



RBC BlueBay  
Asset Management

# Investment Outlook Presentation

March 2024

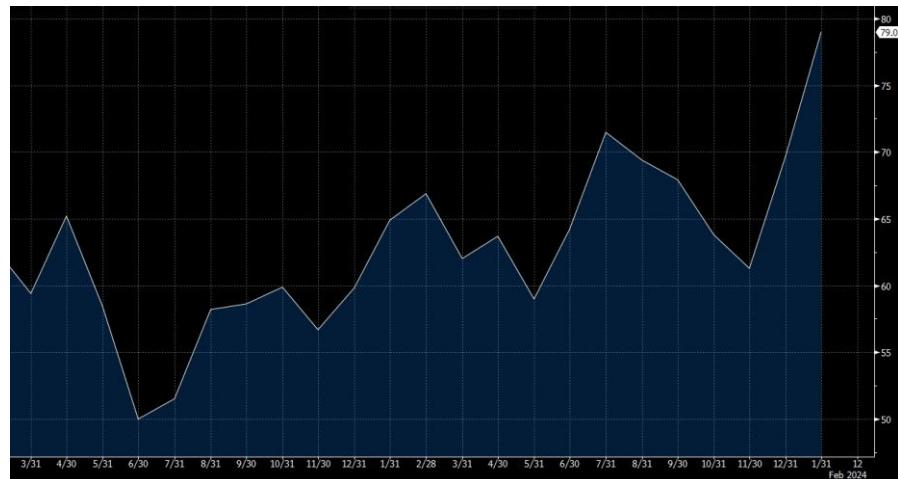
**Mark Dowding**

Chief Investment Officer

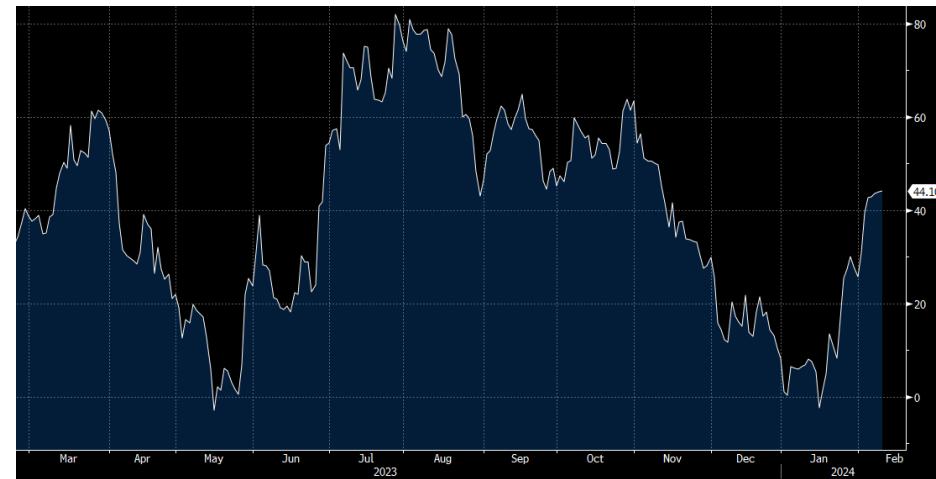
# US growth continues to confound the sceptics

- US economy grew at an above trend pace in H2 last year, confounding predictions of a slowdown
- Economy retains plenty of momentum coming into 2024
- Recent data shows signs of acceleration, linked to easing in financial conditions
- We expect activity to moderate in coming months, with a soft landing the most likely scenario

Consumer confidence highlights robust economy



US Economic Surprise index accelerates



Source: Bloomberg 14/2/2024

# The destination is more important than the timing

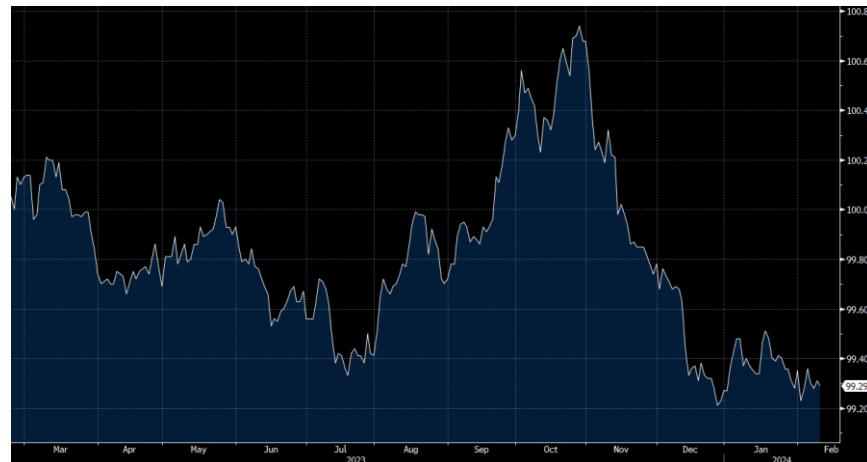
- FOMC expects to start cutting rates in the coming months – markets have been impatient, wanting to front run the Fed
- With economy robust and markets buoyant, there is no pressure for the Fed to be in a hurry – unless there are political motives at play
- Bigger question is the extent of easing likely in the course of the coming cycle

