

# Flash Fixed Income

November 2024

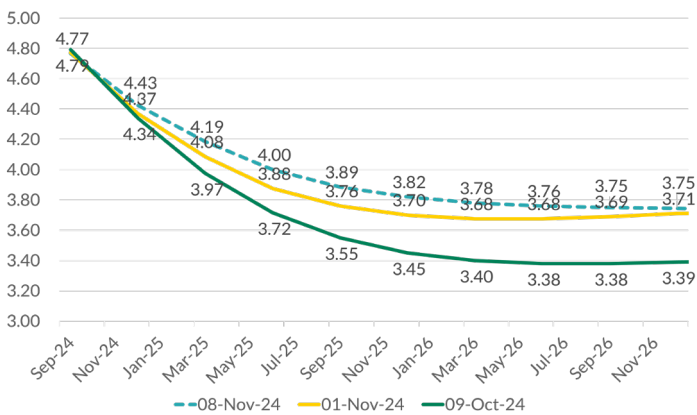
## Trump to reshape rate cuts in US and Europe

- Donald Trump's election victory means policies widely regarded as inflationary should slow the Fed's easing of monetary policy.
- We expect the differential in rate cut expectations between the US and Europe to grow given the latter's weak growth trajectory.
- Despite a more challenging macro backdrop, European credit offers excess spread versus the US and may also benefit from capital gains associated with more rate cuts.

When we discussed the potential impact of a second Donald Trump presidency in last month's Flash Fixed Income ([What would Trump do to Treasuries?](#)), our central conclusion was that his policies advertised on the campaign trail were likely to curtail the Federal Reserve's (Fed) ability to meet the current market expectations for US rate cuts.

Longer dated US Treasury (UST) yields duly surged as Trump's solid victory became clear last week, though some of the widening has been clawed back in the days since. The market-implied path for rate cuts has reduced by around 25 basis points (bp) versus a month ago (see Exhibit 1), while the consensus among professional economists is for a reduction of at least 50bp.

**Exhibit 1: Market-implied path of US policy rates**



Past performance is not a reliable indicator of current or future results. Included for illustrative purposes only. Source: Bloomberg, 8 November 2024

What politicians promise and actually deliver are often two different things, so investors continue to weigh which specific policies they believe will be enacted. But given the certainty of a Republican President with control of the Senate (and control of the House looking extremely likely at time of writing), as fixed income investors what interests us now is whether this will drive a more serious divergence in monetary policy between the US and Europe.

### How will the Fed react?

In the US, the key consideration is how much the Fed will shift its course in response to Trump's stated aims, many of which are widely regarded as inflationary. In the near term the magnitude of tariffs (a direct increase to costs) the market will look to price in may be determined by the cabinet appointments Trump makes to his Commerce and Treasury departments. Immigration curbs have a more indirect impact on costs through the higher wages associated with a tighter labour market, which the Fed currently sees as being in balance. The US experienced inflation which was more demand driven than Europe, reflecting its higher magnitude of post-pandemic government stimulus. An expansion in US fiscal policy would be expected to further drive that cause of inflation.

The most dovish interpretation of the Fed's reaction we can foresee is that it may choose to view the price impact of tariffs as transitory, while focusing on supporting the US economy through the tariff supply shock and associated lower growth. However, we think the more prolonged impact of a tighter labour market makes this route unlikely.

## Credit market performance

	Total return YTD (%)	Total return last 30 days (%)	Yield (%)	Duration (yrs)
EUR IG	3.83	0.27	3.3	4.4
GBP IG	1.06	-0.62	5.6	5.9
US IG	3.71	-0.86	5.1	6.7
EUR HY	7.52	0.72	5.7	2.9
GBP HY	9.31	0.41	8.4	2.9
US HY	8.03	0.44	7.2	3.3
EM HY	12.33	0.18	7.7	3.9
Euro Senior Banks	4.28	0.33	3.2	3.6
CoCo	10.41	-0.13	6.6	3.2

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The Fed chair, Jerome Powell, tried to remain apolitical at his November 6 press conference, which immediately followed the election, where he reiterated: “in the near term, the election will have no effects on our policy decisions”. However, he did assert his and the Fed’s independence, commenting that his removal is “not permitted under law” and that he “would not resign if asked to”.

Ultimately we think there is little doubt that the Fed will have to slow its easing of policy restrictions. It will want to look reactive to changes in government policy, rather than pre-empting them, but over 2025 as a whole we now expect there to be fewer cuts.

## What will tariffs mean for Europe?

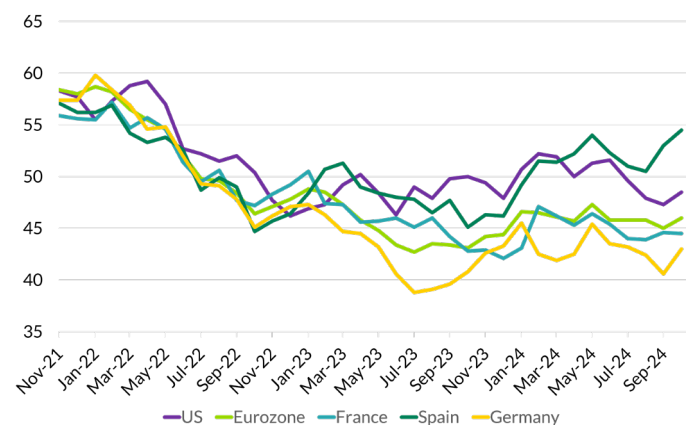
With European inflation having more disparate influences, changes to the path of European Central Bank (ECB) monetary policy may be harder to predict. Recent commentary from ECB members suggests they are wary of upside risk to inflation following the US election result. Members have highlighted worries that while tariffs will weaken growth in Europe, they will increase deficits, fuelling inflation. A US trade war with China is likely to result in global supply chain issues, forcing up costs further. This would also be unhelpful for productivity growth, which is another concern for the ECB. Any fiscal mitigation against the growth impact from European governments would almost certainly be seen as having an inflationary impact. Moreover, Trump appears likely to demand greater military spending from NATO members, adding to the fiscal load. These factors may tempt the ECB to shift to a more hawkish approach.

