MUFG Asset Management

Global Fixed Income Monthly

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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

- The inflation position remains largely unchanged versus our January 2024 update; inflation data has come down into a zone where it remains high rather than outrageously high. Whether it continues to decline or lingers is a question which 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 inhibited the economy. However, the very fall in inflation has also meant that contrary to 2023 real incomes will be growing again. 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 with growth as yet to fall to long term trend (estimated at 1.8%) let alone fall below.

- 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 question is one of whether the world today is more similar to the post GFC period (real rates very low) or to the pre-GFC period? Quite a bit of the pre-GFC period was one where inflation expectations were not well anchored and central banks were constantly having to establish their credentials, where productivity growth was high, where population growth was quite different to today etc. So the economic landscape (once the inflation shock dissipates) is more similar to the post GFC period than to the previous period. So when considering where rates should be it is a little surprising that we so readily accept that we have re-joined the pre-2008 norm rather than thinking we should be closer to the post 2007 norm. It appears more reasonable to take the calmer periods of the pre-2008 period rather than the heavy high inflation expectations/establishing inflation fighting credibility ones. Doing that and we end up with rates around 1.9% to perhaps 3%.......2.4% in such a context seems at worst fair value and at best rather cheap. Therefore it is worth being a bit long from a longer term perspective.

- Any argument is dependent on the idea central banks will retain their inflation targets. Quite a number of academics have argued, given low productivity and therefore low real interest rates, the inflation target should be higher. Thus far central banks have pushed vigorously against this idea.

- We note it is curious real interest rates in forward markets have risen around two percentage points which should have caused real assets such as housing and equities to have seen severe falls. In real terms housing has been flat and equites have risen substantially. If equities are boosted by expectations of a very strong rise in productivity, presumably due to AI, then this would justify higher real bond yields. Failing that it appears an anomaly, thus favouring the idea bonds are relatively good value. We incline toward the latter and await more evidence for the former.

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- Our view is that whilst we recognise the resilience shown in economies and also think that in the decade following the GFC rates were too low and stayed there due to a series of economic shocks, nonetheless there are and there remain distinct differences between economic conditions now and where they were in previous decades. For example productivity growth is lower, inflation expectations are better anchored, population growth is lower, demographics are in favour of higher savings, inequality remains high, investment has shifted from physical structures to computing. Therefore real rates consistent with previous periods are either fair value or cheap, it seems difficult to argue they are expensive. From a long term perspective we therefore think it makes sense to be somewhat long higher yielding markets to lock in these rates. That means overweighting the longer end.

- 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 it 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 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 as well as the turnaround in geopolitics are issues that are different and need to be considered. However 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. However, if the market sells off we would be inclined to increase duration.

- 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. Control those weights, such as during risk-off.

- 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.

   Accordingly, we remain underweight EUR and CNY, and overweight USD, NZD, PLN, and MXN, while keeping in mind the correlation between currencies in normal conditions 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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