Global Rates Strategy

Marketing material for professional / institutional investors only

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Market backdrop

Characterised as a pre-emptive move, the Federal Reserve's (Fed) decision to lower the Fed Funds target rate by 50 basis points (bps) in September was motivated by risk management concerns aimed at mitigating any "unexpected" further deterioration in the labour market. In the press conference following the decision, Fed Chair Jerome Powell emphasised that the economy remains "solid" and that the labour market is still close to full employment. The updated Dot Plot indicated that the median participant anticipates the Fed Funds rate at 4.4% at the end of this year, 3.5% at the end of 2025 and 2.9% in 2026, suggesting that 50 bps rate cuts are unlikely to be the norm. The Summary of Economic Projections portrayed a relatively benign outlook, with the median participant forecasting unemployment to peak at 4.4% in 2025 and core Personal Consumption Expenditures (PCE) inflation projected at 2.6% by year-end. With real Gross Domestic Product (GDP) growth revised to 2.0% for 2024, marginally above the Federal Open Market Committee's estimate of potential GDP growth, the median participant still expects robust growth, not a recession.

In terms of the labour market, August's jobs report was mixed, with softer payrolls offsetting the decline in the unemployment rate. This was consistent with the Job Openings and Labor Turnover Survey (JOLTS) which pointed to softening labour demand and moderating underlying wage growth. According to the Bureau of Labor Statistics, payrolls have been revised down most months this year. Among survey data, the August National Federation of Independent Business (NFIB) Small Business Hiring Plans index pointed to a further slowing in the pace of hiring, with a net 13% of small business owners planning to create new jobs in the next three months, down two points from July. The uptick in August's core Consumer Price Index (CPI) was entirely attributed to airfares and hotel prices. The Fed's preferred measure of underlying inflation, core PCE, remained steady at 2.7% year-on-year (yoy), pointing to minimal progress in disinflation since the start of the summer. Other data released during the month showed that industrial production surprised to the upside in August, retracing most of the decline in July, while retail sales indicated a decline in discretionary spending, consistent with softening in the Conference Board's measure of consumer confidence.

Among the other major central banks, the Bank of Canada implemented its third consecutive 25 bps rate cut in September, with Governor Macklem providing further dovish guidance. The European Central Bank cut its deposit rate by 25 bps to 3.25% as expected, with the policy statement and updated staff forecasts all pointing to gradual easing in the coming months. The Bank of England reinforced its gradual easing guidance, opting to keep rates unchanged and maintaining the pace of quantitative tightening during the month. The Bank's caution is likely to be attributed to, at least in part, elevated services price inflation which re-accelerated to 5.6% yoy in August from 5.2% yoy in July. The Norges Bank also kept its policy rate unchanged at 4.5%, accompanied by only a marginal reduction in the rate path, reflecting the Committee's ongoing concerns around elevated wage growth and currency weakness. In contrast, Sweden's Riksbank cut its policy rate by 25 bps to 3.25% and opened the door to a larger cut at one of the two remaining meetings this year. The Reserve Bank of Australia (RBA) kept rates unchanged, with headline inflation back within their target band. In a change to the recent rhetoric, Governor Bullock notably mentioned that the Board did not consider raising rates at this meeting.

As widely anticipated, the Central Bank of Brazil unanimously raised the Selic rate by 25 bps to 10.75%, citing both the resilience of domestic economic activity and the labour market. In expressing concerns around "the slowdown in structural reform efforts and fiscal discipline" the central bank is restoring credibility, which we believe will ultimately preclude the bank from hiking the Selic rate to the extent implied by market pricing. Additionally, inflation surprised to the downside in September, with the unadjusted mid-month consumer price index, IPCA-15, declining to 4.1% yoy from 4.4% in August.

Within fixed income markets, 10-year government bond yields fell by 13 bps in the US, by 17 bps in Germany and were unchanged in the UK. Among the major currencies, the South African rand, the Brazilian real and Australian dollar were the best-performing currencies during the month, up +4.1%, +3.8% and +2.9% respectively on a total return basis.

Performance

The GAM Star Global Rates USD (Inst) share class was up 127 bps (net) in September, with gains in fixed income driving performance.

Performance contributors

- Developed Market Curve steepeners +156 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.

- Long European rates versus UK and US +66 bps
- Short Swedish rates versus Europe +67 bps
- Long Norwegian krone versus basket of currencies +5 bps

Performance detractors

- Long Brazilian rates outright and versus UK -206 bps
- Short US Fed Fund futures -10 bps
- Short EUR versus USD -8 bps

Positioning

In fixed income we re-entered a short UK versus Europe interest rate futures position and later took profit on this position. We took profit on a US interest rate futures steepener and took partial profit on steepeners in the UK. We reinstated a short Fed Funds futures position and initiated a short US versus Europe theme via interest rate swaps.

Outlook

The path for near-term policy easing by the Fed appears to be validated by the recent softening of the labour market and disinflation. However, just because labour markets are less tight than they were 12 months ago, this does not imply that the economy is close to recession. Initial jobless claims remain modest and progress on underlying measures of inflation has, in some cases, stalled. The Indeed wage tracker suggests that nominal wage growth is rebounding in higher-wage sectors and demand continues to outperform the underwhelming sentiment data. A renewed focus on the full employment mandate and its impact on the Fed's reaction function has driven gains in the front-end of developed fixed income markets and has contributed to the performance of our steepener positions. However, market pricing of the trajectory of near-term policy easing appears overly dovish relative to the Fed's own forecasts. Further out, with 10-year US inflation break-evens below 2.5%, synchronised policy easing from the Fed and the People's Bank of China against a backdrop of accommodative financial conditions, twin budget and trade deficits, and the prospect of additional fiscal stimulus by either Presidential candidate, suggest that the risk of re-kindling inflation may be underappreciated.

The Global Rates strategy remains focused on several, uncorrelated, high-conviction themes. 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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