RBC BlueBay Asset Management

Market Commentary

Trump Slump!

Tariffs and trade: a new level of chaos

Key points:

- Treasury yields rose at the start of the week, as investors sought safety amidst falling US stock prices and economic concerns.
- Trump's tariff threats and policy pronouncements raised trade war fears and unsettled investors.
- Income German Chancellor Merz's fiscal policy reversal has led to higher inflation and growth projections in Europe.
- Our meetings in Tokyo suggest a strong Japanese economy, with a likely increase in domestic allocations towards Japanese fixed income.
- The potential for a decline in risk assets remains, and we maintain a cautious stance on credit and risk assets overall.

14 March 2025 (London) – With Treasury yields rallied at the start of the week, as lower US stock prices prompted a flight towards quality. Although economic data, such as last week's payrolls report, remain relatively healthy, concerns with respect to how tariffs and Federal job cuts may weigh on economic activity have led to some concerns with respect to forward equity earnings.

Meanwhile, those investors who had assumed that a 'Trump put' would prevent equity indices moving lower, were shaken in this complacency by comments from the US President last weekend, suggesting that he is much less sensitive to weaker markets in the near term compared to his first term in office, as long as the agenda of transformation he is seeking to deliver is able to be fulfilled.

Although equity market declines stabilised for a time mid-week, it was notable that any recovery in equity indices was muted, even as flight to quality flows in fixed income were reversed as the week progressed.

From a fixed income perspective, it is hard to build much of a case for the Fed to consider lowering rates in the near term and, despite a somewhat better-than-expected US CPI print, there remain risks to inflation in the context of tariffs being imposed over the course of the months ahead.

We have argued that the imposition of tariffs in the US economy represents something of a negative supply shock. Central banks will voice how their toolkit is suited to managing aggregate demand in the economy and can respond to demand shocks. However, interest rates are not such a helpful tool in the context of supply shocks, as we experienced during the Covid pandemic.

With interest rate futures markets already discounting 75bps of additional Fed easing in the remainder of 2025, we think that this is too much, and in light of this, we moved to a short duration stance in US rates just over one week ago.

At the current time, it is still hard to even rule out that the Fed may end up hiking as its next move, notwithstanding interest rates sitting at levels above its assessment of the long-term neutral level of rates.

In particular, having been wrongfully dismissive of the move up in inflation in 2021, the FOMC won't want to repeat such a mistake again. Consequently, we think there may be a pain threshold around 4.0% on core CPI (3.5% on core PCE), at which point the Fed could feel under pressure to nudge rates higher.

Meanwhile, in the White House, the past week has seen no end to the ongoing pronouncements around policy coming from Trump and his team. The threat to double tariffs on Canada and to implement retaliatory tariffs against any country with the temerity to respond to US trade actions, has unnerved investors, who fear the consequences of an escalating trade war. This has not stopped many countries, especially the Eurozone, from slapping retaliatory tariffs on the US, resulting in ever more aggressive rhetoric out of the White House. An eventual endgame in which the US legislates a 10% tariff as a pseudo consumption tax may end up being seen as a reasonable landing point.

However, with Trump's confrontational and occasionally bullying approach, the risk is that tensions continue to mount in the near term and relations sour to the point where an immediate off-ramp becomes more difficult to agree, absent more material economic and financial market harm in the interim.

Certainly, it may seem that uncertainty can drive sentiment in the short term and businesses will reflect in general that what they need to thrive is stability, not instability, in the macro and policy environment.

Across the Atlantic, markets continue to digest the ramifications of last week's fiscal U-turn from German Chancellor Merz. Investors have continued to revise up their projections for German and Eurozone inflation, and we believe that GDP is now likely to trend at around 1.5%, compared to half of that amount prior to these moves.

Similarly, we see inflation higher than before, with CPI expected to trend at around 2.5% compared to a level a bit below 2% previously. As the ECB also revises its forecasts, we think this means we may have seen the last rate cut in the current ECB easing cycle and, against that backdrop, we believe that interest rate markets still discount too much additional monetary easing.

If this means that cash rates stay at 2.5%, then average Eurozone government 10-year yields at 3.25% today seem not far from fair value, though from a spread perspective, bund yields may continue to edge higher as they lose some of their prior scarcity premium, given prospects for much more material forward-looking supply.

Meeting with policymakers and investors in Tokyo this week have affirmed a perception that the Japanese economy is in good shape. Growth momentum picked up towards the end of 2024, and we look for a strong outcome in the Shunto wage round to continue to support inflation and ongoing monetary policy normalisation.