## Obsession over timing of first cut



Source: Bloomberg 14/2/2024

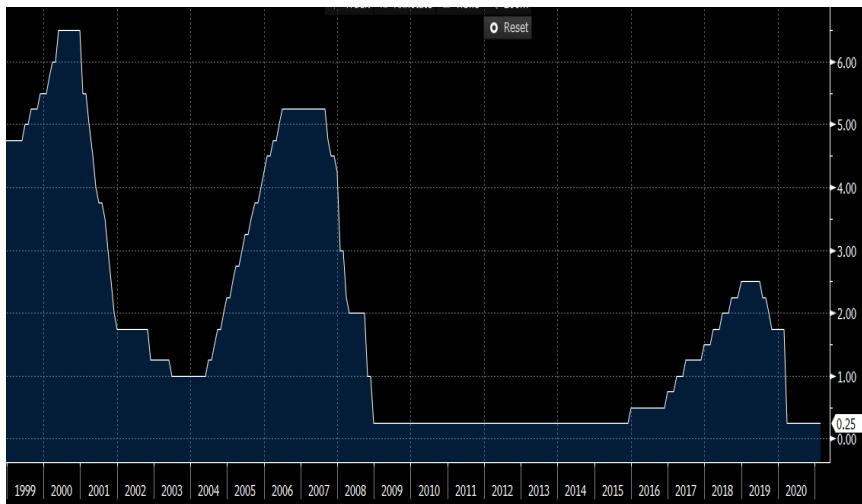
## GS Financial Conditions Index Has Eased Already



# Up the staircase and down the elevator?

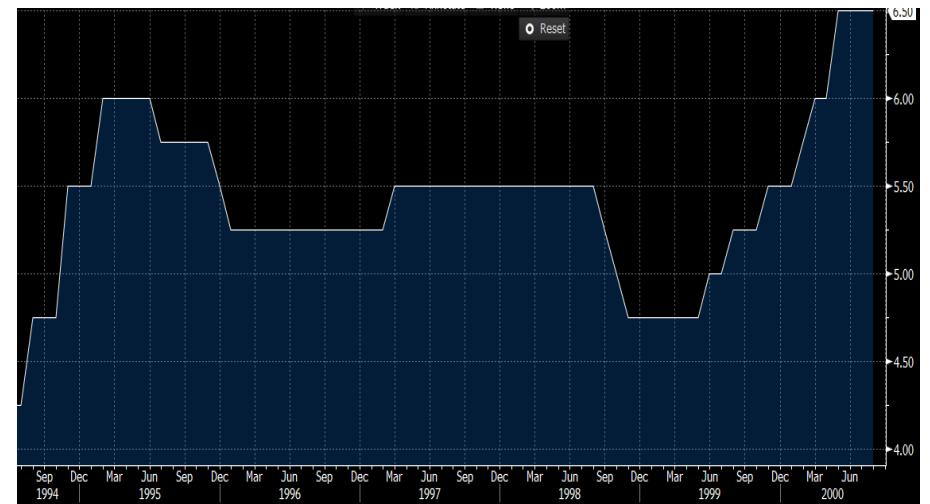
- Conventional wisdom holds, that rate cutting cycle is much faster than a tightening cycle
- Aggressive rate cuts (>200bp) will be delivered if there is an abrupt slowdown (hard landing) or a major financial market event
- In a soft-landing scenario, a rate cutting cycle could be shallower (<100bp) - like the examples from mid 1990s

The last 3 Fed cutting cycles since 2000



Source: Bloomberg 14/2/2024

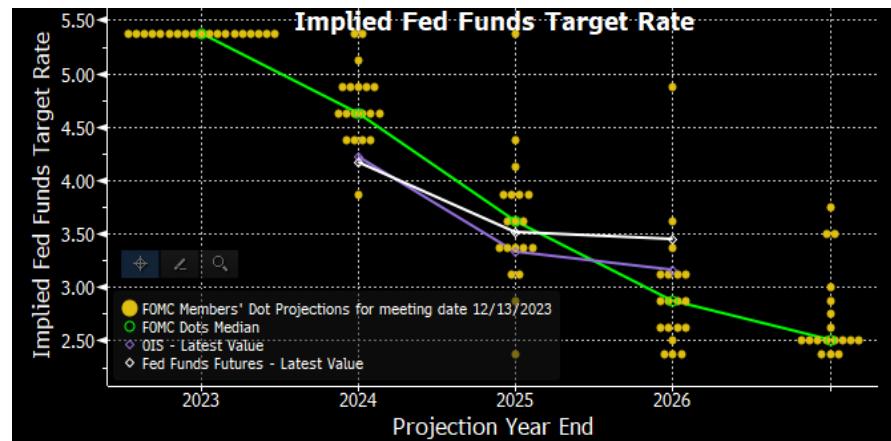
The previous 2 rate cutting cycles in the 1990s



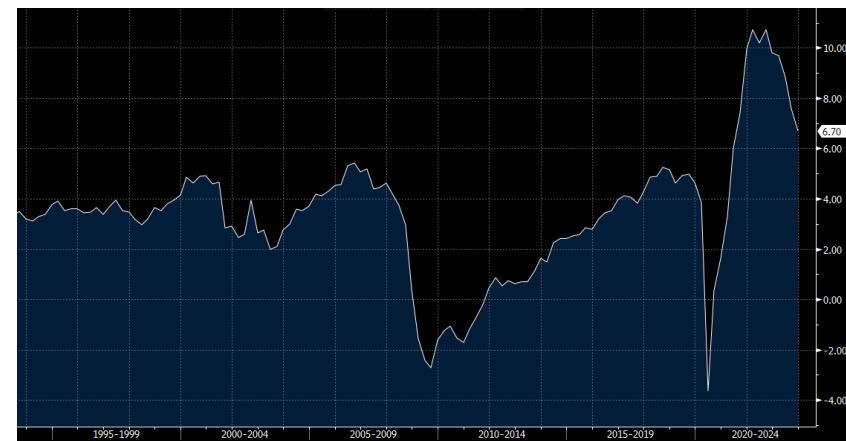
# Estimates of $R^*$ will respond to inflation trends

