RBC BlueBay
Asset Management

Market Commentary

A noisy Trump, but relief that there isn't any follow through….(yet)

Buckle up for a bumpy ride.

Key points:

- Tariff delay offers a temporary reprieve, but markets are wary of Trump's unpredictable trade moves and the looming spectre of economic upheaval.
- Long Treasury yields dip as trade policy concerns overshadow economic data, while the Fed holds rates steady, and the ECB eyes potential easing.
- The Bank of England cuts rates, with dissenting votes for deeper cuts signalling a dovish shift, as sterling faltersand inflationary pressures loom.
- Japan's yields and yen rise on strong wage data, with BoJ Board member, Tamura, supporting further rate hikes, aligning with market expectations for normalisation

7 February 2025 (London) – Trade policy developments were the focus of market attention over the past week, with President Trump managing to create a degree of havoc in overseas capitals. The threat to tariff Canada and Mexico at 25% raised the possibility of widespread economic disruption, given the interconnectedness of these economies in key sectors such as autos and energy.

Were such a tariff to be implemented, this would represent a negative supply shock, which would adversely impact growth, whilst boosting inflation. Although concessions with respect to border security and fentanyl imports have seen the imposition of tariffs delayed by one month, it would seem complacent to us to conclude that this threat has now been fully averted.

We have consistently heard from Trump that he sees tariffs as a means of raising revenue and diverting investment and production towards the US, on his mission to 'Make America Great Again'. Consequently, we think that some amount of tariffs will be imposed on both Mexico and Canada, albeit at a reduced rate below 25%, for 'good behaviour'.

However, analysing the evolution of trade policy is made difficult, given the mercurial nature of POTUS. This is something put into relief by the subtext that even the Treasury Secretary, Scott Bessent, appears not to have been read into Trump's tariff plans when these were released from the Oval Office last weekend.

It appears that only a very few individuals (probably including Peter Navarro) have been privy to the President's plans. Moreover, if the US Treasury is left in the dark as to what is happening and when, it highlights how challenging it will be for market participants to gain much of an understanding.

What does seem clearer is that the EU will be up next in the Trump tariff assault, and there is a sense that a 25% EU tariff announcement could land at any time. It is suggested that this would similarly be lowered to a figure like 10%, as long as the EU does not retaliate in kind and commits to increasing both defence spending and purchases of US energy and agricultural produce.

Yet it is not clear that the EU will be so ready to comply to US demands, as has been the case in some of Trump's other bilateral negotiations to date. With Trump also making outlandish claims this week about taking over Gaza and displacing Palestinians in the process, there is a sense in European capitals that Trump is an erratic and unreliable partner and a bully who someone will need to stand up against.

However, it would be easier for the EU to take such a stand from a position of unity and strength. The reality is that the economy remains weak and political trends are pushing individual member states in a more nationalistic direction.

Long Treasury yields declined over the week, partly as a function of investors seeking to reduce active risk positioning at a time of macro uncertainty. Macro hedge funds have been inclined to bet on higher long end yields and rising volatility, with positioning being unwound, following a soft month of performance in January.

We continue to run a broadly flat stance on US rates but continue to favour bunds versus Treasuries on a relative value basis, given divergent economic performance. Inasmuch as tariffs represent an upside risk for US inflation, the Fed is very unlikely to cut interest rates for the foreseeable future. However, the ECB could move to accelerate monetary easing, in the case that a trade war adds to economic downside risks.

Elsewhere in Europe, the BoE lowered rates by 25bps to 4.5% this week. This move was largely expected, but with two members favouring a larger 50bps easing, there is a sense that BoE thinking is increasingly dovish. This saw sterling weaken in FX markets, and short dated UK rate contracts rallied.

However, at a time when inflation is moving in the opposite direction, it was notable that longer dated gilts yields moved higher on the day. With respect to inflation, a relatively cold European winter has seen gas storage levels dropping, pushing the price of forward contracts higher.

