

# Portfolio Manager Perspectives

## Mark Dowding's Global Macro Update

October 11, 2024

### Milton versus Dante

A week which saw scenes of 'Paradise Lost'

#### Key points

- Economic data have taken a backseat to global developments, particularly due to the volatile situation in the Middle East.
- The narrative, for now, is that the US economy appears to be gathering more traction. However, the impact of the hurricane season remains to be seen.
- In Japan, the focus is on the elections taking place on 27 October, as new Prime Minister Ishiba seeks to cement his mandate.
- UK gilts have continued to underperform global markets, which we believe is due to inflation remaining stickier.

US yields consolidated over the past week, having jumped in the wake of last Friday's strong employment data. The narrative that the US economy remains firm for the time being appears to be gathering more traction, with the US Economic Surprise Index rising to +14 (from a low of -47 in July) and the Atlanta Fed Nowcast for Q3 GDP rising to an above trend 3.2%.

Core CPI may have stopped declining a couple of months ago and although some further Fed easing is to be expected in the months ahead, it has been striking to observe how market expectations for the terminal level of the Funds rate have evolved over the past few weeks.

Since troughing at 2.8% in September, the terminal level of US rates is now projected to settle around 3.4%. This pricing is around a level where we would see fair value and, in light of this, we have closed a short duration position that we have maintained on short dated SOFR interest rate contracts. However, we retain a bearish stance with respect to 30-year yields. Looser fiscal policy points to a need for term premia to increase on a structural basis, and we think fair value for the long end of the curve is likely to sit closer to 5%.



Meanwhile, during the past week, there has been a sense that economic data have taken more of a backseat relative to other global developments. In the Middle East, the region remains on a knife edge as Israel pushes into south Lebanon and simultaneously mulls its response to last week's missile attack from Iran.

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Our own analysis of the situation suggests that Netanyahu has established 'escalation dominance' in the run-up to the US election. The Israeli authorities are aware that there is little that Iran or its allies can do to strike the country, based on the effective blanket of protection afforded by the Iron Dome defence system. They are also aware that if they strike Iran and Iran attacks back, then the US administration will be forced into supporting it, given how failure to do so could badly impact Harris' election chances a month from now. In this case, there is a window for Israel to up the ante, which is also bolstered by domestic sentiment within the country.

Similarly, logic might dictate that if Iran has appreciated that its weapons are rendered largely obsolete and it is exposed in terms of its own ability to defend itself, then this will lead to it needing to double down and accelerate efforts to build its own nuclear deterrent.

In turn, if Israel and the US perceive this, then game theory suggests that they need to act now, in order to avoid this outcome. That said, with the US eager to keep out of the fight as much as possible, we doubt that near-term Israeli escalation will target nuclear facilities, on the basis that these are 300 feet below ground and require more sophisticated US weaponry. In this case, a hit on oil refinery capabilities would seem more likely, noting that this will hit the economy and necessitate Iran to export more crude.

### **“Attention has been more focused on hurricane Milton, which has wreaked destruction across a wide swathe of Florida.”**

This speculation aside, what matters to global markets will be moves in oil prices. Thus far, these have been contained and under most scenarios we would note that the ability for Saudi production to replace lost Iranian output should cap prices below USD100 per barrel. This may limit contagion, even in the event of escalation, and only scenarios which see Iran mount an effective blockade of the Strait of Hormuz or target Saudi oil facilities in the hope of inflaming a Sunni/Shia conflict, would risk a much bigger move in oil. That said, in such scenarios, we might imagine this would prove very short lived, if it only serves to accelerate the demise of the regime in Tehran.

Several thousand miles away, attention has been more focused on hurricane Milton, which has wreaked destruction across a wide swathe of Florida, coming shortly on the heels of hurricane Helene just a few weeks ago. Notwithstanding the impact to insurers and more importantly, those whose lives have been directly impacted by these natural disasters, within fixed income markets, attention has quickly switched to the amount that will need to be spent in terms of reconstruction and the economic and fiscal impact this may have. Rebuilding can lead to a net boost in economic activity and also exert an inflationary impulse if there are shortages of the required materials or labour.

From an inflation standpoint, there is some relief that a looming port workers strike has been averted and so this will not compound matters. However, there is some sense that the labour market remains tight, as shown by the strike underway at Boeing. In this way, it is possible that policymakers may have been a touch hasty to dismiss wage growth as a factor, which might hamper inflation's return to target.

In Japan, economic data and meetings with policymakers also continue to underline a largely constructive view on domestic wage growth, due to a shortage of labour supply. In the short term, focus is now on Japanese elections taking place on 27 October, as new Prime Minister Ishiba seeks to cement his mandate.