- In the period up to the GFC, the Taylor Rule was seen as giving a reliable guide to where US interest rates should be
- During past decade  $R^*$  was revised lower as inflation persistently undershot targets, taking the long run dot down to 2.5% on the FOMC plot
- If inflation remains a bit above 2% going forward, expect an upward revision over 3%

FOMC Dot Plot sees rates falling materially



Taylor Rule estimate for US Interest Rates



Source: Bloomberg 14/2/2024

## Beware assuming that we will return to the norms of the 2010s

- 2010s were an unusual period in economic and financial market history
- Ever since the pandemic there is a desire to ‘return to normal’ but 2010s was not a normal decade post GFC
- Peaking globalisation / Green Inflation premium / Demographics / Labour Market behaviour – all make it more likely that inflation will be a bit higher in future periods
- Is today’s world more like the 1990s?

Abnormally low US inflation during 2010's



Labour now wanting more

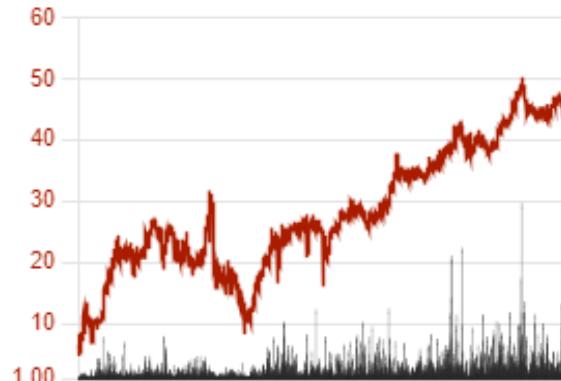


Source: Bloomberg 14/2/2024

# US Election 2024 –can Trump be stopped?

- Trump is the most likely candidate to win the 2024 election
- Trump victory means more isolationist / more protectionist United States
- A Trump win is a major source of concern for Europe / Ukraine
- Trump victory means lower taxes, bigger deficits & higher inflation (border & tariffs)

Trump election probability (%)



Could Biden be replaced?



Worries in NATO and beyond

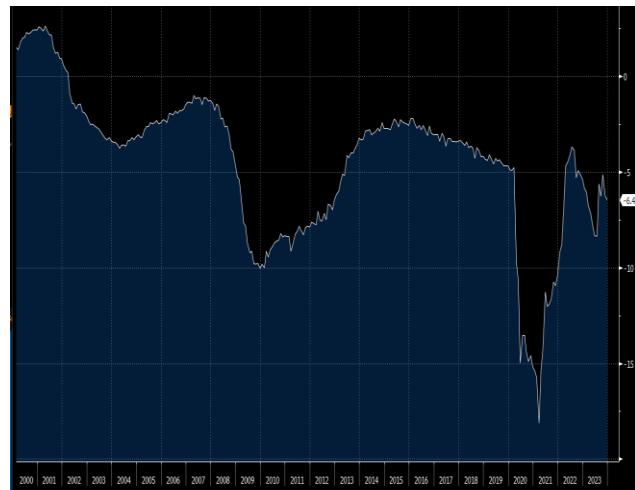


Source: Betfair.co.uk , Twitter 14/2/2024

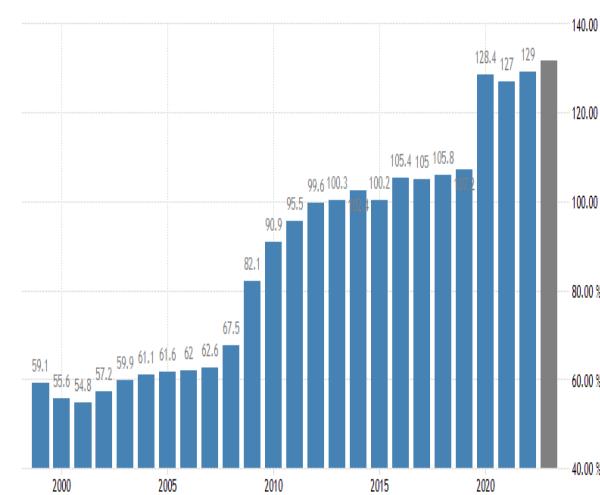
# How vulnerable are US Government finances?

- US Fiscal deficit stands at 6.5% of GDP, notwithstanding booming economy
- Economic slowdown would risk a deficit heading toward 10%
- US is becoming more vulnerable as interest costs rise
- Strong growth and position as Reserve currency means a problem may still be a few years away – but debt levels seems set to rise further

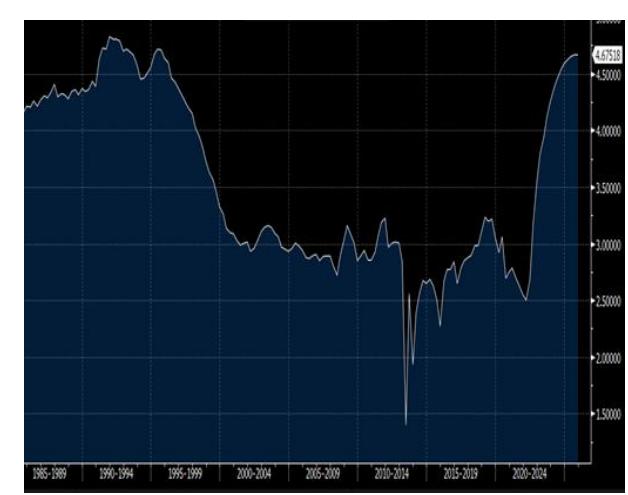
US Fiscal Deficit (% GDP)



