Global Rates Strategy

Marketing material for professional / institutional investors only

Market backdrop

The Institute for Supply Management's (ISM) Purchasing Managers Index (PMI), employment, price and wage data were all stronger than expected in the US during October. Given that investors started the month pricing aggressive rate cuts from the Federal Reserve (Fed) it is little surprise that bond markets weakened. While treasuries lost 2.5% during the month, UK gilts fared worse as the new government's spending plans, announced in the 30 October budget, troubled investors. UK gilts ended the month down 2.7%, with the spread between UK and German 10-year bonds moving out to over 200 basis points (bps). Even within the euro area where the European Central Bank cut rates by 25 bps and, where growth was more subdued (the latest composite PMI pointing to a contraction in growth), bonds still fell 1.0%.

With expectations of interest rate cuts being scaled back, inflation optimism stalling and growing concerns over the fiscal outlook in a number of countries, the US dollar was the top-performing currency, with the dollar index up 3.2%. Precious metals also performed strongly with gold and silver up respectively 4.2% and 4.8%.

Performance

The GAM Star Global Rates USD (Inst) share class was up 162 bps (net) in October, with most of the returns coming from interest rate positions.

Performance contributors

- Long euro area rates versus Sweden +45 bps
- Long US breakeven inflation +70 bps
- UK curve steepeners +80 bps
- Short Fed Fund futures +40 bps
- Short USD front end versus Europe +10 bps
- Long NOK versus SEK +20 bps
- Long USD versus euro +20 bps

Performance detractors

- Long Brazilian rates -95 bps
- Long Australian rates versus the UK -10 bps
- Short CAD versus NOK -30 bps

Positioning

We took profit on the bulk of our UK front end steepening positions, our short Fed funds futures trade, our short front-end US versus Europe (via forward-starting swaps) and our long USD versus euro. Most of these trades had performed as global rates, led by the US, moved higher. We added a tactical long euro versus GBP immediately after the 30 October UK Budget.

Outlook

Following the 50 bps cut in US interest rates on 18 September, investors very quickly priced in a further 120 bps of cuts over the subsequent three meetings. That looked aggressive to us and encouraged us to short the market (via February Fed fund futures). As at the beginning of November, and on the back of stronger data, investors have scaled back their expectations to just over 60 bps of cuts over the next three meetings. We believe this is much more reasonable and as a result have closed out our short positions and our short US rates risk versus other markets. Some markets, including longer-dated bonds in the UK, are now beginning to look a little more attractive.

The big event on the near-term horizon is the US election and this letter will have gone out before election date. While we try to avoid running material risk over binary events we do wonder if the outcome may prove more muted than many fear simply because whether it is Trump or Harris who ultimately wins, meaningful changes in legislation will still need Congressional approval. Election or not, the two somewhat linked areas where we have the highest conviction is that large deficits will continue and debt levels will remain on an upward trajectory. While the cost of this will be a longer-term drag on growth it will also add to inflation pressures. To that end, we remain comfortable with the inflation protection we own via US breakevens. One area that, to date, has been a drag on returns has been our exposure to Brazilian interest rates. Stronger-than-expected growth and worries over the administration's commitment to its fiscal goals have hampered this trade. However, looking ahead, we remain optimistic that growth is in the process of moderating (helped by higher real interest rates). And, perhaps more importantly, that the government is set to announce meaningful spending constraints that should go some way to reassuring investors that they are serious about their goal to return to a primary fiscal surplus. If convinced, there is scope for a material rally in front end rates which are pricing around 250 bps of rate hikes from the current 10.75%.

The bulk of our risk (57%) remains in interest rates, around 10% is in currency and 33% in inflation trades.

Adrian Owens
Manager of the Global Rates Strategy

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GAM Investments

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