-term worries relating to political stability in Paris start to abate. However, we think this period of calm could be challenged later in the year and therefore OAT spreads below 70bps to bunds could represent an opportunity to move back to a short position in French assets.

Yet, with Italy testing 100bps and Spain down at 60bps versus Germany, it is worth noting that part of the recent spread move is a function of weakness in the German credit profile relative to others, with concerns prevalent in the run-up to the German elections at the end of February. Here, the right-wing AFD has seen its support firm, and the promotion of a 'Deutschland First' narrative by Musk on the X platform is something that needs to be monitored.

Aside from that, the next government in Berlin will be a coalition, which one assumes will be led by Merz. But with the FDP challenged in whether they passed the 5% required vote threshold, a grand coalition seems to do little to offer much hope or inspiration to German voters.

In that case, future outcomes could become more uncertain,and it seems likely that Germany and other countries in the EU are moving in a more nationalist and less federalist direction, which can risk future political coherence within the single currency area.

In the UK, gilt yields have offered Rachel Reeves some relief over the past week, with the curve rallying, in line with a move in Treasuries. A weakening of labour market demand and deteriorating sentiment suggest the UK economy is at stall speed at the current point in time, with GDP data likely to show 0% growth over the final quarter of the year. Government borrowing has been increasing on higher funding costs, thus highlighting how fiscal policy is now largely captive to movements in bond yields.

Looking ahead, it seems very likely that the Bank of England will use any opportunity it can to lower interest rates and, in that context, it is expected to cut rates to 4.5% in February. However, we continue to see inflation remaining stubbornly around 3.5-4.0%, which means that we struggle to see Bailey being able to lower rates much further than this.

Meanwhile, we would highlight how recent US Federal Reserve rate cuts have actually seen longer dated yields rise, not fall, as instructive in the UK context. If the BoE is too dovish and adds to upside inflation risks, then the UK curve is likely to steepen, with longer dated gilt yields rising. For now, we maintain no position in gilts, but are inclined to take a bearish stance if yields decline much further in the near term.

In Japan, the BoJ hiked interest rates today to 0.50%. We expect further normalisation in Japanese monetary policy to follow during the course of 2025. Japan core inflation is above 3% and we are projecting a wage increase above 5% in this quarter's Shunto pay negotiations. Profit margins remain robust and the Japanese macro backdrop is largely constructive.

In this context, we see the BoJ hiking again in July to 0.75% with cash rates hitting 1.00% next January. This should see 10-year JGB yields rise towards 1.75%, though we feel that longer dated bonds may hold in better with the 10/30 yield curve continuing to flatten, in line with the recent trend.

Meanwhile, we are hopeful that renewed attention back on the Japan story could provide a catalyst for the yen to appreciate in the weeks ahead. The Japanese currency remains extremely undervalued on most valuation models and, as interest rate differentials narrow, we think that this will help the yen perform better in 2025.

In this light, we continue to favour the yen versus the euro and sterling, and we have maintained increased conviction in this move, at a time when it seems that opportunities in Japan have temporarily been overlooked by the majority of global investors.

Credit markets have continued to trade with a firm tone over the past week. Declining volatility and bullish sentiment in equity markets continue to push spreads tighter. However, when looking at the extremely rich valuation of swaps versus government bonds, we are inclined to wonder if this trend could soon be set to reverse. With US 30-year swap rates some 80bps below the yield on US government bonds, it would not be too surprising to us if the Trump administration were not to conclude that the depressed relative valuation of government bonds are not in the US national interest.

This could prompt tweaks to the capital charges and leverage treatment afforded to cash bonds relative to swaps – which could prospectively push down long dated bond yields, helping to lower Treasury borrowing costs and benefit the deficit, at the expense of higher swaps yields. Indeed, articulated in this way, one could wonder why the government would not want to do this and unlock billions in potential savings in the process.

Few portfolio changes have been made over recent days, and we feel that more interesting opportunities may present themselves, should volatility increase in the next couple of weeks. For now, we see more scope to take risk in FX than in rates and credit. From this standpoint, we will clearly be monitoring newsflow around tariffs in the coming days.

Looking ahead

As we look forward, we feel that the start of 2025 has already been relatively breathless thus far and we doubt the overall level of noise in markets is set to quieten down anytime soon. There is still plenty of uncertainty in the macro backdrop and it also strikes us that, with a range of bullish and bearish forecasts coming across our desks, in 2025 we could witness a period in which all views may actually be proven correct (and incorrect), at different points in time.

From that standpoint, the thing we feel most confident about is volatility. In some respects, we won't be surprised if a number of markets end the year close to where they started, albeit witnessing material moves higher and lower in the interim. This means timing on trades and picking the right entry and exit points will be very important, which calls for a degree of discipline in decision making.

There may consequently be points in the year when we want to maintain elevated risk levels with respect to active positions and others, such as the situation right now, when we are happy to sit back with much lower levels of active risk, seeking to identify the right time to get involved once more.

Meanwhile, in a week when it has been all about Trump, and when the commander-in-chief has been on ebullient form, it may be worth highlighting the 55% price drop in the value of the Trump meme token over the past five days. Mind you, that represents an outperformance compared to an 80% reversal from the peak value of the associated Melania token, which you can also find on the Birdeye platform.

Indeed, it could appear that the crypto community has been left upset and demeaned by the rise of these meme assets, with bitcoin valuations also moving lower. Perhaps it is instructive to remember that all that glitters certainly isn’t gold and that when it comes to Trump, it is dangerous to conclude that he is guaranteed to end up making you money! This aside, that Trump token still has an outstanding market cap of around USD7 billion, meaning that Donald himself is probably left laughing all the way to the bank….

Notes to Editors

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About RBC BlueBay Asset Management

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