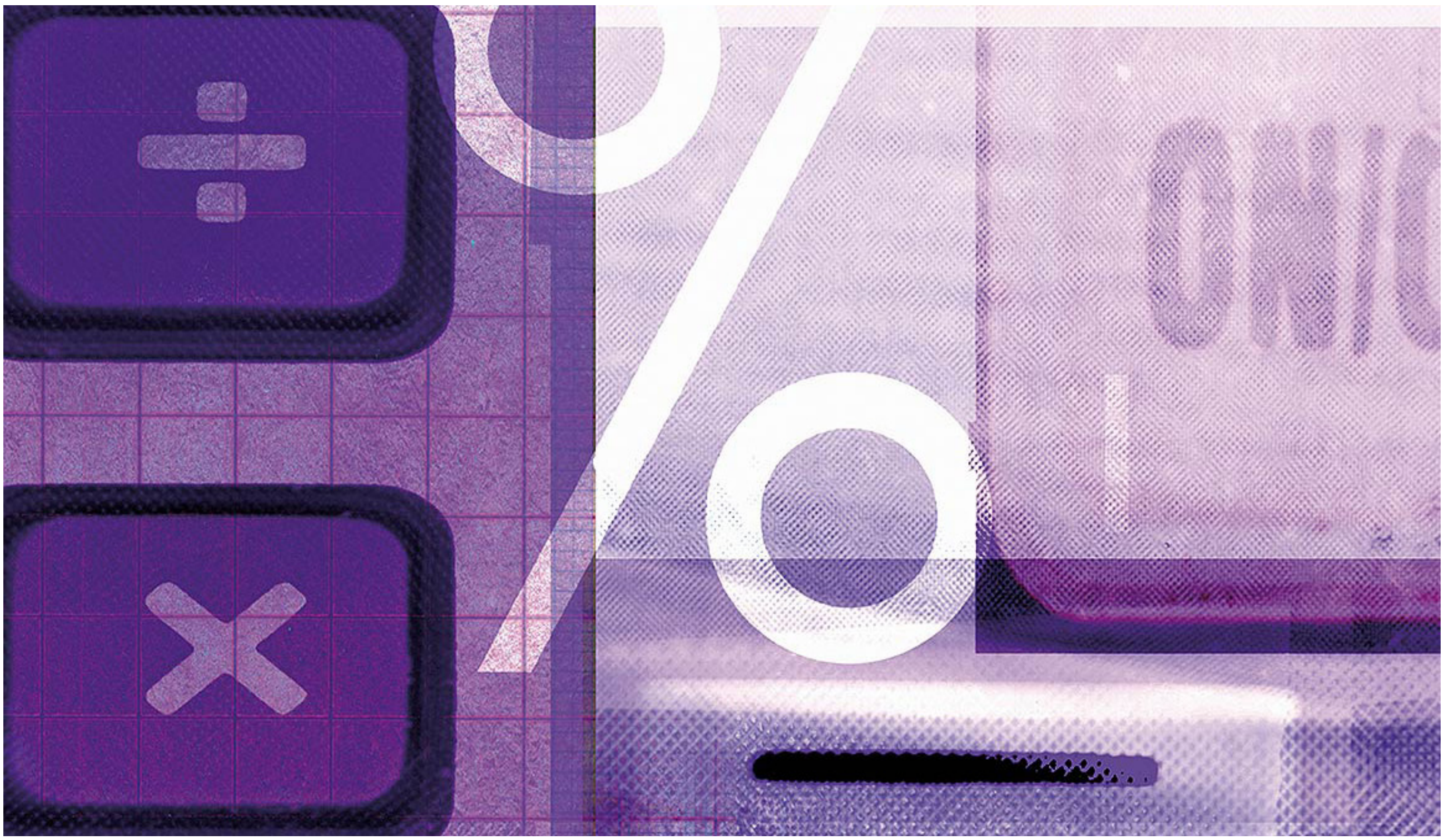
RBC Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
Mark Dowding's Global Macro Update

July 5, 2019



Are Interest Rates Set to Disappear?

Radical rates chatter seems extremist to us – long live central banking!

Soft global PMIs saw bond yields continue to move lower over the past week, on anticipation of forthcoming monetary easing by central banks.

A relatively soft data backdrop in China dragged Asian sentiment weaker and, although a truce with respect to tariffs has been agreed, it seems likely that further steps will be required to stimulate growth, with activity seeming to stall after a constructive start to 2019.

European data has also been a cause for concern, even if falling unemployment and rising wages suggest that the domestic economy is in better shape, with the service sector in a much healthier position than manufacturing.

US data has continued to hold up much better than elsewhere, but this has not stopped investors buying Treasuries and pushing interest-rate expectations lower – even with 50bps of cuts already fully priced to September and 75bps discounted through to the end of the year.

Data round-up

In our view, data surprises to the upside could yet see the Federal Reserve (Fed) defer a decision on rates later this month with equity markets at record highs. However, there is a clear sense that the risks of making a policy error, by over-stimulating demand and creating inflation, appear to be low at this juncture.

Therefore, it may require a jobs report adding more than 225k payrolls, plus evidence of higher wages and consumer prices, in order for the Fed to stand pat, with Powell also under ongoing political pressure from the White House to cut rates and stimulate the economy.

In Europe, bond yields have driven to fresh record lows in the past week, as markets continue to digest a more dovish outlook for the ECB, in the wake of Draghi's Sintra speech.