In that context, recent dovish comments from Ishiba can be viewed through the lens of desiring the stock market to rise in the run-up to the vote. Nevertheless, we think these comments will have little bearing on BoJ deliberations to raise rates at its December or January meeting. Although a hike in October is off the cards, we wonder if the BoJ might be tempted to accelerate its taper of bond purchases, given that since announcing its exit from Yield Curve Control, yields have been very well behaved.

Moreover, we might infer that the BoJ and domestic investors, such as regional banks, would like to maintain a steep yield curve as interest rates rise and therefore, it may be appropriate for the BoJ to exit from quantitative easing more rapidly, given how this acts as an ongoing support to 10-year yields.

UK gilts have continued to underperform overseas fixed income markets of late. In part, we think this is down to UK inflation remaining stickier. As we have argued previously, wage growth in the UK is driving service price inflation and, in an economy with little productivity growth, it seems inevitable that wage gains will be passed through into higher prices.

Additionally, however, focus has come onto the UK government's fiscal plans in the run-up to next month's Budget. Working with the Office for Budgetary Responsibility and tweaking the debt definitions utilised in their calculations, has led to a suggestion that Rachel Reeves could have up to an additional £67 billion available to spend.

Yet, fixed income markets are likely to balk at anywhere near to half of this sum, given the impact of issuance on yields, even if spending is targeted to invest into the economy. Noting that Labour has already spent around £9 billion handing wage settlements to unions, our own thinking is that this may leave an additional £15-20 billion that she can spend, before triggering angst in markets.

Unfortunately for Labour, the scars of the Truss government lie just below the surface. The tax cuts, which Truss and Kwarteng announced, amounted to approximately £45bn at the time and triggered the tantrum in the gilt market, which saw her removed from office after just 45 days in power. This summer saw Labour voted into power with a large majority and a sense of optimism that they could offer an exit to the Tory chaos.

However, perceived incompetence in handling a range of issues to date has seen Starmer's approval rating plummet like a stone and the impression formed is that the new government can't be much trusted, nor was much prepared to take office. This sense of credibility is important. Arguably, the UK government's finances remain in a better state than is the case in France, or for that matter, the US.

### **“Notwithstanding turbulence in politics and geopolitics, we are inclined to believe that corporate bonds can continue to outperform for now.”**

Yet if markets sense that Labour's plans aren't credible and that the administration can't be trusted, then they could find themselves in an uncomfortable position quite quickly. Hopefully it won't come to that.

Notwithstanding turbulence in politics and geopolitics, we are inclined to believe that corporate bonds can continue to outperform for now, helped by positive seasonal factors and the fact that many investors have been underweight and need to put cash to work in the wake of receiving inflows.

### **Looking ahead**

Having digested recent payrolls and CPI releases, we are now moving to the part of the month with fewer significant upcoming data releases. This being the case, it seems politics and geopolitics may be the main drivers of price action in the short term.

On the US election, betting markets have been shifting slightly in favour of a Trump victory, albeit with the House still tilted towards the Democrats. This direction of travel is seen as favouring the dollar, inasmuch as Trump will still be able to deliver tariffs via the Executive Order.

We have been inclined to think that Trump will win next month, and certainly the narrative in the Middle East and also around the recent hurricane devastation plays in his favour, as we note that the Biden administration has taken flak for a disappointing response to hurricane Helene. However, the race is still too close to call, in terms of taking a decisive investment stance.

That said, we remain content to maintain a US curve steepening bias, with an overall short duration stance expressed in the long end of the curve. We have also favoured inflation breakevens, at a time when the Fed has eased into a relatively strong economy and as a hedge to higher inflation outcomes on a possible Trump victory or on Middle East escalations that could see a bigger jump in oil prices.

In Europe, we also favour the inflation breakeven trade, but are somewhat more constructive on duration, given the lack of political agreement over any fiscal delivery, plus an underlying economy which continues to look soft. We maintain a strong conviction with respect to a short in JGBs but continue to wait for an opportunity to enter a structural long yen position, at more attractive levels.

Otherwise, we continue to run long risk in sovereign and corporate credit. That said, on a Trump victory we are inclined to want to sell strength in credit and risk assets in general, versus buying into weakness should Harris prevail.

As for Milton, we can only hope that this is not a tale of 'Paradise Lost'. In the midst of the scenes of destruction, prospects still remain pretty upbeat in the Sunshine State. By contrast, the Middle East seems sadly more like something from Dante's Inferno...



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