That said, there does not seem much urgency on the part of the BoJ to hike rates before July, and with JGB yields having risen materially over the past couple of months, there is a broad-based assessment that there will be an increase in domestic allocations towards Japanese fixed income, at the expense of overseas fixed income, in the coming fiscal year.

In some respects, having been berated by domestic investors for expressing what they saw as an overly bearish view on Japan rates and yields in the past, it seemed odd that we now have a view much more in line with the domestic consensus. We continue to project yen cash rates at 1.0% at the end of 2025, and rising to 1.5% in 2026, with 10-year JGBs climbing to 1.75% and 2.0% over the same time horizon.

However, we think that at that point, the rise in JGB yields will be contained. To date, the rise in yields has been broadly welcomed by policymakers. Yet, with Japan maintaining high levels of government debt, if yields rise too much then this can feed concerns related to fiscal debt sustainability. In this way, either domestic investors will step in to support the market, or otherwise policymakers may end up doing so in their place.

Meanwhile, we continue to highlight the relative cheapness of 30-year JGBs relative to 10-year securities on the Japanese yield curve. Aside from this though, the biggest opportunity in Japan appears to be in the FX space. In recent days, the yen has reversed some of the gains it had been making as risk aversion started to rise.

However, as rate and growth differentials narrow, so we think things are pointing in the yen's favour on a forward-looking basis. Policymakers in Washington and Tokyo both desire a stronger yen and, as Japanese investors look more to domestic assets, so this can also be a supportive factor.

Meanwhile, some of those who have been most bearish on the yen long term point to a contraction in GDP as the population shrinks. However, inasmuch as retired citizens sell overseas assets as they draw down their retirement savings, this is less than clear. Additionally, it is worth challenging the notion of a long-term Japanese GDP contraction. Productivity growth in Japan is currently 1% (compared to 0% in most of Europe).

Furthermore, investments in technology and corporate reforms both suggest there could be room for productivity growth to increase further in Japan. It is also striking that the country continues to maintain a strong work ethic at a time when this is on the wane in the west. There are few other countries you can travel to, if any, where you still get a full schedule of meetings on a Friday and everyone is attending the office five days per week on a routine basis!

In corporate bonds it is worth highlighting the outperformance of European corporates compared to the US so far in March. European spreads are unchanged despite some weakness yesterday, while US spreads are wider, with the ongoing supportive technicals in Europe thus far trumping the concerns around tariff news, and of course the risk off tone in stocks.

According to ICE BofA indices, European corporate spreads remain at 90bps, while US has widened back out to 97bps. This is the first time Euro spreads have traded inside of US spreads since the invasion of Ukraine in Q1 2022.

Looking ahead

We think that policy noise from Washington may diminish somewhat after a couple of turbulent weeks. On trade policy, attention is likely to switch towards deadlines at the start of April.

Eventually, we may expect it to become clearer that the forward-looking path will be to legislate tariffs in Congress at a reduced rate around 10%, noting that this legislation needs to occur in order for revenues raised to be incorporated into the Federal Budget calculations.

This process will take time and, in the interim, Trump will continue to make use of executive orders in order to drive his tariff agenda, and also as a mechanism to leverage other policy aims, including border security and drug control to name but two.

Macro and geopolitical reshaping may have both short-term and long-term implications for economies and asset prices. In the near term, it may seem that there may remain risks to the downside on risk assets, and we maintain a cautious stance on credit and risk assets in general. However, we don't think that economic slowdown fears should be overplayed, and we continue to see a US recession this year as unlikely.

We also foresee relative winners and losers, as well as unintended beneficiaries and casualties, from Washington's stance. We remain cautious on prospects for Canada as the upcoming election makes it politically popular to try to confront, rather than acquiesce, Trump.

We have also been wondering about macro implications for an economy such as Ireland. The Celtic Tiger has roared over the past few years, helped in no small part by heavy inward investment from US firms. This has been particularly notable in the tech sector, where companies have established corporate headquarters to take advantage of beneficial tax rates.

In this case it is easy to see how Trump and colleagues will want those jobs and investment back in America and, if re-shoring is widespread, then this could be a factor that impacts local property markets and other sectors of the economy.

Notes to Editors
Lydia Cambata: +44 7578 252 424
LCambata@BlueBay.com

About RBC BlueBay Asset Management
RBC BlueBay Asset Management ("RBC BlueBay") represents RBC Global Asset Management outside of North America and is an active asset manager with expertise across fixed income, equities and alternatives.

RBC BlueBay's solutions-driven approach means it endeavours to empower clients with the knowledge they need to help shape their investment decisions. It works and evolves with clients, creating and customising investment products that meet their needs.
Responsible investment is embedded across RBC BlueBay's business. This means it is not just an investment focus but is also ingrained in its client service experience and work to deliver solutions that support real-world impact.