MUFG Asset Management

# Global Fixed Income Monthly

GARY HUTCHINGS
HEAD OF INVESTMENT

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**Mitsubishi UFJ Asset Management (UK) Ltd.**
A member of MUFG, a global financial group

## 1. Monthly Macro View

- In keeping with the theme of our previous comments on inflation, it remains in a zone where it remains high rather than outrageously high. Whether it falls happily to target and stays there or lingers over time above is a question that will be determined by how resilient economies are to interest rate levels.

- On the whole weakness had been evident in economies outside the US, with the US itself showing evidence of calming down to a sustainable pace of growth as interest rate levels gently inhibit the economy. However, the very fall in inflation has also meant that contrary to 2023, real incomes will be growing again. There are signs of some economic revival. It remains to be seen whether this is sufficient to cause interest rates to stay 'higher for longer' or whether the likely improvement in growth remains insufficient to prevent a rise in the output gap.

- In our view whilst it is difficult to see a recession due to a lack of economic distortions, so it is also difficult to see the conditions for a boom. We therefore think interest rate settings are sufficient to gradually bear down on inflation, but that rate cuts are likely to be later than expected. The US is the most robust economy although with high levels of immigration forecasts of trend growth are shifting up (was at 1.8% but some now suggesting 2.1%) which somewhat changes the view on inflation pressure.

- We think a refined judgement about the precise timing of rate cuts is too precise in what remain choppy and uncertain data conditions. Our judgment currently is therefore more based on longer-term value considerations. In current bond markets there are two ways of thinking about things. The first is that real rates are now at levels consistent with the lower end of previous history ex post 2008. That appears a little odd given that only recently much lower interest rates seemed unable to lift growth and not much in terms of underlying economic structures appear to have changed. The other way is that interest rates have risen, economies have proven resilient and therefore rates are reasonable at this sort of level going forward.

- The argument for higher rates is based on the fact that economies have proven resilient at higher rates, high government debt levels should push the longer term risk premium up and the probability of greater productivity growth from AI is solidifying. The surprising resilience of equities given large increases in real rates is only really explainable if growth expectations have risen.

- Putting all of this together, we have to register that we can see quite a range of plausible outcomes. Central bank officials are also, it seems, struggling to understand where rates are likely to settle. Nonetheless we think the distribution of rate likelihood is tilted to the downside, with a central forecast around 3% to 3.5% for the US. The five year forward is currently just above four per cent so we think the market over the long run is more likely to see yields decline than not.

- We think spread product remains decent if not outstanding value. We don't think a significant recession likely and don't see slow growth combined with high persistent inflation as plausible. Over time, therefore spreads offer positive returns albeit we don't see spreads marching strongly in given they are already below the median. Financials are good value versus Industrials given the currently unusual spread differential between them.

- Currencies: like fixed income, currencies will be very sensitive to any signs of continued economic strength or any sign monetary policy is turning things around. Given the resilience of the US economy it would appear the USD will retain its strength, the UK has high interest rates and a likely fiscal boost so will likely be firm for some time although in the long run it is vulnerable due to a fundamentally weak economic background, the EUR has lower rates and although somewhat firmer economic conditions may sustain it the interest rate differential should favour returns from higher



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yielding currencies. JPY will likely strengthen as the end of the zero rate policy approaches, but the essential weakness of the economy means that there will subsequently be disappointment at the limited and slow rise in rates.

## 2. Portfolio Positioning

- Duration: We are slightly long duration. We are more positive higher yielding currencies, meaning we are relatively negative on the EU and Japan. The positioning is based on long term value, not short term economic dynamics. Most work seems to imply the dynamics causing secular stagnation have not shifted much so real rates are likely to settle at a low level. Nonetheless the possibility of AI shifting productivity is gaining ground, the turnaround in geopolitics is notable and the high level of government debt is also an issue.

  Although we think rates will settle higher than pre-Covid levels we think that they will not remain as high as current levels. In the short run, inflation has shifted from external to core internal led as employment levels have remained very high with some possibility that falling inflation will bolster personal consumption going forward. If the market sells off on the back of this, we would be inclined to increase duration.

- Our currency positions are based on:

1. Current profitability
2. Future profitability based on each country's macroeconomic disparities and their forecasts
3. Forecasts of changes in money flows based on geopolitics and international politics.

   Regarding currencies, positions are determined based on current profitability, future profitability based on each country's macroeconomic disparities and their predictions, as well as forecasts of changes in money flows based on geopolitics and international politics.

   From that perspective, we build a portfolio by underweighting EUR and CNY, and overweighting USD, NZD, PLN, and MXN, keeping in mind the correlation between currencies in normal times. In currencies, position sizing is crucially important, particularly during risk-off conditions.

- Spread: long and again on value considerations. Not looking for substantial spread compression, but for carry to prove positive. Both consumers and corporates have strong balance sheets so this should limit downside even in an adverse economic situation.

  Equally, we think a boom requiring much firmer monetary action is also a remote likelihood. The latter has been rendered less likely given tamer inflation. Nonetheless, we are underweight cyclicals.

  We are also long Financials versus Industrials given the robust balance sheets of major banks and the current wide spreads between the two sectors.

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