SWITCHBACK BONDS

Major central banks have pivoted. The easing cycle is underway. But US bond markets cannot decide how to react. As equities continue to rise on the back of the AI boom and the intrepid US consumer, bond markets have switched this month from pricing in three rate cuts, assuming one more "double" cut of 50 basis points before the end of the year, to pricing in just two cuts with a non-zero probability of only one in either November or December. The ten-year yield dropped by five basis points in the immediate aftermath of the Federal Reserve's jumbo rate cut in September before selling off in subsequent weeks. This week it rose back above 4.20%.

Bond market investors are not the only ones grappling with uncertainty. The US election is now just days away. There are important differences between the two presidential candidates – on economic and regulatory policy as well as much else. Differences on tariffs and tax cuts will affect inflation and interest rates. Differing attitudes to climate change and technology, as well as on competition policy more generally, will have sectoral implications for earnings and equities. But with just days left until November 5, there is still no front-runner. It is rare for a Presidential race to be so close, so near to Election Day.

To add to uncertainty, House and Senate races that will determine the President's freedom of maneuver are also too close to call. The most likely outcome is a divided Congress, with either the House or the Senate controlled by a different party from that of the winner in the White House. That would force a compromise on some issues, notably on tax changes and spending decisions. But it is also possible that one party wins both chambers in Congress and is then in lock-step on legislation, either in support of or in opposition to the President. At the moment, Republicans have the upper hand in Senate races, with fewer to defend than Democrats.

WHAT SHOULD INVESTORS MAKE OF ALL THIS?

Whatever the outcome of the election, the US economy is likely to continue to outperform its peers. Forecasts from the International Monetary Fund (IMF) released this week showed the global economy growing as expected, at 3.2% this year and next. But the IMF nudged up its projections for the US while seeing somewhat slower growth elsewhere. That included China, now expected to grow at 4.8% in 2024, just missing the government's 5% target. The IMF's chief economist, Pierre Olivier Gourinchas, declared that the US soft landing is here. New gdp data for Q3, due out next week, is expected to show the economy continuing to expand above potential, at around the 3 % rate seen in the first half of this year. That pace is likely to slow in coming months with the lingering effect of tight money and a weakening labor market. But Gourinchas noted that growth would be supported by the easing of monetary policy now underway as well as by continued strength of consumption as wages – particularly among low income workers – have now started to grow by more than prices. The IMF projects gdp growth of more than 2% next year.

Contrast that with the IMF projection of essentially zero growth in Germany in 2024 and less than 1%

next year and an average growth rate of less than 2% for all developed markets. Japan's fortunes continue to be affected by political turmoil. Snap elections this weekend could undermine Prime Minister Ishiba, who has only been in office for a few weeks, rather than bolster his majority as he hoped when he dissolved parliament earlier this month. The Bank of Japan is unlikely to make another rates move until the political situation settles. As a result, the yen has slid back to 152 versus the dollar, levels last seen in the day's leading up to the BOJ's surprise rate hike in late July. Domestic equities – one of the world's strongest performers over the last 18 months – have been more muted, with the primary driver being whether to manage a hedged or unhedged position given the depreciation of the Yen.

TARIFFS, REGULATIONS AND TAX CUTS ADD UP TO…?

Most economists and business experts agree that sharp increases in tariffs, as former President Trump has called for, will damage the US economy over time. This is partly because of expected retaliation from other countries which would hit US exporters. Tariffs also raise prices and, over time, will lead to inefficiencies in investment and production that will curb growth.

They remain politically popular however. They hold the promise, together with other subsidies of domestic industry, of bringing back steady and well-paid manufacturing jobs, the loss of which has hurt many communities across America. Chasing these jobs will not succeed, and will be costly, according to most analysis. As American Enterprise Institute economist Michael Strain wrote this week "US tariffs will not bring back jobs from China." It is unclear whether President Harris would maintain the broad tariffs on Chinese goods that former President Trump introduced and President Biden continued. But the expectation of higher tariffs –and possibly large tax cuts– in the event of a Trump victory is likely what is causing markets to price in higher inflation and interest rates as predictions of a Trump win have climbed, and vice versa.

While tariff increases are unpopular with business leaders and Wall Street, the possibility of a shift to less regulation under a Trump White House is attractive to many. The more aggressive approach to competition under current FTC chair Lina Khan is thought to be a dampener on M&A activity. The fossil fuel industry would expect to gain if former President Trump wins the presidency, although coal stocks have actually gained under the Biden-Harris Administration.

THE "RULES-BASED" ORDER PROMOTES GLOBAL COOPERATION AND GROWTH: BUT WHOSE RULES?

This week in Washington saw world financial leaders gather for the Annual Meetings of the World Bank and IMF. Finance ministers, central bankers and hundreds of others marked the 80th anniversary of the creation of the institutions at Bretton Woods, New Hampshire.

Calls for reform have been loud almost throughout the 80 years. The Bank and Fund have been blamed for enforcing tough conditionality on countries borrowing from them, for disproportionately favoring the views of richer countries, which hold the biggest shares on their boards, and – by the US – for being costly and inefficient.