US Federal Debt to GDP ratio (%)



US Interest Expense (% GDP)



Source: Bloomberg, TradingEconomics.com, White House: 14/2/2024

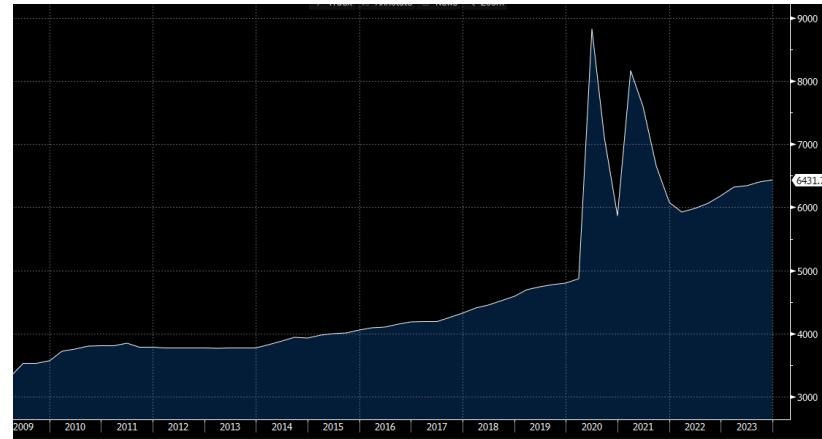
# Voters respond to a message of lower taxes and increased spending

- Notwithstanding the deficit, politicians compete on further tax cuts
- Since 2008, federal spending has been on an accelerating trend
- Everyone would like lower taxes and higher spending
- This political reality will only change when these policies push up rates and voters become worse off as a result

Full employment – yet still more tax cuts!



US Federal Expenditures (\$bn)

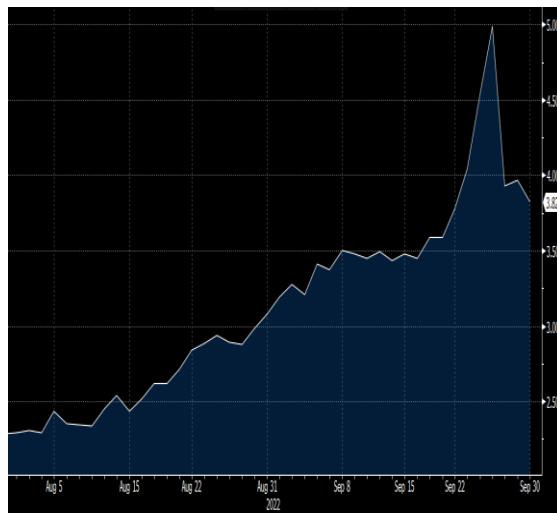


Source: Bloomberg 14/2/2024

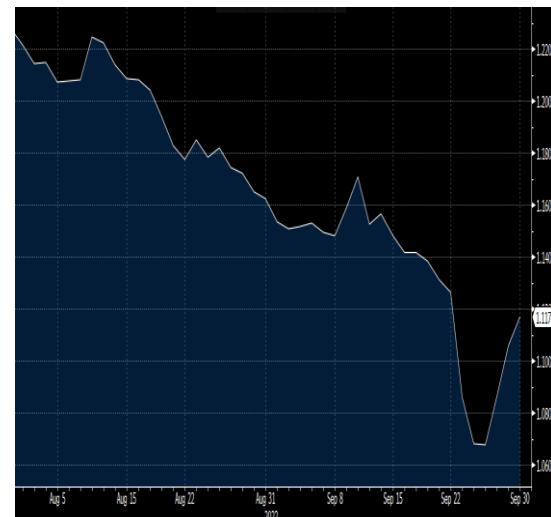
# As debt levels rise could we witness another bond market tantrum?

- In 2022, markets lost confidence in UK fiscal plans, leading to the ‘Truss Tantrum’
- We have learned that as debt levels continue to climb – eventually this may expose a fault line in the government bond markets
- When markets move, then governments will be forced to course correct
- Could a rating downgrade or failed auction could be the catalyst for these fears to metastasize in a market like the US?

Truss Tantrum: UK yield (%)



Truss Tantrum: UK£ / US\$



When could fault line crack?