Comments from other board members in recent days, alluding to further policy stimulus, have provided additional confirmation of a pivot in monetary policy, with markets speculating on forthcoming easing steps in the weeks ahead.

ECB appointments get political

The impression of a more dovish ECB was also reinforced by the nomination of Christine Lagarde as the next president of the central bank, as part of a package of appointments that has seen Ursula von der Leyen put forward to head the European Commission.

These appointments seemed to highlight a relative victory for France and Italy in these negotiations, inasmuch as it points to an EU agenda which will likely be more pro-growth, fiscally relaxed and monetarily dovish than would have been the case had a candidate such as Jens Weidmann taken over at the ECB helm.

From our perspective, we would observe that Lagarde's limited experience in economics and central banking make it likely that she will rely quite heavily on chief economist Philip Lane when it comes to setting monetary policy. In this way, her candidacy may represent continuity at the ECB, given how closely aligned Lane has been to Mario Draghi. Arguably, Lagarde is a clever choice – albeit a political one.

We would also observe that if difficult decisions to deliver policy initiatives are likely to be needed, then there will be a desire to ensure that steps are taken prior to her taking office in Q4 this year, so that she is not exposed at the very start of her tenure, noting that anyone coming after Draghi would always be a tough act to follow.

This being the case, we anticipate a 10bps rate cut later this month, along with deposit tiering to offset the detrimental impact that negative rates are having on the banking sector. Thereafter, we see scope for reactivation on the CSPP and PSPP programmes in September, should downside risks in the eurozone persist.

Brexit: Summer impasse to general election?

UK Gilts also rallied this week, with the BoE joining the chorus of monetary doves and 10-year yields moving below cash rates. This price action may seem quite logical on the face of it, with economic data surprising to the downside and the looming prospect of a Johnson premiership pushing the country in the direction of a 'no deal' Brexit later this year.

However, we continue to believe that a Brexit impasse will make a general election in the autumn an inevitability, and we would place a 30% probability on there being a Labour-led coalition in government by the end of this year.

In this case, we believe that Gilt yields could move materially higher. In discussions with Labour, it appears that they fully understand the need for a monetary to fiscal policy hand-off at a time when further rate cuts and QE would only drive-up asset prices to the benefit of the few and to the detriment of many in society. Plans to invest heavily in new technologies, notably in the green economy, we feel could help stimulate productivity growth over time and seem appealing.

Moreover, it could be said that with real yields on inflation-linked bonds as low as -2.2%, this only serves to impoverish savers and to force companies to invest cashflow in non-productive pension assets instead of boosting investment or jobs.

In this way, it can be argued that governments which are failing to use fiscal policy effectively are governments without any ideas; in our view, the true fiscal irresponsibility of our time is the obsession with debt reduction and austerity, whose costs fall disproportionately on the vulnerable.

Indeed, rethinking fiscal policy will be a big challenge for many policymakers whose thinking is rooted in the past.

In many cases, we feel a reverse Keynesian tap could prove beneficial. It is also odd to think that at a time when governments in Europe can issue bonds at a negative yield, the easiest way to reduce your debt levels is to issue more debt!

That said, we observe that policy tends to move slowly and although the direction of travel is towards fiscal accommodation, this will take time to evolve in much of the Continent – although we anticipate a Labour government in the UK would be much quicker to embrace such thinking.

Central banking called into question

As global bond yields have continued to fall in the past week, it has been interesting speaking with policymakers, debating whether interest rates, as we know them, could end up disappearing.

Federal Reserve nominee Chris Waller has espoused the view that the Phillips curve does not exist, citing low levels of both inflation and unemployment in Japan. Alongside fellow nominee Judy Shelton, there is a line of thinking that monetary policy cannot impact inflation and therefore whether central bank rates are a historical relic and actually serve any purpose in today's economy.

In extremis, this could lead one to question to whether interest rates should be abolished altogether – adopting a monetary policy stance that the Taliban would surely approve of! However, we find this narrative deeply disturbing and greatly mistaken. Central banking is not dead and to think that the job of the Fed is to follow market expectations is highly dangerous.

With rate expectations pushed lower as bond yields fall, it is interesting to see how rising equity valuations have seen risk parity funds needing to buy even more bonds as a hedge to their long equity positions.

Without any checks or balance, this could see market expectations continue to run ahead and were the Fed to feel a need to confirm market thinking, there seems a real risk that this may create more economic harm than good.

Arguably central bankers should seek to lead the market, not follow it. Moreover, even if the Fed were to conclude that the level of interest rates is having little impact on consumer price inflation, it can still have a massive impact on asset price inflation. In this context, cutting rates to drive up asset prices may seem like an attractive idea to Donald Trump – but this will surely widen income disparities within society and risks creating bubbles, while depleting the scope to ease policy in the future when these bubbles eventually burst.

Looking forward

Our core views have shifted relatively little. We remain constructive in the euro periphery and see fundamentals, valuations and technicals all pointing in a favourable direction in Italy and Greece over the summer.

We remain bearish on UK Gilts and the pound on political uncertainty and election risk and maintain a constructive view on euro credit spreads and financials, in particular.

We are inclined to think that the Fed will under-deliver on rate cuts versus market expectations and this leads us to a short duration bias. As for talk of recession risks in the US, we remain dismissive.

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