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Market views and strategy

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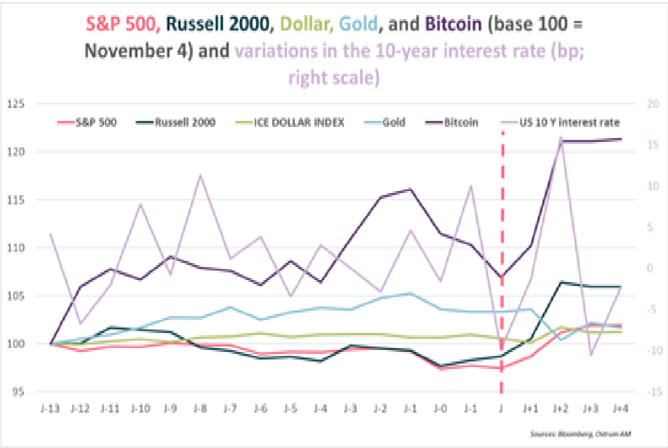
Topic of the week: The Fed vs. Donald Trump
by Axel Botte

- The Fed has cut interest rates a second time this year to 4.75%. Further rate reductions and the end of QT should be implemented in the coming months.
- The Fed believes that its current policy stance is restrictive but strong domestic demand growth and somewhat elevated inflation could be seen as evidence of the contrary. There is also considerable uncertainty regarding the level of the neutral rate.
- Inflation is top of mind for US households. The Fed's inflation targeting framework is out of synch with the people's experience with prices. Donald Trump will use every opportunity to attack the Fed's inflation record, even as his trade and fiscal policies are likely to spur inflation.
- For now, rates will keep falling towards 4% by March, and then 3.75% as the neutral rate debate heats up. But the Fed's job will be harder under a Trump presidency.

Market review: Red sweep, US equities all green
by Axel Botte

- Markets reacted to the election outcome with gains in US equities, higher yields and a stronger dollar.
- China unveils a CNY 10 trillion plan to restructure local government plan.
- European equities underperformed, as markets expect further cuts by the ECB.
- Euro swap spreads continue to narrow.

Chart of the week



The knee-jerk reaction of financial markets to Donald Trump's win at the Presidential elections was in line with expectations.

Promises of corporate tax cuts sparked a rally in equities, and a sizeable outperformance of the Russell 2000 index. Long-term bond yields increased as the public deficits are unlikely to be curbed under Trump, though investors bought bonds back after a strong 30-Yr bond auction.

Tariffs on foreign-made goods contribute to a stronger dollar. In crypto markets, the rise in Bitcoin prices reflects the alleged support of Donald Trump to the industry. Gold in turn weakened moirroring the stronger dollar.

Figure of the week

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China approved a 10 trillion yuan package for local authorities to bring off-balance-sheet debt onto the books. Local debt resolution is a critical aspect of policy support.
Source: Bloomberg

Topic of the week

The Fed vs. Donald Trump

The Fed cut interest rates further by 25 bps last week and stands ready to bring rates down to around 4% by March 2025, which is still slightly above the Fed's estimate of a neutral rate. Likewise, the Fed may soon put an end to QT. In the short run, the Fed thus appears to be on autopilot. But the pressure on the Fed will build under Trump. The incoming Administration's policies will materially change the outlook for growth, inflation and public finances.

Monetary easing amid fiscal largesse, be careful what you wish for

The Fed's 50-bp cut in September was followed by a bond market crash.

Since the Federal Reserve cut interest rates by 50 bps in September, long-term bond yields have moved higher by around 70 bps from 3.61% to 4.36% at present. Higher long-term interest rates were clearly unintended and unhelpful for a central bank aiming at a less restrictive monetary policy stance. The larger-than-usual reduction in the Fed funds rate had been leaked through newspapers during the pre-FOMC blackout period. Days before the September FOMC it became increasingly likely that the Fed would go big to make up for 'lost time' after a string of weaker job reports. This was poor communication to say the least, but it was not the only factor behind the resulting steepening in the US yield curve. Fiscal responsibility must be restored in the US and neither candidate to the White House took the issue seriously. The forecasted public debt trajectory keeps adding to bond market angst. Treasury bond swap spreads to SOFR OIS indeed dipped below -50 bps on 10-Yr notes and -80 bps on 30-Yr bonds. In other words, investors in US bonds are now demanding a sizeable term/credit premium to hold Treasury securities. This is unusual. Can a 'Liz Truss' moment occur in the World's largest and most liquid bond market? Still unlikely, but a bond crash is a non-zero probability event.

The US repo market sent some bad signals at the turn of the September quarter. The repo market is essential to the functioning of the US Treasury bond market. Repurchase agreements enable primary dealers to make markets and arbitrageurs to provide liquidity via basis trades. Two weeks after the Fed's 50-bp shocker, repo lending rates hit an intraday high at 5.45%. The Fed's $500 billion standing repo facility *should* have prevented repo rates from shooting through the ceiling of the Fed funds range, but somehow it failed. Maybe, the marginal borrower did not have access to the Fed's facility, or the transaction was too small to matter. But, it shows that the repo market squeeze of September 2019 can be repeated. And the fiscal situation makes disruptive market events all the more likely.

