POLITICS LOOMS?

This month showed that politics can intrude on markets, at least in Europe, even though investors continue to shrug off potential risks from the impending US elections. Indeed, while European markets have sold off again this week, in the US markets ended higher for the third week in a row.

Next week's televised debate in the US between President Biden and former President Trump could bring more focus to the stakes involved in the November election. But these are unlikely to be as closely linked to market events as in Europe. There, for the first time in a decade, talk about a second euro crisis rattled markets, fearful of snap French parliamentary elections called on June 9 by President Emmanuel Macron.

ELECTIONS: A FRENCH GAMBLE, A UK HAIL MARY, AND NECK AND NECK IN THE US

Macron's surprise decision to dissolve the French national assembly followed a rout for centrists – and greens – in European elections. Macron is gambling that support for the far-right party of Marine Le Pen will not carry the day in new national elections. Markets and pollsters do not agree. Fears that Le Pen's party could prevail pushed spreads between the yields on French and German government bonds to their highest since 2017. The French election will determine which party chooses the Prime Minister and takes the lead on domestic policy. President Macron's term runs for another three years. He hopes that he will not be forced to "co-habit" with the far right.

Even if that happens, a Euro Crisis 2.0 is not likely, despite market fears. In addition to the continuity from President Macron, France is a core member of the European Monetary Union as well as the EU more broadly. It is neither Greece, with a history of fiscal problems and inflation, nor the UK which always kept a certain distance even before Brexit. And, importantly, the European Central Bank (ECB) has shown its ability to be flexible since then-President Mario Draghi promised ten years ago to "do whatever it takes" to hold the euro together. Current ECB President, Christine Lagarde, will be equally determined. Spreads above German bonds, nominally with identical risk, nevertheless stayed high this week.

The market reaction in Europe pointed up a contrast with the US. Markets here have appeared unmoved by twists and turns in the Presidential race or by shifting expectations of which party will win a majority in the House and Senate – a critical factor for future tax and spending plans. Equities have risen to new heights this month, ending this week up 1%. The dollar ended the week flat.

The apparent indifference to politics could be because the November election is still far off. It could also reflect the difficulty of defining potential financial or economic implications of the election, given uncertainty about which man will win and how much scope for action he will have from a new Congress.

In the UK, there is virtual certainty about who will win the July 4 election and an expectation that once it is over, the Bank of England will go ahead with a 25 basis point cut in rates. Prime Minister Rishi Sunak may have hoped to capitalize on better inflation news when he called the election now rather than waiting for the fall. But his chances of winning were always going to be dim, whenever the vote. It is even possible that the Prime Minister will receive the extraordinary rebuke from voters of losing his own parliamentary seat, hitherto a Conservative stronghold. It seems clear that the Labor party led by Sir Keir Starmer will be in power by July 5, just before the second round of France's poll is expected to take place on July 7. In the UK, the only question is how large a majority the government will have in Parliament. Interestingly, a bigger majority is likely to make governing more difficult as restless new Members of Parliament press for moves away from the center that both Starmer and his likely future Treasury Minister, Rachel Reeves, have said they will adhere to.

FED-SPEAK

Last week's Federal Reserve policy meeting gave little help to investors who are wondering what the Fed is likely to do in the second half of this year. Yes, there was an updated "dot plot" that showed central bankers had revised down from three to one their expectations of the number of interest rate cuts between now and December. But markets had already internalized a slower pace of easing than expected in March. And it seems that the better inflation data for May, released just before the end of the Fed meeting, was not incorporated into all the dot-plot projections. Some on the Fed committee – probably including Chair Jerome Powell – still expect two cuts of 25 basis points before the year is out.

The uncertainty about rates reflects the muddy picture of what is happening in the economy – together with the Fed's determination to make its decisions "data dependent". Some recent data releases, notably for retail sales and consumer confidence, support the story of a slowing economy. But job growth remains strong. And while the May consumer inflation report looked good – with no overall increase in prices during the month – that was partly due to actual declines in some volatile prices. Underlying inflation is still above the Fed's 2% goal, perhaps by a full percentage point. Doubts also continue about whether today's rates are truly restrictive or whether the economy is better able to withstand high interest rates now than in the aftermath of the global financial crisis. Rising equity prices suggest ample liquidity.

Fed decision makers who need to stay quiet ahead of meetings have been speaking freely this week. Their views vary, although the overall thrust of the comments was similar: the next move in rates will be downwards, but it won't happen just yet. New President of the St Louis Fed, Alberto Musalem, was perhaps the most hawkish as he warned that it may take "quarters" and not just months to be sure that inflation is sustainably on a path to 2% and noted that if inflation sticks above target, the Fed will need to discuss rate hikes. That is not his baseline forecast however.