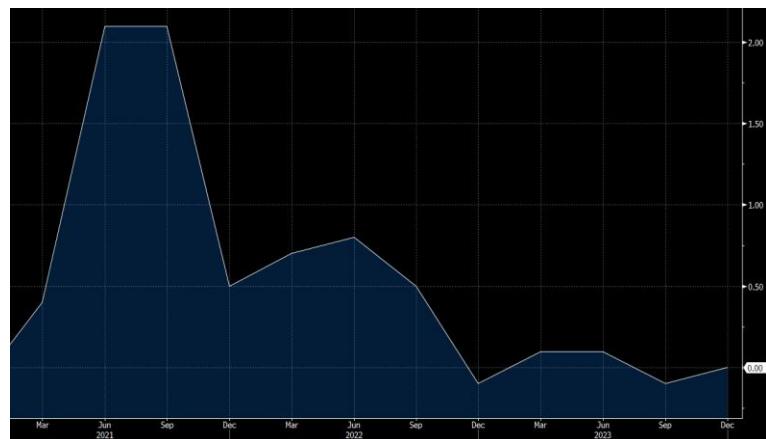


Source: Bloomberg 14/2/2024

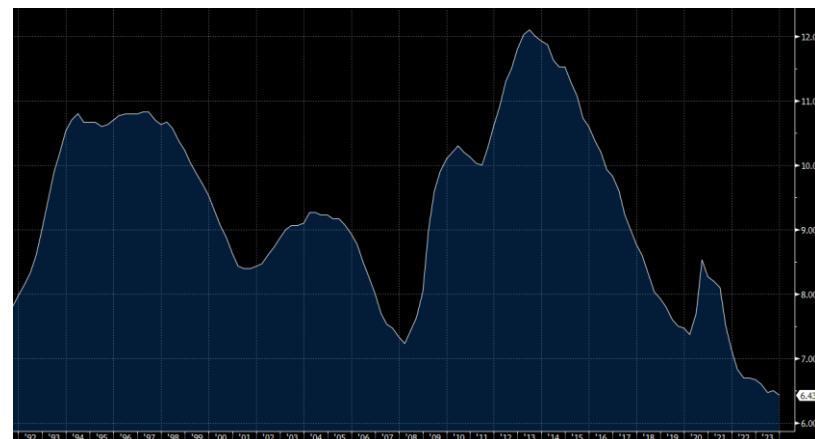
# Weak Eurozone growth pushes ECB towards rate cuts

- Weak growth trajectory in EU is very different to experience in US economy
- ECB now likely to start cutting rates in advance of the Federal Reserve
- Tight labour market and wages represent an impediment to more dovish policy
- Expect 75bp total rate cuts during 2024, starting in June
- Bund yields close to fair value

EU GDP growth hovers around 0%



Record low Eurozone unemployment rate

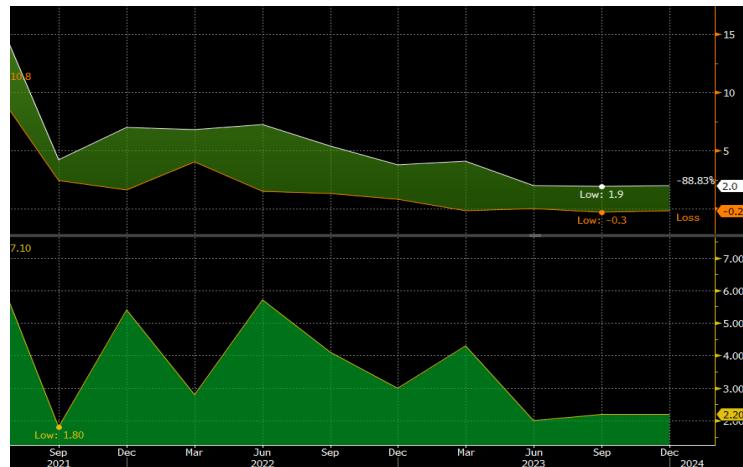


Source: Bloomberg, Tradingeconomics.com 14/2/2024

# Sovereign spreads in EU

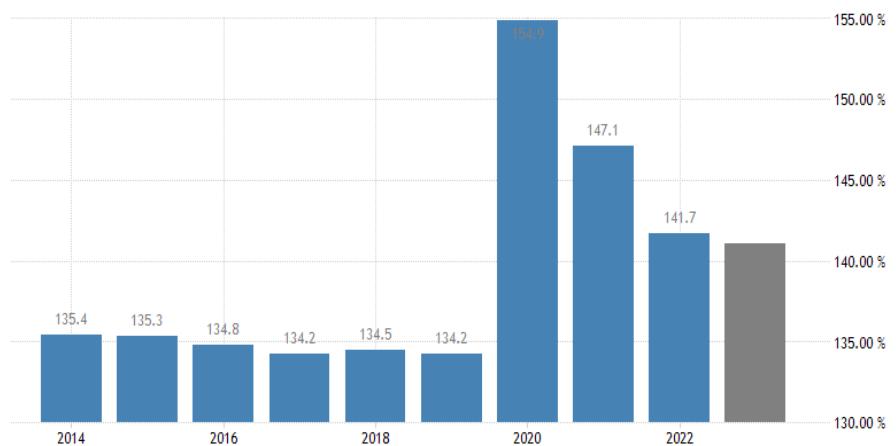
- Southern Europe is outperforming; scope for Spain to converge vs France
- Italian spreads are stable for now – low growth is bigger issue than debt level
- Greece back in IG indices; spread <100bp due to strong technical
- Politics in EU represent a bigger threat to spreads in 2025 and beyond

Spain vs Germany GDP growth gap



Source: Bloomberg, Tradingeconomics.com 14/2/2024

Italy debt to GDP (%)



# Political risks in Europe are moving north

- Georgia Meloni has performed well as Italian Prime Minister thus far – Italian political risks are subdued for now
- Success of a female, right wing leader is a factor boosting Le Pen ratings in France – French political risks are rising
- Populism remains a risk in the EU, in the absence of growth and prosperity