Has the Fed misunderstood main street's inflation concerns?

US households remain unsatisfied with the higher cost of living.

The need for easier monetary conditions at this juncture is debatable. Fiscal policy has been extremely supportive for years. The US economy grew by 2.8% in the third quarter, significantly above trend. The unemployment rate is near equilibrium at 4%. Core PCE inflation is above the Fed's comfort zone at 2.7% in September.

Monetary easing seems rooted in the Fed's belief that current rates are at restrictive levels. Yet bank credit remains readily available. Financial market conditions are supportive with 20%+ gains in US equities this year and tight credit spreads. Against this backdrop, the Fed should rather focus on risks to financial stability and lean against rising delinquency rates in credit cards, car loans or commercial real estate loans. Tighter policy instead may be a better strategy to mitigate the risk of a financial meltdown and a hard landing.

As regards its inflation record, the Fed appears convinced that past interest rate hikes have 'worked' so that it can take the foot off the brakes without causing inflation. We fear that the Fed could be overly confident on inflation prospects. With hindsight, the average inflation targeting (AIT) framework, once championed by Jerome Powell, would have called for an extended period of monetary tightening. But we know that AIT went out the window as the Fed would never aim at *lower* prices. However, 2% inflation after more than three years of 5% inflation on average just cements outsized purchasing power losses for US households. In the past, former Fed chair Ben Bernanke had advocated for temporary price-level targeting (however in the context of residual deflation risks). This objective could have been helpful to quell the perception of a higher cost of living. Households' inflation experience is influenced by their memory of prices on staples and other non-discretionary goods. The Fed is clearly missing this point. And Trump will use every opportunity to criticize the Fed's inflation record.

The Fed on autopilot for now, then comes Trump

The Fed may go neutral and then assess the impact of Trump policies.

As expected, the Fed funds rate was lowered by 25 bps on November 7th to a 4.50-4.75% range. The Federal Reserve is likely to proceed with 25-bp rate cuts to 4% by March 2025. Beyond March 2025, monetary policy will have to take into account the expected impact on inflation and growth of Donald Trump's trade and fiscal policies. There is also considerable amount of uncertainty surrounding the neutral level for interest rates. FOMC policymakers firmly believe that current policy rates are in restrictive territory, but their own estimates for the long run policy rate fall within a wide range of 2.375% to 3.75%. We expect Fed rates to settle around 3.75 % in the second quarter of next year. In parallel, the central bank will put an end to quantitative tightening, possibly before March 2025. The Fed currently rolls over at auction the principal payments from its Treasury bond holdings that exceeds a monthly cap of $25 billion. MBS proceeds to the extent that they exceed 35 billion per month are reinvested into US government bonds. This policy will be amended to roll all maturing holdings into new Treasury securities. The decision will ease financing conditions for the US government by $ 300 billion per annum, roughly one sixth of the expected annual federal deficit. However, given long-term fiscal challenges, the Fed may choose to reinvest in short-term bonds only, to avoid being accused of facilitating fiscal irresponsibility. The maximum maturity of bond reinvestments could be set at 5 years.

Powell can't be demoted under the law… but Trump may undermine Fed independence.

Donald Trump and his allies will surely try to undermine the independence of the Federal Reserve. In his first term as President, Donald Trump frequently interfered and criticized the Fed's decisions. The monetary institution stands ready to defend its independence. Jerome Powell made it clear that he will not resign, and he cannot be demoted under the law. But fiscal irresponsibility could result in a loss of independence. The danger for monetary authorities is always fiscal dominance. Once deficits and debt get out of control, central bankers are forced to monetize the debt.

Likewise, a Trump administration may try to deregulate the financial sector. The lack of mid-sized bank regulation played a role in the demise of Silicon Valley Bank. Changing the asset threshold below which lighter regulation applies could be pushed to Congress by the new Administration sometime next year. It could make the Fed's financial oversight task harder.

Conclusion

The Fed is gradually dialing back monetary tightening even with above-target growth and inflation above the Fed's comfort zone. Gradual rate cuts should continue into the first half of 2025 as the Fed aims at a more neutral monetary stance. In the meantime, the election of Donald Trump will make the Fed's job harder. Trade and fiscal policies proposed by Donald Trump could worsen imbalances and add to inflation.

Axel Botte

Market review

Red sweep, US equities all green

Trump's win ignites fiscal responsibility debate, as Fed cuts rates and S&P500 sets new record highs.