Consequently, it looks like the UK energy price cap will rise around 5.5% in April. At the same time, council tax increases and other regulated price hikes will also kick in. This should see UK CPI around 4% in Q2 and, against this backdrop, we tend to believe that it will be hard for the BoE to lower rates further.

Meanwhile, Japanese yields continued to rise on the week, with the yen also firmer on the back of strong Japan wage data coming into 2025. BoJ Board member, Tamura, articulated the case for a further 50bps of rate hikes in the coming 12 months, which is in line with our own thinking.

Slowly, it also seems that domestic investors appear to be revising upwards their thinking, with respect to the required neutral level of interest rates in Japan. We continue to target a move to 1.5% on 10-year JGB yields in the coming months. However, we would reiterate that we now think that opportunities in Japan are more skewed in favour of taking long FX risk in the yen, rather than in short duration positions in the rates market.

Looking ahead

We have US payrolls later today, followed by CPI in the coming week. However, it may seem that economic data is taking something of a back seat to what is coming out of the White House for the time being. Based on the dialogue we have had with policymakers to date, we get a picture that the US administration believes that it can position tariffs as a form of consumption tax on US consumers (albeit one which domestic producers are exempt from paying).

After all, Europe levies VAT taxes on US goods, which are sold across the continent. This VAT generates tax revenues for national governments and so the US reasons, why should they not shift the burden of taxation in the same way. In this light there is currently no Federal US sales tax.

Moreover, the current structure of the tax system in the US favours offshoring of production. It is thus reasoned that the re-onshoring of this production will bring jobs and revenues back to the US, and so it is in the country's interests to do this.

However, the risk in this US policy calculus is to assume that others can't and won't be able to retaliate effectively. Yet, this thinking may be misguided. Indeed, in the case of Canada, it would appear they already have a list of counter-tariffs they are ready to move forward with, which could prompt further US escalation and therefore greater economic pain on both sides of the border.

Meanwhile, we have already seen tariffs imposed on China in the past week. It was also interesting to see loopholes closed with respect to small scale shipments, meaning that is has become much more difficult to avoid these tariffs. Although there may have been some relief that this was done at a more modest 10% rate than some had feared, it seems that Beijing is unlikely to take things laying down and quietly.

The US administration is eager to remove dependency on China from US supply chains, though this isn't something that can happen overnight. In particular, in the case of critical minerals, China has a dominant share in the refining of these and so it would not be difficult for Beijing to significantly disrupt US industrial production, were it to wish to act against Washington.

From this perspective, it can be seen that trade policy volatility is something that may well play out throughout the entirety of the Trump Presidency. This fact on a standalone basis may impact confidence, delay investment, and infer a softer economic outcome.

We would also note that the short-term wins that Trump may be able to claim around immigration and other policy issues may be achieved at the cost of materially damaging the perception and standing of the US on the foreign stage for years to come.

Additionally, the Trump decision to pull out of USAID has left $50bn of projects around the world potentially hanging in mid-air, with others left to pick up the pieces. On Gaza, one may charitably try to imagine that Trump was trying to rationalise that the whole territory effectively needs to be rebuilt from scratch and it won't be safe or compatible to live in a building site, whilst this is taking place. Yet these comments were at best tone deaf, showing little regard for history and the realpolitik on the ground.

Notwithstanding this, there is a sense that Trump is currently really enjoying himself. His approval ratings are strong, and his domestic detractors have beaten a retreat. The US economy is booming and financial markets have been riding high. He is throwing his weight around and getting things done. In a way, for POTUS, this may be as good as it gets.

But it is sobering to reflect that if this is how the President is conducting affairs when pretty much everything is going his way – how might things play out in a more unpleasant way, were things to start going wrong. Reflecting on this, we continue to think that running low levels of risk and proceeding with a sense of caution is the right way ahead for now. It is just hard to imagine that 2025 will all be plain sailing…

Notes to Editors

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