Brussels warms to Meloni



Le Pen is gains in France



Ugly Populism in Netherlands



Source: Bloomberg 14/2/2024

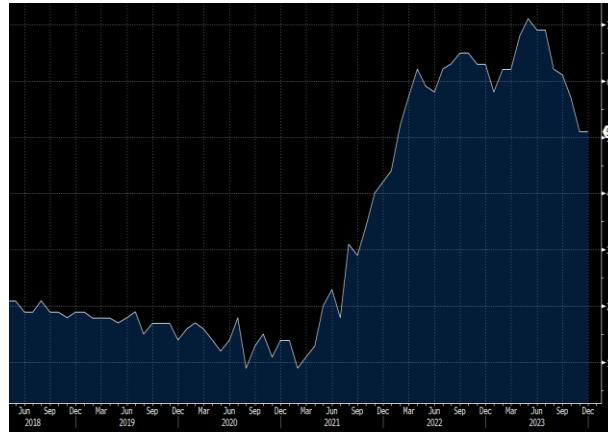
# UK tax cuts make life difficult for Bank of England

- UK economy remains weak, but inflation remains elevated and wage growth is too high
- Conservative fiscal stimulus risks government finances and could add to inflationary pressure
- Difficult for the Bank of England to cut rates this year
- Labour Party having to scale back their own plans post-election

Conservatives buying votes?



UK Inflation stuck near 5%



Labour to inherit Tory troubles

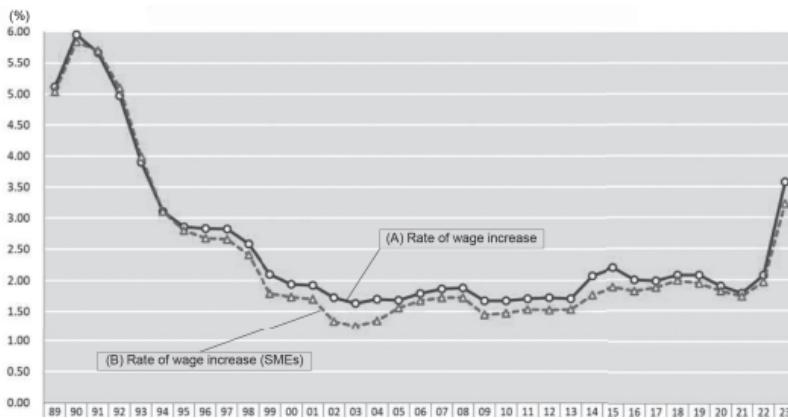


Source: Bloomberg, Twitter 14/2/2024

## The destination is more important than the timing (2)

- BoJ have been slower to start normalising policy than we expected last year
- Change is now imminent – wage gains have been the final piece in the puzzle
- We expect cash rates to rise to 0.50% by the end of the year and > 1.25% for JGBs
- $R^*$  in Japan is probably around 1.5% in a 2% inflation world

2024 Shunto likely to post further gains



Japan core inflation (%)

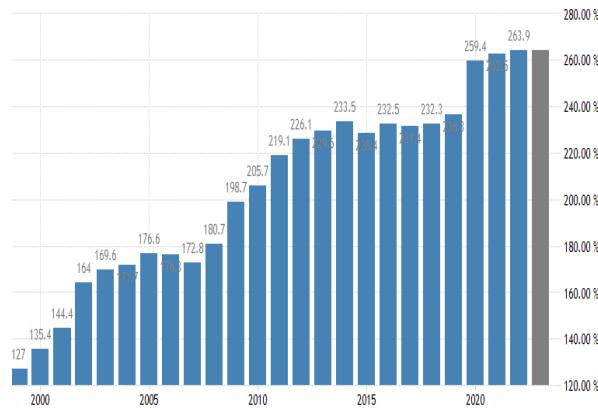


Source: Bloomberg 14/2/2024

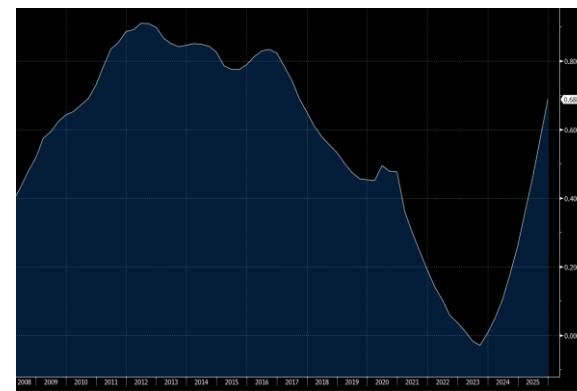
# Do we need to worry about Japanese debt sustainability?

- Japanese debt levels are elevated and demographics suggest that it will be difficult to reduce this materially in years to come
- Interest costs have been low as a function of ZIRP, but this is now changing
- Keeping interest costs down is consistent with 10 year JGBs <2%
- Rating risks could be a source of market stress

Japan debt levels are very high



Interest expense is low for now



Credit rating risks

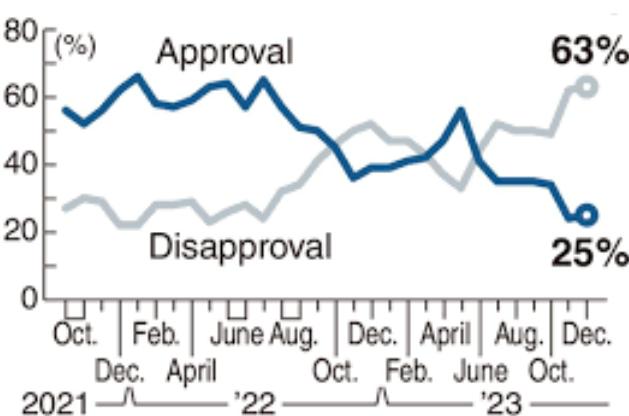
	S&P	Moody's	DBRS	TE
Czech Republic	AA-	Aa3		85
Estonia	AA- ↓	A1	AA (low)	83
Ireland	AA	Aa3	AA (low)	83
Israel	AA- ↓	A2 ↓		81
Kuwait	A+	A1		81
Bermuda	A+	A2		78
China	A+	A1 ↓	A	78
Japan	A+	A1	A (high)	77
Lithuania	A+ ↓	A2 •	A (high)	76
Saudi Arabia	A	A1 ↑		76

