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

- Inflation data has come down into a better zone but where it remains too high. Whether it falls happily to target and stays there or lingers over time above and requires interest rates to be restrictive for longer is a question which will be determined by how resilient economies are.

- On the whole, the picture has been one of seeming economic weakness but with employment remaining resilient. With inflation coming down and real incomes starting to rise the question is open to whether a soft landing can be achieved with current interest rate expectations or whether higher for longer will be necessary. The standout economy has been the US, where interest rate rises of five hundred basis points have only achieved thus far a return to trend growth if not slightly above.

- 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. However, there appears to be a wide range on possible interest rate paths given very low unemployment levels. This means markets are very sensitive to news of relatively strong or relatively weak growth and move more strongly on the back of that news than might usually be the case.

- 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 and are reactive rather than forward looking. 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 above four per cent so we think the market over the long run is more likely to see yields decline than not. Our confidence, however, is weak.

- 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 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

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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. The AI impact, however is likely to be seen further down the road.

  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.

- Currencies:
  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.
     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.
- 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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