For the Fed overall, inflation remains the top focus as long as labor market indicators stay robust. And on inflation, more data is needed to confirm May's better picture. A similar message is likely from Chair Powell when he testifies before Congress in mid-July. By the time of the next policy meeting, two weeks later, the central bank will have June inflation and unemployment data. But that will not be enough to trigger a rate cut. Market hopes for a cut are centered on mid-September, when the Fed will release an updated forecast and dot plot. By then, there could be enough evidence to reassure all the committee that the time for a cut is ripe.

EQUITIES

Despite softening into the weekend, US equity markets continue to power higher, but that market is increasingly dominated by Nvidia. Just this week, the Bay Area-based chip firm briefly became the most valuable company in the world, thanks to its dominance in the growing AI computing market. It underperformed the broader market following the midweek Holiday, but the company is still responsible for about a third of the S&P 500's near 4% rise month-to-date. The magnificent seven together account for more than 70% of the index's return this month; removing their performance leaves the index up about 1%. The S&P 500 equal weight index is down in June. After a brief wobble earlier in the month, various AI-related thematic baskets have rebounded strongly. In the past two weeks, Goldman Sachs TMT AI, AI Datacenter, and Power Up America baskets are up 5%, 3%, and 1%, respectively. Taking a step back, it is worth noting the disparity in returns between mega-cap and non-profitable tech. So far in 2024 a basket long the former and short the latter has returned 75%! Internationally, developed market equity performance has been soft, underperforming the US by a wide margin. But, that underperformance is reduced significantly when one adjusts for the mega-cap contribution. The MSCI World ex-US, for example, is -1% MTD. European markets are the worst performing developed cohort, lagging the Japanese Nikkei and the UK equity market. French equities, unsurprisingly, are leading losses related to the election jitters discussed above. The MSCI France is -6% vs. -3% for MSCI's broader gauge of European equities. Japanese equities are ahead of the developed world ex-US but still down slightly amid the slump in broader equity markets and some mild headwinds as the BOJ looks to normalize monetary policy. Nevertheless, fundamentals remain strong with 12-month forward earnings estimates continuing to march higher and roughly half of Japanese household savings sitting in cash.

In emerging markets, performance is more mixed, but broadly ahead of the developed market indices. Most interestingly, AI beneficiaries leading the charge there as well. MSCI Taiwan is one of the best performing markets in the past few weeks, this month, and YTD – it rose 9%, 14%, and 32% respectively – driven by its semiconductor fabrication darling. Taiwan Semiconductor (TSMC) is up nearly 12% in the past two weeks, bringing the MTD return to +20% and YTD to +60% (this is for the local shares; the ADR has done even better). Goldman Sachs, Morgan Stanley, and JP Morgan have all raised their price targets for the stock multiple times this year, with a total average increase of approximately 60%. Recent upgrades to the company's outlook are linked to increased demand not only from Nvidia, but from Apple as well. The weakest performing EM in recent weeks has been Colombia, which is currently plagued by a ballooning fiscal deficit that has sent the MSCI country index 5% lower and weakened the currency by a further 5%. The two biggest markets in EM, China and India, have resumed their relative performance of prior years with MSCI India rising 5% in June, handily outpacing China's 1% rise. As has happened multiple times in recent memory, the strong rally in Chinese equities has been unable to sustain its momentum as optimism around potential improvements in the economy give way to the reality of significant structural challenges and ongoing hostility from the west, including growing trade tensions with Europe.

RATES

The action in government bond markets was dominated by Europe this week. As mentioned above, French spreads to German Bunds are the widest they have been in nearly a decade, but that is perhaps not the most interesting perspective of how much France's potential fiscal picture has deteriorated. French government yields are now trading very close to, and in some instances higher than, those of the countries formerly (unceremoniously) dubbed the PIIGS: Portugal, Ireland, Italy, Spain, and Greece. In fact, Portuguese spread over French bonds is now negative. The same is true of Irish bonds, while Spanish, Italian, and Greek yields are within 75bps of their French counterparts.

Another idiosyncrasy to note is that the nearly 30bps of widening in spreads came from a combination of a small back-up in French yields and a bigger rally in German yields. This is meaningful because the rally in German bunds mirrors those moves of US and UK 10yr bonds as well. The rally in government bonds helped send the overall bond market higher in the past few weeks. In the US, higher quality sectors have outperformed with Treasuries and MBS leading the way, followed by investment grade corporate credit. High yield also gained but to a lesser degree. Moving out the risk spectrum, dollar denominated EM bonds were positive as well but local currency EM debt was down.

This rally in fixed income comes in the wake of a renewed hawkishness from various Fed members. Not to be outdone by its latest governor, Neel Kashkari said on June 20 that it may take years, not months, to reach 2% inflation again. Amidst all this rhetoric, not even front-end short-term interest rates have moved meaningfully. In fact the small, seven basis point move from prior to the Fed meeting until now is in the opposite direction and fractionally moving toward more cuts than less.