RBC Global Asset Management

A White House comeback: our US fixed income perspective

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Following Trump's decisive victory, Andrzej Skiba, Head of BlueBay US Fixed Income, gives his views on the Republican sweep and what it could mean for economies and markets.

Key takeaways:

- The scale of the Republican win has surprised markets.
- We prefer shorter duration US fixed income exposure, until we gain policy clarity.
- A loosening of regulation will impact certain industries, such as energy.
- European markets have responded to the result with caution.
- This period of uncertainty could provide attractive entry points for active investors.

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What are your views on Trump's historic return to power this week?

We felt that Trump was likely to win, but the scale of the win and the fact that Republicans captured not just the presidency and Senate as was expected, but also the House, with a small margin likely there, has surprised markets. The fact that essentially all sides of Congress and the executive branch are now under Republican control is an outcome few foresaw as a base case. An expectation of a split House and Senate means the result has been much stronger than anticipated.

The two key voting blocks impacting the outcome were 1) the Latino vote, where across genders, we've seen strong shifts, to the extent that Latino men were now net voting for Republicans for the first time and 2) younger voters, and whether that's to do with the conflict in the Middle East or some other reasons, it's the smallest outperformance for Democrats amongst under 30-year old voters that has been seen in a while. These are the key reasons why Harris underperformed expectations so much.

How is the US economy likely to be impacted, in terms of fiscal policy, interest rates and growth?

Generally, we expect this outcome to allow the administration to have a pretty blank cheque in terms of policy, with little opposition from Congress in terms of implementation. That said, the US is already running high single digit deficits. We don't believe Trump has ample room to add to this deficit, were the US economy to slow down. But clearly, it will remain at elevated levels. That is a key reason why the weakest performing part of the US fixed income universe, within the Treasury complex, is longer duration bonds, because of concerns around deficit levels over the coming year.

Are any under/over-valued asset classes set to be affected by the new administration's policies?

From a fixed income perspective, we prefer shorter duration exposure, until we gain policy clarity. We note that the market will have to contend with higher inflation and the Fed having less of an ability to cut rates into a slowing economy.

That said, from a tactical perspective, spreads are reacting positively, following positive sentiment in equity markets. Lower taxes, less regulation, and more M&A are all factors that support equity valuations. That sentiment has sipped through into the fixed income universe, where even though total returns have been hit hard following the election, with a rise in government bond yields, we've seen spreads move tighter.

One area we think investors will gradually pay more attention to are floating rate assets. In a higher-for-longer environment, as long as issuers that would be particularly exposed to the trade war are avoided, the leveraged loan space should look attractive to investors capturing elevated yields, but not facing potential negative impact on total returns from a rise in government bond yields.

In terms of potential regulatory changes, what could be the impact on key industries e.g. energy?

We would expect less regulatory intervention in the new administration. One area of the market most powerfully impacted will be M&A. The Biden administration blocked a range of transactions, and that is expected to diminish under Trump's rule.

At the same time, we also expect a loosening of regulation in certain areas, e.g. energy. There is a strong willingness from the Trump administration to facilitate more drilling activity in the US, but whether US E&P companies take up the administration on those offers remains to be seen; they've been very careful in terms of increasing production, and there's much more focus on cashflow generation rather than growing revenues across the energy space, but from a permitting perspective at least, we expect a loosening of terms compared to previously.

We also expect to see some ESG-related regulations diminish in scope or removed, and businesses having more flexibility in terms of planning and CapEx. That should be stimulative, from a growth perspective.

While we expect some of these changes to be broadly contested by the Democrats, they will have very limited ability to stop them through Congress.

How do you see the US' relationship with Europe playing out?

Europe is in a tricky place. There's a reason why German government bonds have initially rallied, rather than sold off in sympathy with Treasuries. A trade war impacts Europe negatively, and given the trade surpluses many European countries have with the US, Europe can't do much to stop Trump's policy implementation. From a growth perspective, this could be a drag for Europe.

Equally, it also raises challenges from a fiscal perspective, now that we expect the US to reconsider supporting some initiatives e.g. Ukraine in its war with Russia, or to have a much more transactional approach to supporting NATO, by calling on European partners to step up defense spending.

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In countries like Germany, for example, will there be a shift in policy that allows for more spending, whether that's defense related or elsewhere? Mario Draghi's recent paper highlighted how Europe is falling behind, so will a different tone and a more self-centered US perspective spur some initiatives to add to fiscal spending and help increase competitiveness within Europe?

So far, we've seen piecemeal responses, but it will be interesting to watch whether Trump's arrival is the catalyst that was needed for Europe to wake up, in that respect. We think it's perfectly appropriate for risk assets in Europe to respond to the Republican sweep with a sense of caution, and make it more likely for the ECB to consider a 50bps cut over coming meetings, anticipating some of the negative impact of growth from changes in US policy.

Which key policy developments are you monitoring, in terms of influencing investment decisions?

We're focusing on the budget for the next administration and understanding how stimulative it will be. We will also monitor how heavy Treasury issuance plans will be, since running elevated deficits could put a strain on Treasury markets.

That is partly why we see potential for more pressure, especially further out the curve for Treasuries, as the market has to absorb a lot more issuance and might not be inclined to do so, as highlighted recently in the moves in swap spreads.

We will also look at perspectives from the Fed, how they're taking into account change in both fiscal and trade policy, and in assessing inflation risks in the US versus the prospect of potential slowdown, as we go through 2025.

The above will help determine how long we should remain cautiously positioned, especially in credit markets that are close to multi-year tights, and when to re-engage with the space, either through treasury markets or the credit universe.

What are your views on the dollar, going forward?

The result should be supportive of the dollar, and we saw a rally as results came in. The extent of a further rally depends on the policy mix, and Trump's implementation of his promises. Some of the move happened in the 24 hours after the election, and the market might want more clarity in terms of policy implementation to determine how much further the dollar needs to strengthen.

And finally, how do you believe the US-China relationship will play out, following Trump's win?

We believe China will be the first to have tariffs implemented, which would create space for volatility in US-China relations. However, Trump has sounded less committed to supporting Taiwan recently, and much less committed than the Democrats. We can see how tariffs could be used as a negotiating tool. The same goes for the extent of US support for Taiwan becoming more transactional.

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There are very few if any members of Trump's economic or policy circles who are dovish on China. Instead, there are many China hawks, but we understand that Trump often pursues a transactional type of diplomacy. So, we will see how the US uses the different levers it has as its disposal, over the coming months.

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