Global Asset Management
BlueBay Asset Management

Market Commentary

As popular as Kanye West

It's not just a certain rap star who is falling out of favour…

4 November 2022 (London): Treasury yields pushed higher in the wake of this week's Federal Reserve (Fed) meeting, with Chair Powell playing down hopes of a move to a more dovish stance. Incoming data with respect to the labour market have continued to be relatively robust, and although there is broadening evidence of slowing growth across the economy, inflation remains too high and robust labour demand risks adding to this, if wages push higher.

In this context, today's US jobs report will be closely scrutinised. As a point of reference, jobs gains need to average around 70k for the labour market to be in balance and for unemployment to be stable. For the FOMC to reduce the pace of rate hikes from 75bp to 50bp in December, we think that they would want evidence that the three-month average for jobs gains moves below 150k per month from a level that is currently double that pace.

Interest rate-sensitive sectors of the economy have cooled, and this week's ISM report showed that goods price pressures also seem to have abated. Service price inflation may also moderate soon, with rents coming off the boil and prospects for lower inflation from the healthcare sector, which should show up in the data in the next couple of months. Yet, core CPI remains at the high of the cycle and wage pressures represent a risk of second round inflation effects, should inflation expectation start to de-anchor.

In this way, it is very understandable that the Fed is prepared to take rates too high for too long, rather than risk ending the rate cycle prematurely and risking inflation re-accelerating. Consequently, it seems that the FOMC will hike above 5% by the end of Q1, and until data shows the jobs and price pressures cooling, then it remains hard to give an exact prediction of where rates will peak.

This backdrop is a challenging one for risk assets. The dip-buying mentality embedded within the equity market continues to lurk just below the surface and has seen stocks range bound for the past couple of months, even as rate projections for 2023 move higher and the outlook for economic growth and earnings becomes darker.

Robust risk appetite has thus supported financial conditions, but it may seem that any data disappointment, which could trigger fears of a Fed heading towards 6% rates, could lead to a sharp correction. Better data would clearly support hopes for a Fed policy pivot. Yet for now, it seems the burden of proof is sitting very much on the shoulders of those looking for a moderation in the jobs market and prices to occur.

Across the Atlantic, the Bank of England (BoE) also hiked rates by 75bp this week, taking the base rate to 3.0%. Unlike the situation in the US, where the Fed has been responding to an economy that has experienced excess demand, the backdrop in the UK is much more sobering, with the BoE projecting a recession over five or more quarters depending on the path of inflation and interest rates.

We have thought that this weak-growth backdrop would see Bailey deliver fewer rate hikes than markets have discounted, but with short-term SONIA rates having rallied, we have now booked profits on this

position. We continue to remain underweight in the pound and see sterling underperforming on a medium-term view, as the UK economy struggles versus peers.

Prime Minister Sunak is expected to announce a relatively restrictive Budget later this month. This may help stabilise gilt yields. However, it is striking that the UK backdrop is now characterised by weak growth, high inflation and higher taxes. There isn't a lot of joy to be had in a landscape of stagflation. Ultimately we think that the country will turn itself around.

Yet, things will probably need to get a deal worse before they can get better. Along with other countries in Europe, it may appear citizens have grown lazy and entitled. There is a desire to claim leadership on issues such as climate, and a sense of moral superiority. However, it is becoming ever clearer that decisions that have been taken by policymakers and society at large have put us on a path to a broken future, and change will need to come.

The problems of the UK economy have been compounded by Brexit, but are otherwise largely familiar across the continent. Thankfully, mild weather in the past few weeks has kept a lid on gas prices, though more broadly speaking, the latest set of CPI reports across the EU have only added to concerns.

The ECB will similarly find it difficult to pivot against a backdrop of accelerating inflation and as the overshoot drags on, so the risk of de-anchored expectations becomes a rising threat. Fiscal support may help limit the downside to EU growth somewhat, though unless there can be more broad-based agreement in Brussels, the risk is that countries needing to ease policy the most (like Italy) are those which will find themselves in the position of a country like the UK, without the fiscal space to do too much, for fear of being debased by the financial markets.

Broadly speaking, we have been content to close directional positions on rates and look to re-enter risk, if it appears that markets are overshooting. The exception to this is Japan, where we continue to run a short stance with respect to JGBs. The pressure on the Bank of Japan (BoJ) to end Yield Curve Control is continuing to build as policies diverge.

Notwithstanding comments from Kuroda, excessive monetary easing from the BoJ is the singular reason for the weakening of the yen and it feels that policymakers in Tokyo should not be deaf and blind to how inflationary pressures have been allowed to build by central bankers elsewhere, only for them to live to regret this.

In this context, the BoJ's 'transitory inflation' narrative feels badly out of date in 2022, yet Kuroda has the chance to correct course and avert the mistakes made by others. Otherwise, Japanese inflation will continue to build. Businesses that have absorbed rising costs will pass them on and suddenly, prices that have not budged in 20-30 years could suddenly start to move. We feel it makes sense to position short in JGBs in anticipation of a policy change, though as and when this occurs, we then feel there could be even bigger gains to be made by turning more structurally bullish on the yen.

Elsewhere, corporate credit enjoyed a constructive month in October, as investors put cash to work at attractive valuations. As spreads have rallied, we have been inclined to add CDS hedges, as we are somewhat more concerned that risk assets could struggle, should pivot hopes be dashed by uncooperative economic data in the near term.

In emerging markets, we have become more constrictive on the outlook for Brazilian assets, following this week's election of Lula. Investors in Brazil should focus away from politics and back on the fundamentals of declining inflation, which may pave the way for rate cuts in quarters to come. Meanwhile in FX, the dollar has outperformed on a more hawkish Fed. We remain long the USD versus the China renminbi. Elsewhere, we are constructive on the Norwegian krone and Hungarian forint versus the Swiss franc, British pound and Polish zloty.

Looking ahead

We think that patience is called for as we look ahead. It is tempting to go looking for a Fed policy pivot and a year-end risk rally, coming off a year that has seen some horrendous absolute beta returns. Investor cash

balances are relatively high and with sentiment downbeat, it may not take much to provide a positive surprise. However, hope in itself is not an investment strategy.

We therefore think it makes sense to monitor data carefully and look for more evidence before adding more risk into funds. Patience is something that doesn't always come naturally to risk takers but with markets remaining volatile, it may be that we do not need to wait for too long before expressing a more assertive view. Yet having dry powder can be a valuable commodity in times such as these. We can see opportunities building, but timing can be everything in successful risk taking.

Meanwhile, with commentators jumping on headlines that the UK faces its worst recession in nearly 100 years, it feels like central bankers won't be winning too many popularity contests any time soon. The fight against inflation is one that must be won, but it is set to become an increasingly painful one. Indeed, as economies contract, so love for Powell, Bailey, Lagarde et al, could soon evaporate, as rapidly as it recently has for Kanye West….

Notes to Editors
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About BlueBay Asset Management
BlueBay is an active fixed income specialist, structured to deliver outcomes tailored for investors seeking to enhance the returns of their portfolios. Investing globally for clients across corporate and sovereign debt, rates and FX, we manage over USD 128 billion in AUM, as at 31 December, 2021.

BlueBay embodies the best of alternative and traditional asset management through a diverse investment team focused on alpha generation and a robust investment process. This is coupled with our established track record across a broad range of specialist strategies including relative return, total return and alternative investment portfolios.

Our collaborative approach to active client engagement enables us to innovate and deliver outcomes tailored to support our clients' objectives and needs.

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