RBC BlueBay
Asset Management

Market Commentary

Little to celebrate on Liberation Day

We may be on the cusp of April but spring's not in the air for 'free-loading Europe'!

Key points:

- Looming tariffs are causing market unease, especially with the decision to impose a 25% blanket tariff on all auto imports.
- In Europe, policymakers are increasing defence and infrastructure spending as a countermeasure to tariffs.
- In the UK, OBR estimates on growth and interest borrowing costs seem overly optimistic, with the gilt market pushing for a commitment to tax hikes or more spending cuts in the autumn.
- Financial markets in Turkey stabilised after President Erdogan intervened to stop political protests.
- We believe there could be a US policy pivot later in 2025, with executive orders replaced by tariffs legislated in Congress at more moderate levels.

28 March 2025 (London) – Long Ahead of Trump's proclaimed 'Liberation Day' on 2nd April, markets have continued to be preoccupied by looming tariffs and the prospective economic impacts, which trade policy seems set to manifest on the global economy.

If reciprocal tariffs are the centrepiece of next week's 'Liberation Day' announcements, then the decision this week to impose a 25% blanket tariff on all auto imports shook off some complacency that the US administration is preparing to water down some of its hawkish comments to date.

This move unnerved markets somewhat, following a recent recovery from losses, which had been recorded at the start of the month. However, US Treasuries failed to benefit from any deterioration in risk appetite or flight to quality.

Instead, yields pushed higher on concerns that a looming trade war is a stagflationary shock, which will push prices higher, even as domestic consumption and growth come under pressure.

For now, hard economic data continue to point to relatively robust underlying economic activity at the start of 2025. However, forward-looking measures continue to point to potential weakness ahead. In this context, the future expectations of this week's consumer confidence survey posted the softest reading for the past 12 years, amidst concern with respect to tariffs and DOGE spending cuts.

This data can be quite erratic, and it also strikes us that individual opinions, in terms of the future, are heavily coloured by political bias. That is to say that many Democrats currently express extreme pessimism when assessing the Trump Administration policy agenda, whereas those who are Trump supporters are inclined to have a more constructive view.

Indeed, when we dig into credit card data, we would observe that declining delinquency rates suggest that consumer balance sheets are relatively healthy, wages are increasing, and unemployment remains at low levels.

With respect to fiscal policy, some pain from DOGE cuts could start to be felt over the next couple of months. We think that spending cuts will ultimately be used to finance tax cuts, and therefore this is likely to mean the contribution to growth on the fiscal side should be negligible this year and next.

This infers a federal deficit remaining around 6.5% of GDP, unless in the interim, debt servicing costs are materially reduced. In our own assessment, we expect economic activity to cool over the next couple of quarters and we would project growth at a below-trend rate of around 1.5%.

However, with inflation set to move higher, we doubt that the Fed will be easing policy any time soon and this may see Treasury yields continue to trade within a range. Having implemented a short stance in 10-year Treasuries around 4.2%, we currently target 4.5% on the view that this would put us close to fair value.

In Europe, we see policymakers readying robust counter-measures to US tariffs. Leaked messages, which saw US Defence Secretary Hegseth calling Europe 'pathetic' have further enraged European capitals, and bullying behaviour with respect to Greenland is adding to this anger. Inasmuch as Europe is deploying fiscal expansion as it increases expenditure on defence and infrastructure, this may embolden politicians to take a tough stance against the US.

There is a level of understanding in policy circles that tariffs represent a negative supply shock and that monetary policy is not suited to respond to this. As Mario Draghi and others have been urging, fiscal deployment makes much more sense at the current time. Though as we see a major easing of fiscal purse strings and as inflation seems set to move higher, we are doubtful that the ECB will be needed to lower interest rates further in the months ahead.

In the UK, there was plenty of interest around the Chancellor's Spring Budget statement. Reeves sought to reassure markets that OBR fiscal rules are continuing to be observed, though the fiscal calculations leave hardly any headroom in the figures.

