BlueBay Asset Management

A British conundrum

News Analysis

UK assets are set for a rough ride and global central banks may be growing more hawkish than previously expected

by
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An upbeat address from Mario Draghi saw Bund yields push higher during the past week, as markets read his comments as indicating that the European Central Bank (ECB) is getting closer to tapering its QE purchase programme. Although clarification the following day suggested that the market was getting ahead of itself, yields stayed higher on the perception that the tide may be starting to turn and with Bank of England's (BoE) Mark Carney flip-flopping, in suggesting that 'some removal of stimulus is likely to become necessary', there is a growing sense that global central banks may be growing more hawkish than previously expected. Notwithstanding this, equity markets traded slightly higher on the week and credit spreads were mostly tighter, helped by a rebound in oil prices back above US$45 per barrel.

Looking ahead, it strikes us that market perceptions which have assumed a continuation of ultra-low inflation and dovish monetary policies are currently being tested by global central bankers, who seem inclined to look through a recent dip in CPI data, against the backdrop of a relatively upbeat global economy. Over the past couple of years, markets have consistently priced materially less monetary tightening than the Fed in its eponymous dot plots, though at some point, it will be difficult to continue to fight the Fed if it is determined to proceed with policy normalisation along the path, which we expect. In the week ahead, the monthly payrolls report will be closely watched with wage numbers also an important area of focus. With broad financial conditions moving easier notwithstanding three rate hikes in the past six months (thanks to a softer US dollar, higher equity prices and tighter credit spreads) should labour market data surprise to the upside, we would not be overly surprised if the Federal Open Market Committee meeting in July is used to announce the start of the balance sheet reduction programme. It is widely believed that this is more likely in September, but with most of the details already pre-announced to the market in June to a relatively muted market response, we do not believe it will be necessarily imperative to start this at a quarterly meeting when a Janet Yellen press conference is scheduled.

In the eurozone, we continue to hold the view that the ECB will remain very cautious, as it eyes the exit of its policy of monetary accommodation. Whilst the economic backdrop continues to remain very upbeat, low inflation and a large output gap mean that Mario Draghi can bide his time and consequently we believe that 10-yr Bund yields can remain in a range between 0.25% and 0.50% for another few months to come. This backdrop should continue to support risk appetite in the periphery as political risk continues to wane and we remain overweight in Cyprus and Italy in anticipation of tighter spreads. We also remain constructive on credit spreads, with Euro financials likely to continue their recent outperformance in our view.

The backdrop for emerging markets (EM) also remains broadly supportive in our perspective. We expect a number of central banks to cut interest rates in EM, with real interest rates relatively high and inflationary pressures moderating. A recent easing of financial conditions in China should also be growth supportive and more broadly it appears that commodity prices may be trending higher again, away from the dynamics of oversupply in the oil market. We don't see many clear trends in FX for the time being, though in the absence of broad based US dollar strength, we believe that a number of EM currencies including the Indian rupee and Malaysian ringgit have room to rally.

By contrast to the constructive global outlook, we continue to retain a downbeat assessment on the UK. Slowing growth as the economy loses jobs, investment and tax revenue along the road to Brexit should lead to a worsening budgetary position. This is likely to be exacerbated by fiscal easing, as the tide turns against austerity and Tories are required to loosen the purse strings to counter declining popularity and growing support for Jeremy Corbyn. It no longer seems right or fair that public sector workers such as nurses should be limited to a 1% pay rise cap at a time when inflation is moving above 3% coming after years of falling real incomes for the majority of citizens. Moreover, we would observe that the UK has a tendency in its past to reflate its way out of its troubles and we would expect this option to be the path of least resistance over the coming quarters, in order to limit the pain in a stagflationary economy.

Against this backdrop, the BoE is likely to find itself in a difficult position. Ultimately it may become hard to raise rates if growth is slowing, even if many on the Monetary Policy Committee believe that it may be the right thing to do. We remain bearish on the pound in anticipation of a hard Brexit and very bearish on Gilts, given deeply negative real yields, which point to a structural over-valuation. With the BoE unlikely to deliver more QE and Gilt supply likely to grow with the deficit, Gilts are unlikely to be an asset demanding a scarcity premium going forward and with 10-year yields close to 1%, we see little scope for UK yields to fall but plenty of room for yields to rise. With political risk unlikely to go away, it feels like a moment to be structurally bearish on all UK assets. That said, at least there are rumours that the London property market is booming again this week after a woman paid £1 billion for a terraced house with a SW1A postcode.