Nevertheless, the promotion of international cooperation on economics and finance, including at moments of global financial crisis, has been broadly welcomed over the decades. A "rules-based" order which constrains all countries – including the US to at least some extent – has helped the global economy to flourish. Until recently, countries as varied as China and Canada, or Brazil and Britain, bought into that view.

As geopolitical tension and US-China rivalry have grown, the IMF and World Bank – and the G20 grouping begun by the US in the wake of financial

crisis – now face a somewhat different challenge. This week, Russia has hosted leaders of an alternative grouping, under the banner of the BRICS (Brazil, Russia, India, China and South Africa). This group has been expanded to include a number of medium-sized countries who are not part of the G-20. They are represented in the IMF and World Bank, but they wish to demonstrate independence from the US, Europe and other major Western countries. The gathering was a diplomatic coup for Russian President Putin, who met face-to-face with Chinese President Xi for the first time since Russia invaded Ukraine. China and India mended fences on a border dispute just ahead of the summit.

EQUITIES

A strong start to this latest corporate earnings cycle has helped US equities extend their impressive run and maintain their leadership position over other global markets. The setup was quite favorable coming into October with the US economy remaining on solid footing and pessimism on the Street establishing a low bar for earnings to hurdle. Analysts had downgraded their Q3 earnings growth forecasts versus a year earlier from around 7% in mid-July to less than 4% in October. However, the tone from corporate management teams has been comparatively optimistic overall.

The strong profits we saw from the major Wall Street banks were the first sign that analysts were too bearish. The average upside surprise of the banks was more than 6%, and perhaps most importantly their comments underscored a healthy economy and resilient consumer. Spending and payment rates have continued to normalize from post-pandemic highs but underlying credit performance has been in line with expectations and retail spending does not appear to be weakening. Business loan demand remains depressed despite the Fed's initial 50 bps interest rate cut, but that appears to be more a reflection of cost consciousness and prudence on the part of borrowers.

Looking beyond financials, several companies across a variety of sectors garnered attention early with solid earnings beats. TSMC's 54% quarterly profit jump and bright revenue forecast spurred confidence in the outlook for strong AI demand, pushing technology shares higher. Netflix reported strong subscriber growth and made gains in other emerging revenue streams like video gaming, advertisements, and live sporting events. Robust air travel demand and low fuel prices helped boost United Airlines earnings and positive volume trends reported by trucking company J.B. Hunt indicated potential green shoots for the freight environment.

Market reaction to earnings has been heartening for proponents of active management. According to Bloomberg Intelligence, companies in the S&P 500 that have beaten consensus earnings have outperformed the index by a median of 1.7% on the day of the announcement. That measures at a historically high level. At the same time, companies with earnings that that were below consensus have trailed the S&P 500 less severely, by a median of 1.5%. It remains early and the biggest contributions were expected from technology, communication services, and financials while the biggest drags on earnings this quarter were likely to come from energy and industrials companies, many of which have yet to report.

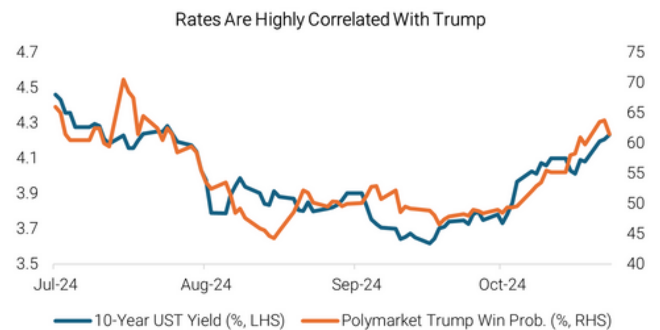
Earnings in Europe thus far have been mixed and less well-received. SAP has been the headliner with its shares hitting a record after the company raises its revenue guidance. It was accompanied by strong results from Roche and Heineken, among others. However, they were somewhat overshadowed by Deutsche Bank's warning of substantial loan losses this year and L'Oreal's report of weak demand in China. Those warnings, and others, have investors worried about Europe's growth outlook, reflected in strong foreign capital flows going to the US. The resulting conundrum is that US stocks are vulnerable to a pullback given stretched valuations (the S&P 500 is trading at nearly 22x forward earnings), and yet they appear poised to continue moving higher given the US's growth prospects vis-a-vis other economies.

Market observers' attention has naturally been drawn to the US with the election less than two weeks away, but Japan remains interesting as well. Japanese voters go to the polls this Sunday to elect members of its House of Representatives, which will impact the direction of its government. The ruling LDP expects to come away with fewer seats but hopes to still secure at least enough to form a majority coalition with its junior partner Komeito and enable Prime Minister Ishiba to govern effectively.