Source: Bloomberg, Tradingeconomics.com 14/2/2024

# BOJ Policy shift can save the Yen ; it may look too late for Kishida

- As monetary policy moves in the opposite direction in Japan to other developed markets, this can be a catalyst for the Yen to rally
- Yen is heavily undervalued and under-owned by global investors
- Weak Yen has been a factor contributing to Kishida unpopularity. It is less clear that a turn in the Yen can materially boost his approval rating at this stage

Kishida Cabinet approval rating



Trade weighted value of Yen



Source: Bloomberg 14/2/2024

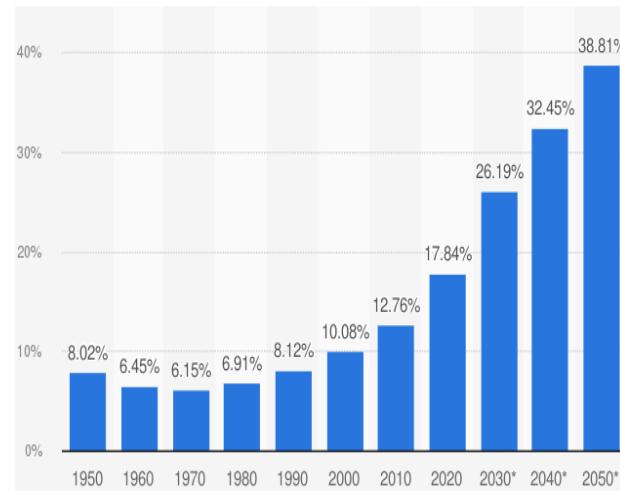
# China prospects remain depressed

- Property slump mirrors Japan in 1990's – several years to remediate
- China set to grow old, before it grows rich (Japan got rich before it became old)
- Little scope to boost exports, little appetite in Beijing to boost consumption
- Domestic deflation, without exporting deflation
- Taiwan eventually at risk, if US becomes more insular over time

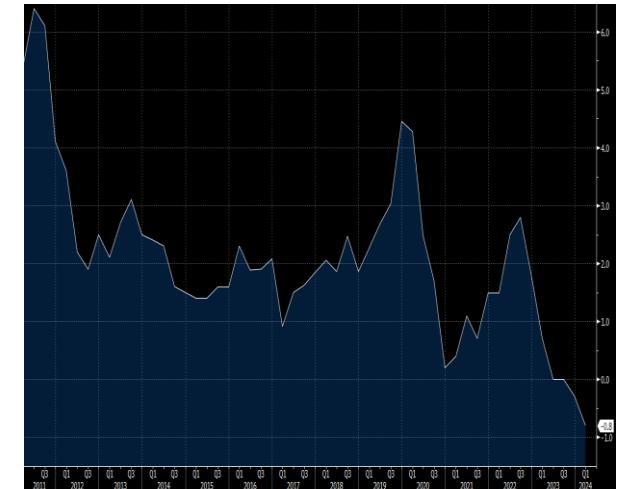
Protracted property slump



Population share >60 years



China CPI inflation (%)



Source: Bloomberg, Statista.com, Twitter 14/2/2024

# IG credit supported by strong supply / demand technicals

- IG spreads have rallied materially, but Euro spreads slightly remain cheap versus historic levels
- Strong technicals due to negative net supply and strong investor demand may see spreads continue to narrow in the coming months
- Euro financials remain a sector, which stands out as cheap on a valuation basis

Euro spreads cheap, US rich vs long run



Source: Bloomberg as at 14/2/24

Euro Financials trade cheap to other sectors

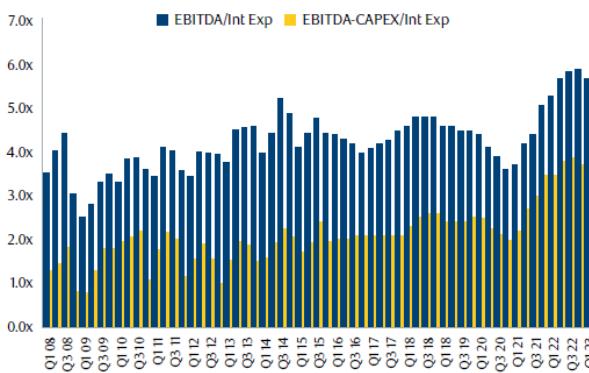


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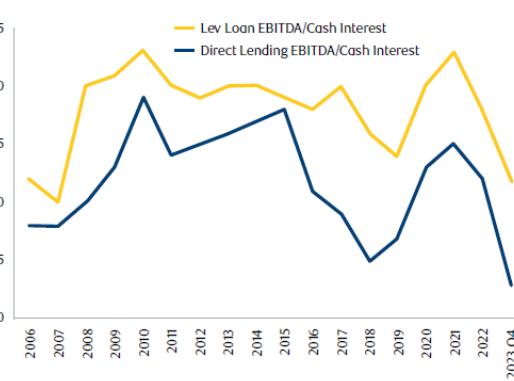
# High yield bonds may be OK, but more cautious in other HY asset classes

- High yield corporate bonds supported by low volume of supply and stronger fundamentals than other higher yielding sectors
- Bank loans at risk, where covenants have been degraded. Recovery rates lower than historically the case
- Falling IPO activity leaves no exit for many private asset owners, highlighting risk in private equity
- A default cycle is coming as the economy downshifts. Opportunities in distressed situations

