Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
Mark Dowding's Global Macro Update

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Troublemakers in Yellow Vests

The Yellow Vest movement has seen Macron's government deliver several concessions to protesters. This means France's resulting fiscal slippage arguably casts the Italian budget in a better light.

Risk appetite has stabilised during the past several days, with the S&P holding technical support above the 2600 level, as China trade headlines have pointed to a temporary easing of tensions with the US. More generally, however, events in Europe have tended to provide most of the focus in the past week.

Risky Strategy

In the UK, having cancelled plans to hold a parliamentary vote on her Brexit deal fearing a heavy defeat, Theresa May managed to fight off a 'no confidence' vote in her leadership of the Conservative Party. Nevertheless, we suspect that attempts to woo European leaders into modifying this deal are set to be given short shrift, and this leaves plans seemingly stuck, with both the UK and the EU needing to accelerate their planning for an unwanted 'no deal' scenario.

As we have written before, avoiding a hard Brexit requires either an agreement to pass, or for Article 50 to be rescinded. Yet with 117 Tory MPs voting against Theresa May in the confidence vote, it seems that the prime minister's authority is weakened, and it is hard to foresee how the current deal will pass without material changes, which the EU aren't inclined to give. Worryingly, it strikes us that many Conservatives are minded to believe the narrative that the EU will always give in at the end of negotiations and so they are best served by running down the clock to March. Yet this is a risky strategy, as opinion could harden on both sides in the interim.

In light of this, we continue to believe that there remains too much complacency around a 'no deal' scenario and the UK will probably need a moment of crisis, where it stares into the abyss, before a change in direction can take place. Ultimately, we feel that the past week is consistent with a view that the Brexit decision may ultimately be reversed but moves to a general election or a second referendum are unlikely to manifest for another couple of months.

Macron's Troubles

Across the English Channel, President Macron has also been having a tough time at home. The Yellow Vest protest movement has seen Macron's approval rating fall below 20%, as civil disorder and rioting has closed stores and made for ugly TV footage.

What started as a protest against planned rises in fuel duty has morphed into a more general outpouring of frustration among the working and middle classes, whose real disposable incomes continue to stagnate, even as economic growth prospects have improved. Rising pressure has seen the government deliver a number of concessions to protesters, hoping to quell these demonstrations, though this has come at the price of delivering negative fiscal consequences.

France had planned for a fiscal deficit of 2.8% in 2019, but a figure closer to 3.5% may now be likely. This means that France, once again, will be in breach of the 3.0% Maastricht ceiling, as it has been in 10 out of the past 11 years. These developments have weighed on French government bond (OAT) spreads, pushing these to their 2018 wides versus Bunds, though we don't see them moving much wider from here.

BTP Spreads Ease

Fiscal slippage in France arguably casts the Italian budget in a better light, relatively speaking. Italian government bonds (BTPs) have rallied in the past week, with Rome announcing a downwardly revised 2019 target close to 2.0%, following pressure from Brussels. This may still see Italy placed into Excessive Deficit Procedure (EDP) by the EU Commission, but the constructive tone of recent dialogue is consistent with the further de-escalation of market tensions and Italexit fears. Arguably economic growth is a bigger threat to Italian prospects than politics just for now and in this light, it is encouraging to see recent data showing bank lending growing by 7% year-on-year.

From a political standpoint, we have also been interested to see La Lega opening a bigger advantage over the Five Star Party (33% versus 26% in the latest polls). There has been speculation that Matteo Salvini could call elections as early as March, in order to win a mandate for a government of the 'Right' in coalition with Forza Italia and Brothers of Italy. Were this to occur, we feel that investors would view this in a positive light and consequently we have been maintaining long positions in BTPs, even as 10-year spreads rally back below 270bps.

Draghi Back in the Spotlight

Meanwhile, the European Central Bank (ECB) continued to deliver a relatively upbeat message with respect to eurozone growth and inflation. Arguably its bullish 1.9% growth projection for 2018 may stretch credibility and may partly be a function of the Committee not wanting to revise figures down too much, at a point when it is de-facto tightening policy by ending its QE balance sheet expansion.

However, a constructive view is also grounded in a relatively upbeat picture from the domestic economy, with GDP details showing that exports were a disproportionately large drag on growth in Q3. In this context, Draghi may have disappointed those who had hoped for a more dovish message this week, with him making no real mention of an extension to longer-term refinancing operations (LTRO) or an Operation Twist – even though these options remain very much at the ECB's disposal in Q1 should downside risk materialise.

Not Done Yet

As we look ahead, the year is now nearly done – yet it seems as if markets have hardly slowed down for Christmas. Next week we will be focusing on the Federal Reserve meeting, with our view that the market is premature in trying to call a top in the US rates cycle. We see US domestic data remaining robust and our analysis of the net fiscal impulse suggests a net add of 0.8% of GDP in the year to October 2019 compared to 0.5% of GDP in the year to October 2018. Growth in jobs and wages are also benefitting incomes and so the outlook for the Mighty US Consumer looks to be strong, as we enter the New Year.

Otherwise, there remains scope for further political developments across Europe before the end of 2018, even as financial market liquidity starts to dry up and this could make for some volatile trading and some interesting opportunities. The ERG Brexiteers within the Tory Party might have failed to push May from office this week, but they look certain to continue to cause trouble and seem unlikely to lay down quietly, even if the prime minister cannot face a similar challenge for another 12 months. Perhaps we may all need to keep a sense of vigilance with respect to Men In Yellow Vests, hell bent on creating trouble.