Another potential policy change with much harder-to-predict market implications would be Trump pushing for some form of resolution to the war in Ukraine. The conflict certainly had an inflationary impact on Europe, but any end to the fighting may not reduce inflation as rapidly if sanctions remain. Rebuilding efforts may also saturate demand in sectors such as construction and building materials, with knock-on effects to pricing and growth across Europe. It very much depends on the nature of an armistice and how cash-strapped Ukraine is in its recovery. For now, this is another “known unknown” for markets to ponder.

## Eurozone growth trajectory suggests more cuts

Nonetheless, the significant divergence in macroeconomic data for the two regions suggests to us that a larger differential in easing will be priced in as the incoming data will be the dominant force on ECB policy. While Purchasing Managers’ Index (PMI) data in the US show sustained growth in economic activity and new orders, those in Europe and particularly Germany make for bleaker reading (see Exhibit 2). It is interesting to note that unusually, in this cycle, peripheral Europe appears to be propping up the core. ECB members will worry how long this can last.

Exhibit 2: US and Eurozone manufacturing PMIs



Source: Bloomberg, S&P Global Purchasing Managers’ Index, 11 November 2024

In contrast to the largely demand-driven nature of US inflation, in Europe inflation has been largely cost-driven; without cheap Russian gas, energy prices have risen and hurt German manufacturing for example. Disinflation is occurring across all of the subcomponents of inflation in Europe – importantly there is far less stickiness to inflation in core services relative to the US.

We think this means the ECB can and will cut more than the Fed. Markets currently have 100bp of cuts priced in for the US over the next 12 months, which is around 40bp less than is priced in for the ECB. We think that differential in easing should be closer to 100bp.

## Rates dashboard

		Current (%)	Change (bp)		
			1 w	1 m	YTD
US Treasury	2yr	4.20	3	24	-5
	10yr	4.33	4	26	45
	30yr	4.53	5	17	50
UK Gilt	2yr	4.45	1	26	46
	10yr	4.50	5	29	96
	30yr	4.96	8	21	82
German Bund	2yr	2.21	-7	-2	-19
	10yr	2.45	5	19	42
	30yr	2.70	11	15	44

	Market projection	Current (%)	Change (bp)		
			1w	1 m	YTD
Base rate 4.75%	end-2024	4.41	3	11	67
	end-2025	3.78	8	38	72
Base rate 4.75%	end-2024	4.59	1	8	98
	end-2025	4.04	2	28	102
Base rate 3.25%	end-2024	2.82	-1	-9	52
	end-2025	1.96	-9	-8	5

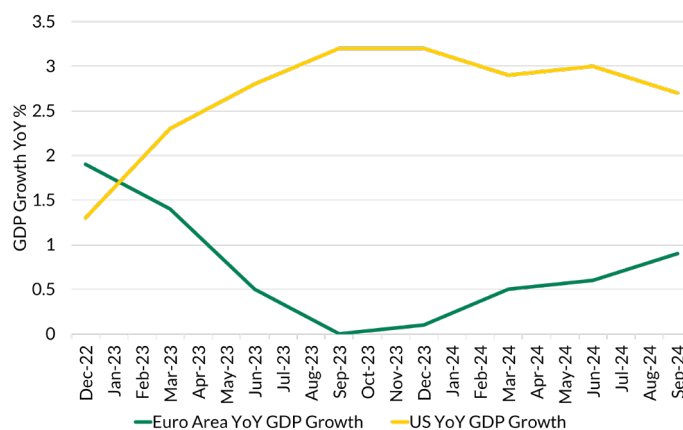
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## Higher quality credit should be more immune to tariff impacts

While global risk markets are currently taking their cue from US equities, which are rising on the expectation of lower tax rates and more favourable regulation, we think European credit investors should expect a lower growth outlook going forwards (see Exhibit 3). That would generally be seen as a tougher backdrop for credit spreads, as default rates likely rise, so we would anticipate the potential for increased spread volatility.

However, that doesn't prevent European credit from being an attractive allocation in our view. Our expectation is that European corporates will simultaneously benefit from greater-than-expected rate cutting from the ECB. We think focusing on higher quality credit names, away from sectors likely to be most damaged by tariffs, can help immunise against growth impacts, since less leveraged businesses do not typically need to achieve high or even positive growth to successfully refinance their debts. In addition, European credit currently offers excess spread versus the US, and may also benefit from the capital gains associated with more rate cuts. And given the divergence of underlying economic strength across the region, active fixed income investors need not concentrate holdings in Germany even though it dominates indices.

Exhibit 3: Slack Eurozone growth suggests more cuts



Source: Bloomberg, 11 November 2024

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