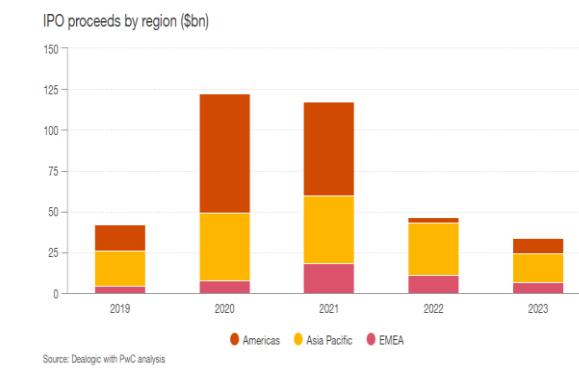
High Yield interest cover robust



Loan market more exposed



Falling IPO market activity



Source: Bloomberg as at 1/11/23, JP Morgan, PwC/Dealogic

# Opportunities in some Emerging Market assets

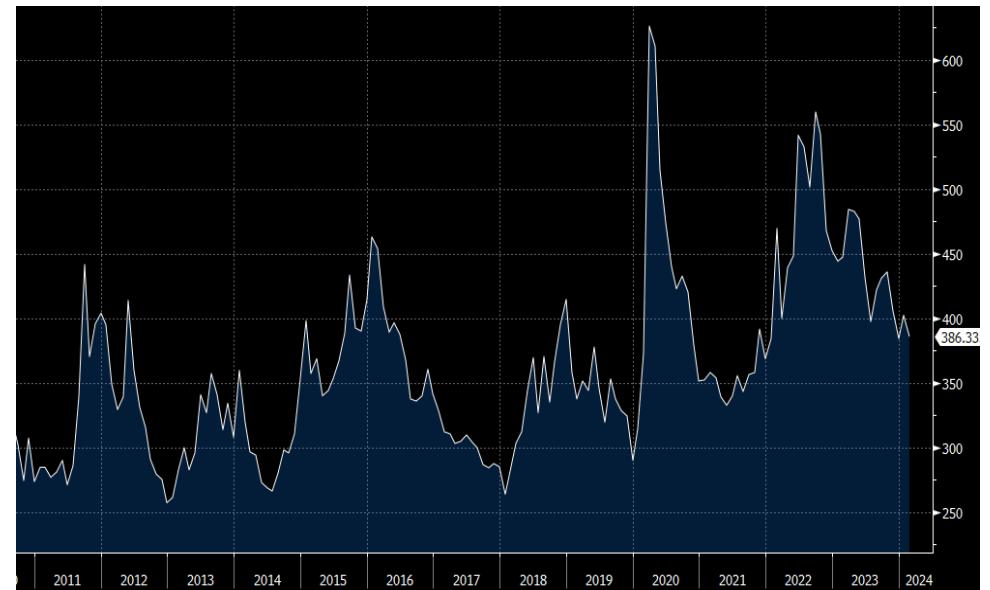
- EM local rates look attractive, with interest rates on a declining path
- EM FX more challenged, as carry is eroded
- Divergence with EM countries. Some EM credit cheap / others rich to fair value

Mexico 10 year real yields (%)



Source: Bloomberg as at 14/2/23

EM Hard Currency Index Spread (bp)



# FX: Focus on relative value themes

- US exceptionalism argues for dollar strength – but valuations are stretched
- US dollar longs most attractive versus EM currencies where rates are falling fastest
- GBP also an attractive short versus US\$, based on inflation fiscal risks
- Yen is very cheap – but needs the catalyst of BOJ policy action before it can recover

## Beer Price in Washington DC

★ Beer in Bottles & Cans ★	
No Drafts	
Lunch 16.9oz Bottle	
Maine Beer Co. Freeport, ME	\$16
Aromas of orange, grapefruit, and lemon with pine and herbal undertones. Tropical notes of guava and papaya with subtle caramel and malt sweetness.	
Slapasaurus Double IPA 16oz Can	
3 Floyds Brewing Munster, IN	\$16
Features rich notes of apricots, marmalade, and orange peel and imparts a lingering mouth warming bitterness.	
Belgian-Style Wheat 16oz Can	
Allagash Brewing Portland, ME	\$13
Hazy "white" appearance, spiced with special blend of coriander and Curacao orange peel	
Parabolita Barrel-Aged Salted Caramel Stout 12oz Bottles	
Firestone Walker Lakewood, NY	\$18
Cocoa nibs and vanilla really accentuate the beer's boozy caramel malt character. It somehow manages to be massive, mellow and drinkable... the dash of sea salt acts just like it does in food. It makes the aromas pop, elevates the flavors and adds texture to the mouthfeel.	

## Mclellan's Retreat in DC



## Sushi Zanmai Shimbashi



Source: Mclellans Retreat, Sush Zanmai as at 14/2/24



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## Conviction ideas for next 6 months

- Position against markets expecting rate valuations to return to 2010 levels – unless data suggests a hard landing
- Curve steepener 10-30yr in US as a way to position for fiscal worries
- Favour Spain vs France in Eurozone
- Structurally bearish on UK Gilts and Pound
- Structurally bearish on JGBs, time to become bullish Yen
- Bullish Euro credit versus US credit on valuation
- Bullish Euro financials within IG credit
- Cautious on bank loans and bearish private equity
- Bullish on Distressed debt &/ special situations in Europe and Emerging Markets



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