The US Presidential race was not nearly as tight as the polls had predicted. Donald Trump will be the 47th President of the US with a Republican majority in both the House and the Senate. Markets have reacted as predicted to the Red sweep. US equities outperformed European stock markets by 5 to 7% last week with a sharp drop in volatility indices. Somewhat surprisingly, Chinese markets fared well with Shanghai gaining 5%. US bond yields increased even as the Fed cut interest rates to 4.75% as planned. A strong bid at the 30-Yr bond auction last Wednesday capped T-bond yields at around 4.60%. The US greenback remains quite strong against all currencies. Swap spreads continue to shrink fast in the euro area. The ECB may react to Trump's trade policy by lowering rates.

The US election was obviously the main event, but there were some noteworthy data. The service ISM confirmed the solid growth environment at the start of the fourth quarter. The employment component increased to 53 reflecting a recover from port strikes and hurricanes. The strike at Boeing ended with an improved pay package for workers. This should add 44k jobs to the next non-farm payroll report. As concerns credit flows, consumer credit rose a modest $6 billion in September which may signal some cooling in October retail sales. Some slowdown in consumer spending looks overdue. In the euro area, PMI were rounded higher from advanced estimates. If anything, growth surprised on the upside in the third quarter. In France, the decline in corporate investment and employment (-0.1%) in the third quarter points to weaker growth towards the end of the year. China finally unveiled a 10 trillion CNY resolution plan for off-balance sheet local government debt totaling more than 14 trillion CNY. Local governments will issue 6 trillion CNY to swap hidden distressed debt held by financing vehicles over the next 3 years. The central government will provide additional support afterwards.

Government bonds have been cheapening against swaps in the past few weeks as investors worried about fiscal plans in France, the UK and lately the US. Yields drifted higher to close to 4.50% on US 10-Yr notes before solid demand at the 30-Yr bond auction put a ceiling on long-term yields. France also managed to attract strong demand at auctions of long-dated securities. French bonds keep trading around 75 bps against German Bunds. In Germany, Chancellor Scholtz dismissed Finance minister Lindner which could result in early elections in March. The traffic light coalition looks more fragile than ever. In the meantime, Donald Trump's election will force Europe to rethink the situation in Ukraine and defense spending. In credit markets, flows into managed funds continue despite spread widening against swaps. CDS indices rallied in keeping with lower implied volatility.

US equities outperformed their European peers considerably last week. Companies with US revenue exposure fared better than German auto manufacturers, renewable energy and utilities likely to be hit by Trump policies.

Axel Botte

Main market indicators

G4 Government Bonds	12-Nov-24	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	2.15 %	-16	-9	-26
EUR Bunds 10y	2.34%	-9	+7	+32
EUR Bunds 2s10s	19 bp	+7	+16	+57
USD Treasuries 2y	4.33 %	+15	+37	+8
USD Treasuries 10y	4.36 %	+9	+26	+48
USD Treasuries 2s10s	3 bp	-6	-11	+40
GBP Gilt 10y	4.45 %	-8	+24	+91
JPY JGB 10y	1.02 %	+7	+6	+40
€ Sovereign Spreads (10y)	**12-Nov-24**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	76 bp	+2	-2	+22
Italy	128 bp	+4	-1	-39
Spain	74 bp	+3	-1	-23
Inflation Break-evens (10y)	**12-Nov-24**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi	205 bp	-1	-6	-
USD TIPS	237 bp	+6	+3	+19
GBP Gilt Index-Linked	357 bp	-2	+2	+9
EUR Credit Indices	**12-Nov-24**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	99 bp	-5	-10	-39
EUR Agencies OAS	62 bp	-1	-3	-8
EUR Securitized - Covered OAS	49 bp	-1	-12	-29
EUR Pan-European High Yield OAS	325 bp	+3	-23	-74
EUR/USD CDS Indices 5y	**12-Nov-24**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	54 bp	-4	-2	-4
iTraxx Crossover	293 bp	-16	-11	-21
CDX IG	47 bp	-5	-5	-9
CDX High Yield	298 bp	-31	-29	-58
Emerging Markets	**12-Nov-24**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	326 bp	-8	-28	-58
Currencies	**12-Nov-24**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.062	-2.83	-2.58	-3.79
GBP/USD	$1.280	-1.83	-1.97	+0.5
USD/JPY	¥153.91	-1.45	-2.59	-8.36
Commodity Futures	**12-Nov-24**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$72.0	-$3.6	-$6.7	-$2.7
Gold	$2 602.4	-$139.6	-$46.2	$539.5
Equity Market Indices	**12-Nov-24**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	6 001	5.05	3.20	25.82
EuroStoxx 50	4 808	-1.29	-3.92	6.33
CAC 40	7 345	-0.84	-3.08	-2.63
Nikkei 225	39 376	2.34	-0.58	17.67
Shanghai Composite	3 422	1.03	6.35	15.03
VIX - Implied Volatility Index	15.11	-26.26	-26.15	21.37

Source: Bloomberg, Ostrum Asset Management

Additional notes

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