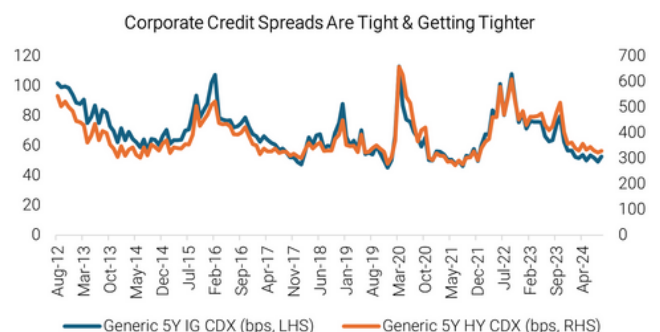
While many Japan investors are being cautious heading into the general election, the debut of Tokyo Metro on the Prime section of the Tokyo Stock Exchange managed to lift animal spirits and attract new investors into the market. Tokyo Metro's IPO helped spotlight the government's expansion of its tax-free NISA savings program, which sought to induce more retail participation in the equity market, and indeed Japanese brokerages reported a strong boost in account openings in the months leading up to the IPO. Tokyo Metro was Japan's largest IPO in six years and fifth largest in the last decade, was reportedly 35 times subscribed, raised $2.3bn, and proceeded to rise 45% on its first day of trading.

FIXED INCOME

Following the Federal Reserve's 50-basis point cut in September, domestic interest rates have largely trended in one direction: higher. Since the FOMC meeting, US 10-year Treasury yields are up roughly 50 basis points to over 4.2% with 2-year yields not far behind, resulting in a slightly steeper yield curve but much higher rates across the board. One possible explanation for this dramatic rise is the market's focus shifting from the Fed to the upcoming US presidential election. National polls and betting markets are suggesting the outcome to be extremely close, with Trump edging Harris overall. As a result, the behavior in interest rate markets – especially at the long-end – may be attributed to this increased probability, given Trump's proposed tariffs, tax cuts and spending plans may place greater burden on the Treasury Department, and therefore elevated borrowing costs and bond yields.



With it looking increasingly likely that the US has successfully achieved a soft landing, corporate credit has responded favorably. Investment grade bonds are trading at spread only a handful of basis points from their record lows, with few downgrades and little systematic weakness in corporate earnings. Furthermore, supply has slowed considerably as companies are hesitant to refinance at higher rates, creating a structural bid for existing seasoned bonds. Down the quality spectrum, high yield spreads have tightened to post-GFC lows, bolstered again by strong earnings and retail inflows as investors reach for yield.



On Wednesday, the Bank of Canada cut its policy rate by 50 basis points – in-line with the Fed's move last month – to 3.75%, hailing a return to a low inflation environment. Headline CPI fell to 1.6% year-on-year, largely driven by a sharp decline in gasoline prices, although some components of the core reading remain elevated, namely shelter. Following three prior cuts totalling 75 basis points, muted demand for good and services along with

weak consumer sentiment weighs on the Canadian economy, potentially leaving room for further 50 basis point cuts in an attempt to spur growth.

CURRENCIES

As Treasury yields have risen over the last several weeks, the dollar has seen a resurgence against most developed market currencies. With the base case having shifted to expecting only two more rate cuts from the Fed between now and year-end, front-end rate differentials have created an immediate yield pick-up opportunity owning dollars compared to other currencies, such as the cyclical-heavy euro, Canadian and Australian dollars, and British pound. Higher Treasury yields has also spurred dollar buying from foreign investors looking to lock in greater returns and hedging out any FX risk, especially from countries with vast FX reserves such as China and Japan, resulting in additional dollar strength against both the yen and the renminbi.

Evaluating potential FX moves given various election outcomes results in a wide range of possible moves. In the event of a Trump win – let alone a Republican sweep – the dollar could see some appreciation given the potential for additional tariff impositions against countries like Mexico, China and the broad Euro area, which may result in EUR, MXN and CNH weakness, while safe haven currencies like the Swiss franc could appreciate. On the other hand, a blue sweep or a Harris win could spur broad dollar weakness and a bounce in commodity currencies, high-beta names and cyclical currencies in Asia. Perhaps ironically, USD appreciation in the event of a Trump victory runs counter to his stated objective of targeting a weaker dollar in order to bolster the competitiveness of domestic exports.

COMMODITIES

Precious metals have continued to perform well in recent weeks. Gold has continued to rise, owing partially to ongoing buying from Chinese investors looking to hedge against a weaker RMB. Additionally, silver – commonly held by retail investors – has finally started to catch-up versus its sister metals like gold.

On the other hand, industrial metals like copper and iron ore have encountered some headwinds, with a lack of substantive action from the Chinese following their late-September stimulus announcements resulting in softer demand, driving prices lower. Crude oil has also retraced somewhat from its early October highs, owing again to weaker demand from China and easing concerns around Middle East oil production amidst the ongoing conflict in Lebanon and Gaza. Furthermore, data has shown Russian exports of crude oil via sea-based tankers continues to rise, particularly to Asian countries like India and China comfortable with skirting around sanctions imposed by Western nations on Russia.