It is hard not to think that OBR estimates on growth and interest borrowing costs are too optimistic and it seems that the gilt market is already wanting to push for a commitment for higher taxes or additional spending cuts at the Autumn Budget. February UK inflation data was a bit better than expected, though any good news in this regard is likely to prove short lived.

We see inflation rising to 4% in Q2 as rising bills and administered prices jump in April. In this context, it seems as though the government is left sitting between a rock and a hard place, hoping and praying for better economic news. However, there are some technical measures it could adopt, which would help to alleviate upward pressure on yields.

This first of these would be to tell the Bank of England to cease quantitative tightening. Since the losses the Bank of England is making on gilt sales go straight into the Budget, this is hurting the government badly. There seems no need for QT at this point and ending this harmful policy would help the supply/demand picture in the gilt market as well as benefitting government finances.

Secondly, exempting gilts from banks leverage ratios would also encourage banks to own more gilts than they do today. In this respect, existing financial legislation makes it advantageous to own swaps rather than gilts and this can be seen in gilt swap spreads, which are as wide as -0.85% in the 30-year part of the yield curve. Poor policymaking has thus been responsible for pushing gilt yields higher than they need to be.

In an era when debt servicing costs are one of the UK's biggest and fastest growing budgetary outlays, it can be argued that Labour's lack of understanding of these issues means less money will be available to spend on the priorities voters would like the government to be focussed upon.

In Japan, JGB yields continued to edge higher over the weak, following a 5.5% outcome in Shunto wage round hikes, which mark the strongest gain in 34 years. However, Finance Minister Kato continued to remain non-committal on the question as to whether Japan has permanently exited the period of price deflation, notwithstanding CPI being above 2% consistently for the past three years.

In this respect, the yen remained soft, having lost ground both versus the euro and dollar in the past month. Elsewhere, financial markets in Turkey regained their poise after Erdogan moved to quell political protests. In some respects, it seems like we are living in an era of the political strongman, and suppression of political expression seems to be a less surprising development today than would have been the case up until relatively recently.

Credit markets continue to take their lead from stocks, though volatility remains relatively contained. This would change if concerns over an economic slowdown start to give way to worries that a recession could be looming.

At the time being, we continue to ascribe a low probability to this, though at a time when spreads are tight and there seems limited scope for ongoing spread compression, it strikes us that there is limited benefit from running an overweight credit stance. We continue to maintain hedges against long exposures and, in this way, continue to be more focussed on relative value opportunities in credit, more than an outright directional stance.

Looking ahead

The macro landscape is very challenging to look through with much clarity, given upcoming policy uncertainty. However, we continue to see government debt rising, not falling, on a global basis and this should point towards steeper yield curves.

Additionally, we would see inflation rising in the coming year, not declining, and this may mean that it will be difficult for absolute yields to rally and interest rates to fall, even on the expectation that we are likely to see US growth under pressure in the coming months.

We continue to think that there will be something of a US policy pivot later this year, with executive orders replaced by tariffs legislated in Congress at more moderate levels. However, the journey to this point may be a bumpy one.

In particular, the manner in which the Trump administration is going about its agenda of change is making it no friends overseas. If Trump, Musk, and others expect to be able to bring overseas countries into line, there may be a rude awakening around the corner, and we also continue to express concerns with respect to unintended consequences of US policy actions.

For example, will countries like India and others beyond the BRICS look towards China as their answer? Will other regions such as Europe, Canada and others in a 'coalition of the willing' seek to club together to take a stand against Trump and his minions? If so, what will be the next US response? All of these are difficult questions to answer.

On a 4-year view, we may look at a US economy even stronger and more dominant than is the case on the global stage today. But honestly speaking, who really knows how things will eventually play out. What seems more forecastable is that the next few months are going to be pretty fractious and difficult….

Notes to Editors

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