Global Rates Strategy

Marketing material for professional / institutional investors only

Adrian Owens
Manager of the Global Rates Strategy

Market backdrop

The start of August was marked by a resurgence in financial market volatility as a hawkish rate hike from the Bank of Japan, followed by a seemingly cautious approach to rate cuts from the Federal Reserve (Fed) and disappointing US labour market data forced investors to reassess the likelihood of a potential US recession. Deleveraging pressures amid typically thin August markets were especially acute in Japan where the Tokyo Stock Price Index (TOPIX) lost 12% and the Nikkei Volatility Index spiked to crisis-levels on Monday, 5 August. In currency markets, the yen appreciated sharply as leveraged carry trade positions were unwound. Unsurprisingly, given the extended period of low volatility preceding this, carry positions had grown substantially and estimates suggest that speculative shorts in yen currency futures alone had reached an historical peak of around 75% of open interest. Markets stabilised just as quickly, with the S&P 500 fully recovering all the losses incurred since the start of the week by Friday, 9 August and the VIX receding to lower levels.

Speaking after the July Federal Open Markets Committee (FOMC) meeting, Chair Powell indicated a growing confidence in the disinflationary outlook. However, a greater sense of urgency took hold following July's non-farm payrolls report and an unexpected rise in the unemployment rate to 4.3%, breaching the Sahm rule threshold. Later in the month, preliminary benchmark revisions from the Bureau of Labor Statistics showed that the US likely added 818,000 fewer jobs in the year up to March 2024 than previously believed. July's core Consumer Price Index (CPI) fell to 3.2% year-on-year (yoy), but inflation in the usual core services categories, including housing rents and car insurance, remained elevated. The ISM (Institute of Supply Management) services PMI (Purchasing Managers' Index) surprised to the upside, and in contrast to the hard labour market data, the ISM survey's employment component rose to its highest level since September 2023. Headline retail sales for July surprised to the upside although consumers showed increasing restraint in discretionary spending and year to date spending remains weak in most categories. Headline industrial production registered below consensus expectations in July, with output in interest-sensitive spending categories, including automotive products and appliances, continuing to contract. Capacity utilisation also declined as factories cut workers' hours. Where Powell had characterised the labour market at 'normalising' in his post-FOMC meeting comments at the start of the month, by the time of the Jackson Hole speech at the end of August he was explicit that the committee "do not seek or welcome further cooling in labour market conditions," preparing the ground for imminent policy easing. Market expectations for policy easing shifted over the course of the month, from approximately 70 basis points (bps) of cuts priced-in by year-end at the start of August to circa 100 bps by the end of the month.

In the eurozone, the headline Harmonized Index of Consumer Prices (HICP) inflation accelerated to +2.6% yoy in July from +2.5% yoy in June, with core inflation unchanged at +2.9%. While the headline figure was pushed up by energy-related base-effects, progress on services inflation (+4% yoy) remains modest. Monthly data from the European Central Bank (ECB) also pointed to an improving credit impulse to households and non-financial corporations, however the Governing Council is likely to be comforted by the sharp deceleration in negotiated wage growth in the second quarter, from 4.6% yoy to 3.7% yoy. The Bank of England delivered a cautious cut to the bank rate at the start of the month with a tight vote-split. In a similar pattern to the eurozone, energy-related base-effects lifted headline inflation in July, although progress on services disinflation was better than anticipated. Against this backdrop, the Bank of England's Monetary Policy Committee's (MPC) minutes noted the need for monetary policy "to remain restrictive for sufficiently long."

Within fixed income markets, 10-year government bond yields fell by 16 bps in the US and by 2 bps in Germany and rose by 4 bps in the UK. Among the major currencies, the New Zealand dollar, the Swedish krona and Australian dollar were the best-performing currencies during the month, up +5.6%, +4.8% and +4.2% respectively on a total return basis.

Performance

The GAM Star Global Rates USD (Inst) share class was up 269 bps (net) in August, with gains in fixed income driving performance.

Performance contributors

- Developed Market Curve steepeners +237 bps
- Long Australian rates versus UK +30 bps
- Tactical short US Fed Fund futures +20 bps
- Long European rates versus UK +18 bps
- Long EUR versus GBP +7 bps

Past performance is not an indicator of future performance and current or future trends. The performance is net of commissions, fees and other charges. The views are those of the manager and are subject to change. Allocations and holdings are subject to change.

- Short EUR versus USD +5 bps

Performance detractors

- Long Brazilian rates outright and versus UK -36 bps
- Long US inflation breakevens -22 bps

Positioning

In fixed income we took profit on the balance of our long Europe versus UK interest rate relative value futures position and took partial profit on a US steepening position. We initiated and later took profit on a tactical short US Fed Funds futures position following the employment report. We added to our existing long 10yr US inflation breakeven exposure, replacing a 30-year inflation breakeven position.

In currencies, we took profit on a long euro versus short sterling position and initiated a long position in the US dollar versus the euro.

Outlook

Several high conviction views started to perform in August during a period of heightened market turbulence, and there remains significant scope for these uncorrelated themes to play out over the coming months.

Among the most striking asymmetries, with 175 bps of rate hikes priced for the next year, the Brazilian rates market continues to diverge from most developed and emerging market policy rate paths despite a comparable inflation outlook and a central bank governor cautioning against the market's current assessment of policy tightening. In Scandinavia, the broad, real, effective Norwegian kroner remains close to its weakest levels during the outbreak of the pandemic and the import-weighted exchange rate is currently weaker than during the 2008 financial crisis. In terms of fixed income relative value, the market continues to price a broadly similar profile for interest rates between Sweden and the eurozone, despite historically higher rates in Sweden and dissimilar speeds of policy transmission between the two economies. The implied path of interest rates and inverted curves in the US and the UK also precludes the possibility that easing cycles may be shorter and faster than markets anticipate, and while the path for near-term policy easing may be clearer, we remain vigilant to the risks of both structurally higher inflation and higher fiscal premia over the medium term.

The bulk of the portfolio's risk (65%) remains in interest rates, around 20% is in currency and 15% in inflation trades.

For more information, please visit www.gam.com

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